A P P E N D I C E S

APPENDIX 1

PREVENTING MANIPULATION IN COMMODITY MARKETS

"The methods and techniques of manipulation are limited only by the ingenuity of man."

-- *Cargill v. Hardin*, 452 F.2d 1154, 1162 (8th Cir. 1971).

"Sophisticated economic justification for the distinctions made in this area of law may at times seem questionable. Sometimes the 'know it when you see it' test may appear most useful."

-- *Frey v. CFTC*, 931 F.2d 1171, 1175 (7th Cir. 1991).

Summary: Manipulation in commodity futures markets is effectively prevented only by a comprehensive oversight program to detect manipulation and an enforcement program to punish manipulation. Because it is so difficult to bring an after-the-fact prosecution for manipulation, it is vitally important to have an effective market oversight program to detect, deter, and prevent manipulations before they occur.

I. OVERVIEW

As Appendix 2 explains, a central purpose of the Commodity Exchange Act (CEA) is to prevent manipulation of the futures markets. To accomplish this objective, the CEA not only contains a provision that makes manipulation a felony, but it also requires approved contract markets to self-regulate to ensure orderly trading and prevent manipulation. It also directs a federal agency – the Commodities Futures Trading Commission (CFTC) – to oversee operation of the approved markets and to itself perform market oversight and take necessary measures to ensure orderly trading and prevent manipulation. Former CFTC Chairman James Stone explained, "The job of preventing price distortion is performed today by regulatory and self-regulatory rules operating before the fact and by threats of private lawsuits and disciplinary proceedings after the fact. Both elements are essential."[1]

[1] *In the Matter of Indiana Farm Bureau Cooperative Ass'n, Inc.*, 1982 CFTC LEXIS 25, 72 (Stone, dissenting), Comm. Fut. L. Rep. (CCH) &21,796 ['82-'84 Transfer Binder] (CFTC Dec. 17, 1982).

Congress, the courts, the CFTC, commodity traders, and legal scholars have struggled with the meaning of the term "manipulation" for as long as the law has prohibited it. Nowhere in the CEA as currently written or any of its predecessors is the term "manipulation" defined. The current body of judicial and administrative case law is confusing and contradictory. Not surprisingly, there is widespread dissatisfaction with the law of manipulation as it currently stands.[2] A common theme of this criticism is that the CFTC and judicial precedents make it too difficult to determine just what activity constitutes a "manipulation" or to prove, after the fact, that a manipulation has occurred.

The difficulties in prosecuting manipulation after-the-fact, outlined in this Appendix, highlight the importance of prospective safeguards in the regulatory system. Former CFTC Chairman James Stone wrote: "The Act envisions a careful balance between preventative regulation and remedial judicial action. To weaken the latter . . . would strengthen the need for the former."[3]

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[2] *See, e.g.*, Jeffrey Williams, *Manipulation on Trial,* at 8 (1995) ("Manipulation is a particularly vague offense."); *In re Soy Bean Futures Litig.*, 892 F. Supp. 1025, 1043 (N.D. Ill. 1995) ("[T]here is a 'dearth of settled caselaw' on price manipulation; as a result the courts and the CFTC are still struggling to define the basic elements of the claim and to differentiate between fair means and foul in futures trading."); Perdue, *Manipulation of Futures Markets: Redefining the Offense*, 56 Fordham L. Rev. 345, 401 (1987) ("Congress, courts, and commentators have condemned manipulation for over 65 years. Despite this long history, manipulation never has been adequately defined."); Friedman, *Stalking the Squeeze: Understanding Commodities Market Manipulation*, 89 Mich. L. Rev. 30, 31 (1990) ("Congress has been intent on preventing manipulation since the beginning of federal commodities regulation in the 1920s, yet courts, administrators, and academic commentators have failed to agree on a sensible approach to the basic question: What is manipulation?"); Markham, *supra* at 283 ("[U]nder present law the crime of manipulation is virtually unprosecutable, and remedies for those injured by price manipulation are difficult to obtain. Moreover, even where a prosecution is successful, the investigation and effort necessary to bring a case will involve years of work, enormous expenditures, as well as an extended trial."); Lower, *Disruptions of the Futures Market: A Comment on Dealing with Market Manipulation*, 8 Yale J. on Reg. 391, 392 (1991) ("The absence of a clear statutory definition, the elusiveness of the economic concepts involved and the ad hoc nature of the enforcement process has produced a regulatory approach which lacks the clarity and predictability which would allow effective monitoring, early detection and successful prosecution."); Fischel and Ross, *Should the Law Prohibit "Manipulation" in Financial Markets?,* 105 Harv. L. Rev. 503, 606 (1991) ("Notwithstanding the recent focus on manipulation, however, no satisfactory definition of the term exists. . . . As one commentator has noted, 'the law governing manipulations has become an embarassment confusing, contradictory, complex, and unsophisticated.'"), *quoting* McDermott, *Defining Manipulation in Commodity Futures Trading: The Futures "Squeeze,"* 74 NW. U. L. Rev. 202, 205 (1979); Pirrong, *Commodity Market Manipulation Law: A (Very) Critical Analysis and a Proposed Alternative*, 51 Wash & Lee L. Rev 945 (1994) ("Evidence abounds that commodity market manipulation law in the United States is extraordinarily confused."); Kozinn, *Note: The Great Copper Caper: Is Market Manipulation Really a Problem in the Wake of the Sumitomo Debacle*, 69 Fordham L.Rev. 243, 248 (2000) ("[A]ny student of commodity manipulation law will discover a body of law that is a murky miasma of questionable analysis and unclear effect.'"), *citing* Timothy J. Snider, 2 *Regulation of the Commodities Futures and Options Markets*, 12.01, at 12-5 (2d ed. 1995).

[3] *In the Matter of Indiana Farm Bureau Cooperative Ass'n, Inc.*, *supra* at 74-5 (Stone, dissenting).

II. THE LAW OF MANIPULATION

A. Anti-Manipulation Prohibition in Commodity Exchange Act

Section 9 of the CEA states that it is a felony punishable by a fine of up to $1 million or imprisonment for up to 5 years for "Any person to manipulate or attempt to manipulate the price of any commodity in interstate commerce, or for future delivery on or subject to the rules of any registered entity, or to corner or attempt to corner any such commodity."[4]

Although this is one of the core provisions of the Act, nowhere in the statute or the CFTC's regulations is the term "manipulation" defined. Moreover, the CFTC, its predecessor agencies, and the courts have not been able to arrive at a satisfactory or stable definition of the term. Current case law provides contradictory guidance on the types of market behavior that are considered manipulation.

Much of the confusion is inherent in the concept of manipulation. It is extraordinarily difficult – some would say impossible – to formulate a test that will easily or consistently distinguish between legitimate self-interested market behavior and illegitimate and unfair tactics motivated by greed. As far back as the 1920s, during the consideration of the Future Trading Act, which eventually became the Grain Futures Act and later the CEA, Congress recognized the difficulty in drawing the line between legitimate and illegitimate trading. Senator Norris, Chairman of the Senate Committee on Agriculture and Forestry, stated: "[T]hese things are various and perhaps impossible of direct definition. I do not know how we would draw a definition to bring it home to the individual."[5] Shortly after the Grain Futures Act was passed, the Grain Futures Administration reported to Congress that "it is practically impossible, merely because a man sells, to prove that he is doing it in order to manipulate the market."[6] Tommy "the Cork" Corcoran, President Franklin Roosevelt's legendary lobbyist, once stated with respect to securities manipulation, "you cannot tell at exactly what stage a kitten becomes a cat in determining whether a man bought or sold on the market for the purpose of raising or depressing the price."[7] Another practical reason for failing to specify the elements of the offense of manipulation "arose from [Congress's] concern that clever manipulators would be able to evade any legislated list of proscribed actions or elements of such a claim."[8] To date, no-one has been able to establish a "'smoking-gun,' conduct-based test" for manipulation.[9]

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[4] 7 U.S.C.A. '13(a)(2) (West Supp. 2002).

[5] *Future Trading in Grain: Hearings on H.R. 5676,* Before the Senate Committee on Agriculture and Forestry, 67th Cong., 1st Sess. 335 (1921); *cited in* Perdue, *Manipulation of Futures Markets: Redefining the Offense*, 56 Fordham L. Rev. 345, 353, n. 64.

[6] *Commodity Short Selling: Hearings Before the House Committee on Agriculture*, 72nd Cong., 1st Sess. 181 (1932); *cited in* Markham, *supra* at 312.

[7] *Stock Exchange Practices*, Hearings Before the Senate Committee on Banking and Currency on S.Res. 84, 56, and 97, pt. 15, 73rd Cong., 1st Sess. 6509 (1934); *cited in* Markham, *supra* at 366, n. 548.

[8] *In re Soy Bean Futures Litig.*, *supra* at 1044.

[9] Pirrong, *supra* at 992.

Because of the sparse legislative history of the term "manipulation," the CFTC and the courts have often relied upon Arthur Marsh's testimony in 1928 before the Senate Agriculture Committee in interpreting what Congress meant by the term.[10] Marsh, a former President of the New York Cotton Exchange, had accused another witness, William Clayton, of manipulating the cotton market in New York, and in so doing provided the following definition of manipulation:

> Manipulation, Mr. Chairman, is any and every operation or transaction or practice, the purpose of which is not primarily to facilitate the movement of the commodity at prices freely responsive to the forces of supply and demand; but, on the contrary, is calculated to produce a price distortion of any kind in any market either in itself or in its relation to other markets. If a firm is engaged in manipulation it will be found using devices by which the prices of contracts for some one month in some one market may be higher than they would be if only the forces of supply and demand were operative; or using devices by means of which the price or prices of some month or months in a given market may be made lower than they would be if they were freely responsive to the forces of supply and demand. Any and every operation, transaction, device, employed to produce those abnormalities of price relationship in the futures markets, is manipulation.[11]

Clayton denied all accusations of manipulation, and complained about the vagueness of the charge. In response to a Senator's question, Clayton remarked, "The word 'manipulation' . . . in its use is so broad as to include any operation of the cotton market that does not suit the gentleman who is speaking at the moment."[12]

Several of the elements of manipulation identified by Marsh have become part of the basic test used by federal courts and the CFTC in determining whether manipulation has occurred. They include: (1) whether the market prices reflect actual conditions of supply and demand or whether the prevailing prices were artificially created by the suspected manipulator; (2) whether the suspected manipulator caused the artificial price; and (3) whether the suspected manipulator intended to cause the artificial price.

In *Cargill v. Hardin*, the U.S. Court of Appeals for the Eighth Circuit provided the most recent federal appellate exposition on the meaning of "manipulation."[13] Cargill had been charged with manipulating the wheat futures market by controlling nearly two-thirds of the long futures contracts just prior to the close of trading, as well as most of the physical deliverable supply of wheat. The court distinguished between what are perhaps the two most common types of manipulation, a "corner" and a "squeeze." With respect to a corner, the court stated:

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[10] See, e.g., *Volkart Brothers, Inc. v. Freeman*, 311 F.2d 52, 58 (5th Cir. 1962).

[11] *Cotton Prices*: Hearings Before a Subcommittee of the Senate Committee on Agriculture and Forestry, Pursuant to S.Res. 142, 70th Cong., 1st Sess. 201-202; *cited in* Perdue, supra at 362.

[12] *Id.* at 154; *cited in* Perdue at 355, n. 67.

[13] *Cargill v. Hardin*, 452 F.2d 1154 (8th Cir. 1971).

> In its most extreme form, a corner amounts to nearly a monopoly of a cash commodity, coupled with the ownership of long futures contracts in excess of the amount of that commodity, so that shorts – who because of the monopoly cannot obtain the cash commodity to deliver on their contracts – are forced to offset their contract with the long at a price which he dictates, which of course is as high as he can prudently make it.[14]

The court identified a "squeeze" as "a less extreme situation than a corner," in which:

> There may not be an actual monopoly of the cash commodity itself, but for one reason or another deliverable supplies of the commodity in the delivery month are low, while the open interest on the futures market is considerably in excess of the deliverable supplies. Hence, as a practical matter, most of the shorts cannot satisfy their contracts by delivery of the commodity, and therefore must bid against each other and force the price of the future up in order to offset their contracts.[15]

In *Cargill*, the court adopted the following test:

> We think the test of manipulation must largely be a practical one, if the purpose of the Commodity Exchange Act is to be accomplished. The methods and techniques of manipulation are limited only by the ingenuity of man. The aim must be therefore to discover whether conduct has been intentionally engaged in which has resulted in a price which does not reflect basic forces of supply and demand.[16]

Relying upon the various judicial precedents, the CFTC has established a four-part inquiry to determine whether manipulation has occurred. In a 1989 decision, *In the Matter of Cox and Frey*,[17] the CFTC stated that in order to sustain a charge of manipulation, the CFTC must demonstrate, by a preponderance of the evidence, that:

> (1) the accused had the ability to influence market prices;
> (2) the accused specifically intended to do so;
> (3) artificial prices existed; and

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[14] *Id.* at 1162.

[15] *Id.* The *Cargill* court noted that not all squeezes are caused by intentional manipulations, but may also result from "natural market forces," such as natural disasters that destroy the supplies of the commodity. The court cautioned that a person who finds himself with supplies in such circumstances does not have a license to extract as high a price as possible:

> [G]iven a shortage of deliverable supplies for whatever reason, the futures prices can be manipulated by an intentional squeeze where a long acquires contracts substantially in excess of the deliverable supply and so dominates the futures market – i.e., has substantial control of the major portion of the contract – that he can force the shorts to pay his dictated and artificially high prices in order to settle their contracts.

[16] *Cargill v. Hardin*, 452 F.2d at 1163.

[17] 1987 Westlaw 106879 (C.F.T.C.)

(4) the accused caused the artificial prices.[18]

A review of the judicial and CFTC caselaw indicates that establishing each of these elements is an extraordinarily difficult task.

1. Market Power

The first factor, the ability to influence market prices, requires a determination of whether the person accused of manipulation of the price of a commodity had sufficient market power to affect the market price of the commodity, and whether alternative supplies of the commodity were reasonably available to market participants. The two parts of this factor are inter-related and often dissolve into disputes over the appropriate scope of the market to be analyzed.

Federal courts have disagreed over which facts are sufficient to establish market power, the scope of available substitute commodities, and the obligation of commodity traders to purchase such substitutes. In *Great Western Food Distributors v. Brannan*,[19] for example, Great Western Foods was accused of manipulating the price of refrigerated eggs by obtaining possession and control of the supply of deliverable, refrigerated eggs in the Chicago area as well as ownership of between 60 and 75 percent of the open long futures contracts in the week before the futures contract expired. Under these circumstances, the open short contracts were required to bid up the price of the scarce remaining supplies of eggs in the Chicago area in order to avoid default on their contracts for delivery. In addition to finding that Great Western dominated the physical supply of refrigerated eggs in the Chicago area, the court found that fresh eggs "customarily range higher in price than refrigerators," and therefore "were generally not contemplated as part of the supply for these futures transactions."[20] The court found that "out of town prices plus freight and differential charges render out of town eggs more costly for delivery on Chicago contracts than local eggs," and therefore there was ample justification for the conclusion that Great Western "held a controlling position in the available cash supply of eggs deliverable on December futures contracts."[21]

In another case involving the availability of substitutable supplies, *Volkart Brothers v. Freeman,*[22] the Fifth Circuit Court of Appeals reached a contradictory result. Under the futures contract at issue in this case, only certificated cotton could satisfy the contract delivery requirement. Nevertheless, the court held that the supply of cotton that had not yet been certificated prior to the last day of trading must be considered as part of the available supply of certificated cotton where a party stands accused of squeezing the contract for certificated cotton on the last day of trading. The court wrote, "Unless the shorts are to be excused from the performance of their contracts and from the exercise in due diligence to that end, the ample

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[18] *Id.*

[19] *Great Western Food Distributors, Inc. v. Brannan*, 201 F.2d 476 (7th Cir. 1953).

[20] *Id.* at 480.

[21] *Id.* at 481.

[22] *Volkart Brothers v. Freeman*, 311 F.2d 52 (5th Cir 1962).

supply of uncertificated cotton must be considered as available to them."[23] In light of the availability of uncertificated cotton, the court overturned the agency's finding of manipulation of the price of certificated cotton.

In *Cargill v. Hardin*, [24] the Eighth Circuit rejected the Fifth Circuit's reasoning in *Volkart* that the shorts had an obligation to secure supplies of uncertificated cotton to reduce congestion in the delivery of certificated cotton. Cargill was charged with manipulating the futures market for soft red winter wheat after accumulating 62 percent of the open long interest in soft red winter wheat futures – nearly 2 million bushels – just prior to the close of trading on the contract, as well as holding most of the cash market supply of soft red winter wheat in Chicago warehouses. In determining that Cargill had sufficient market power to find manipulation, the court of appeals found that due to differences in use, price, and quality, the supplies of hard wheat in the Chicago area were not "reasonably interchangeable" with the deliverable supplies of soft wheat. The court concluded, "Since there was no soft red winter wheat available in significant quantities from sources other than Cargill, the conclusion is inescapable that the shorts could not fulfill their contracts, at least to the extent of 2,000,000 bushels, without coming to Cargill."[25]

With respect to *Volkart*, the Eighth Circuit stated:

> If in a squeeze situation, the shorts must be forced either to pay manipulated prices to offset their contracts or in the alternative to bring in higher priced outside supplies which are neither wanted nor needed in the local market, then both the cash and the futures market will be dislocated. . . . [W]e have been shown no good reason why the futures price should reflect the cost of bringing in a higher price and grade of wheat for which there is no demand in the local area. . . .[26]

Despite the more recent ruling in *Cargill*, the CFTC has followed the *Volkart* reasoning on several occasions. In *In re Indiana Farm Bureau*, for example, the CFTC majority found that it was "irresponsible market behavior for shorts to enter the delivery month, especially where low cash supplies are evident, without making adequate delivery preparations."[27] The CFTC seemingly sanctioned squeezes that were not "intentionally created," when it stated "[w]here a long has not intentionally created or exploited a congested situation, the long has a contractual right to stand for delivery or exact whatever price for its long position which a short is willing to pay in order to avoid having to make delivery."[28]

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[23] *Id.* at 60.

[24] *Cargill v. Hardin, supra.*

[25] *Id.* at 1167.

[26] *Id.* at 1173.

[27] *In re Indiana Farm Bureau* (1982), *supra* at 31.

[28] *Id.*

In *Indiana Farm Bureau*, CFTC Chairman Johnson concurred with the result, but dissented from this reasoning. "I cannot join in the majority's view," the Chairman wrote, "that it is the 'contractual right' of longs to demand as high an offset price as possible from the shorts during periods of natural market congestion."[29] Commissioner Stone also dissented from the majority's holding regarding the ability of the longs to extract as high a price as possible, writing that this approach "runs contrary to many years of marketplace and regulatory tradition. . . . The surveillance budgets of regulators and self-regulators alike are largely devoted to avoiding the extraction of premiums over cash prices in congested markets. It is a dramatic break from the past if the Commission majority now thinks it legal to extract a substantial premium so long as as this was not the original purpose of the dominant player at the time the congestion was initiated."[30]

In 1987, in *In re Cox and Frey*, a majority of the CFTC commissioners again reasoned it was primarily the obligation of the shorts to avoid congestion by securing adequate supplies of a deliverable commodity prior to contract expiry, rather than the obligation of the longs to refrain from exploiting such congestion.[31] In *Cox,* the CFTC stated "[t]he fact that the local supply of a commodity is scarce does not release the shorts from their obligation to honor their contractual commitments to deliver. We do not believe that a valid analysis of deliverable supply can be made in the context of the last trading day." The CFTC rejected the position that "premium grades of a commodity at out-of-town locations must routinely be excluded from deliverable supply calculations."[32]

Commissioner West dissented, stating, "to simply define the market congestion out of existence because the Commission felt the shorts were negligent amounts to establishing a 'contributory negligence' standard which creates an absolute shield for the longs no matter how egregious their aberrant behavior."[33] Commissioner West added, "If a bank leaves its vault open overnight and a burglar takes the money, the burglar cannot escape guilt based on the bank's negligence. . . . Two wrongs do not make a right."[34]

Commissioner West agreed with the CFTC staff's argument that under the *Volkart* standard, "the more successful the upward price manipulation, the larger the deliverable supply will be, since at artificially high prices parties can profit by disrupting the normal flow of the cash commodity and making delivery to the manipulator on the futures market. At some point, the manipulated futures price will be high enough to warrant shipments of wheat into Chicago from around the country, or even around the world."[35]

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[29] *Id.,* at 59.

[30] *Id.,* at 107-9.

[31] *In re Cox and Frey*, CFTC Docket No. 75-16, 1987 WL 106879 (C.F.T.C), July 15, 1987.

[32] *Id.,* at 5.

[33] *Id.,* at 16.

[34] *Id.,* at 20.

[35] *Id.,* at 17.

The conflict over the appropriate scope of the relevant market is a key contributor to the confusion in the law of manipulation. One noted analyst summed up the problem:

> [T]he analysis of deliverable supplies resembles the vacuous debates over market definition that occur in antitrust cases. . . . [A]ccused manipulators attempt to define the market as broadly as possible, and the accusers attempt to define it as narrowly as possible. . . . If manipulation cases turn on definitions of deliverable supplies, they may simply decay into struggles to draw firm boundaries where none naturally exist. Establishing the quantity of a commodity available at the competitive price requires information on the value of alternative uses of the various stocks. . . . [D]eliverable supply estimates provide little information not already contained in prices, and making a manipulation conviction turn on inevitably artificial estimates of supplies invites confusion and contradiction.[36]

2. Specific Intent to Create an Artificial Price

In the recent *Sumitomo* case involving manipulation of the copper markets, the CFTC stated "the intent to create an artificial or distorted price is the sine qua non of manipulation."[37]

Quoting *Volkart*, the CFTC said "'there must be a purpose to create prices not responsive to the forces of supply and demand; the conduct must be calculated to produce a price distortion.'"[38] "At bottom," according to the CFTC and the courts, manipulation is "'the creation of an artificial price by planned action, whether by one man or a group of men.'"[39]

In several recent administrative cases the CFTC has emphasized that the degree of intent required to establish that a manipulation has occurred is not simply a general intent to undertake the conduct in question, but rather it is conduct undertaken with a manipulative intent akin to the *mens rea* requirement in the criminal law. In other words, the accused must actually have intended that an artificial price result from his or her conduct.

Similar to proving intent to fix prices or restrain trade in violation of the antitrust laws, proving specific intent in commodity price manipulation cases necessarily relies on

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[36] Pirrong, *supra* at 974. This article approved of the holdings in *Cargill* and *Great Western*, "which imply that shorts are not obligated to purchase fancy grades, or to go outside the delivery market, in order to acquire deliverable supplies." *Id.* at 975. It was extremely critical of the CFTC's reasoning in *Cox* ("defies logic") and similar arguments in *Indiana Farm Bureau* ("egregious errors"). The author contended that under these two decisions and *Volkart*, "it is nearly impossible to find a long guilty of market power manipulation." *Id.* at 976. *See also* Markham, *supra* at 355 ("Following the decision in *Cox*, the CFTC's Division of Enforcement was left with an almost impossible burden of proof in proving manipulation."); Perdue, *supra* at 377 n.192 ("But few courts agree on how broadly to construe this concept: should it include, for example, only those goods that were in fact deliverable at the expiration of the contract, or should it include goods that could have been made deliverable if the necessary steps had been taken? . . . The courts seem to lack any coherent theory in analyzing these questions, and the approaches vary considerably.").

[37] *In re Sumitomo Corporation*, 1998 CFTC LEXIS 96; Comm. Fut. L. Rep. (CCH) &27,327, at 16.

[38] *Id.*, *quoting Volkart Brothers, Inc. v. Freeman*, 311 F.2d 52, 58 (5th Cir. 1962).

[39] *Id.*, *quoting General Foods Corp. v. Brannan*, 170 F.2d 220, 231 (7th Cir. 1948).

circumstantial evidence. The CFTC has explained, "Since it is impossible to discover an attempted manipulator's state of mind, intent must of necessity be inferred from the objective facts and may, of course, be inferred by a person's actions and the totality of circumstances."[40]

The CFTC has found several fact patterns to be indications of manipulative intent. The purposeful reduction of supplies in a tight market is one such indication. In a case involving an alleged squeeze of the frozen concentrated orange juice market, the CFTC stated that "manipulative intent may be inferred when the holder of a long position increases his position despite knowledge of a congested situation in the underlying contract."[41] Put another way, "a congested market is not an appropriate venue for unrestrained self-interest."[42]

On the other hand, the CFTC will not find manipulation when a trader merely holds out for the best price in a congested market, for example where the futures contract is near expiration and the physical supply of the commodity is insufficient to cover the outstanding future contracts requiring delivery. "Seeking the optimum price from the futures market (risking, of course, the possibility of delivery) is not unlawful. Manipulative intent may be inferred, however, where, once the congested situation becomes known to him, the long exacerbates the situation by, for example, intentionally decreasing the cash supply or increasing his long position in the futures market."[43]

The distinction between taking advantage of a "natural" squeeze or congestion by holding out for a higher price, versus intentionally creating or exacerbating such conditions by purposely reducing or withholding the supply of the deliverable commodity, has led to more controversy and confusion. As one commentator put it:

> The doctrine of a 'natural' squeeze provides a large trader with a manipulation option; if the trader creates a large long position for a legitimate hedging or speculative purpose, the trader can exercise his option to squeeze the market if conditions subsequently change to make manipulation profitable. One can imagine the havoc that would result if judges were to find only those who meticulously planned a murder guilty of the crime and to

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[40] *In re Indiana Farm Bureau Cooperative Ass'n, Inc.*, 1982 CFTC LEXIS 25, Comm. Fut. L. Rep. (CCH) &21,796 ['82-'84 Transfer Binder] (CFTC Dec. 17, 1982). *See also In the Matter of Graystone Nash, Inc., et al*., 1996 SEC LEXIS 3545 (SEC June 27, 1996) (proof of manipulation under the Securities Exchange Act "almost always depends on inferences drawn from a mass of factual data. Findings must be gleaned from patterns of behavior, from apparent irregularities, and from trading data. When all of these are considered together, they can emerge as ingredients in a manipulative scheme designed to tamper with free market forces."); *citing Herman & MacLean v. Huddleston*, 459 U.S. 375, 390-91 n.30 (1983); *Santa Fe Industries v. Green*, 430 U.S. 462, 475 (1977); *Pagel Inc. v. SEC*, 803 F.2d 942, 946 (8th Cir. 1986); *Mawod & Co*., 591 F.2d 588, 596 (10th Cir. 1979).

[41] *In re Louis Abrams and Theodore Butler*, 1993 CFTC LEXIS 136, at *14 (CFTC, May 4, 1993).

[42] *In re Louis Abrams,* 1995 CFTC LEXIS 196, at *10, Comm. Fut. L. Rep. (CCH) &26,479 (CFTC, July 31, 1995).

[43] *In re Indiana Farm Bureau Cooperative Ass'n, Inc.*, 1982 CFTC LEXIS 25, Comm. Fut. L. Rep. (CCH) &21,796 ['82-'84 Transfer Binder] (CFTC Dec. 17, 1982).

> free those who merely killed impulsively when the opportunity presented itself. The precedents in manipulation law create the conditions for such chaos in futures markets.[44]

Another commenter has noted that persons seeking to manipulate the price of a commodity are not likely to be thinking about whether the affected price levels are "artificial" or do not reflect the forces of supply and demand; the traders only intend "to make as much money as possible." "To frame an intent element in terms of something that most manipulators have either never thought of, or if they have thought of it, are totally indifferent to, simply invites unnecessary complication. . . . [C]ourts either must rely on convoluted notions of intent or attribute to people intentions and expectations bearing little relation to what they actually think about or even reasonably can be expected to think about."[45]

The Law of Manipulation Under British Commodity Law

Like U.S. law, U.K. commodities law distinguishes between a legal squeeze, which results from legitimate commercial transactions, and an "abusive" squeeze, which results from trading activity undertaken partially for the purpose of "positioning the price at a distorted level." The U.K. Financial Services Authority (FSA) Handbook, which incorporates the Code of Market Conduct, the law governing the operation of financial and commodity markets in the U.K., explains, "Squeezes occur relatively frequently when the proper interaction of supply and demand leads to market tightness, but this is not of itself abusive."[46]

British law does not prohibit conduct that results in a squeeze if the trading activity is undertaken for a legitimate commercial justification other than to squeeze the market. According to the FSA Handbook, the U.K. Code of Market Conduct "does not restrict market users trading significant volumes where there is a legitimate purpose for the transaction . . . and where the transaction is *executed* in a proper way, that is, a way which takes into account the need for the market as a whole to operate fairly and efficiently."[47]

Under U.K. law, an abusive squeeze of a commodity occurs when a person with (1) "a significant influence over the supply of, or demand for, or delivery mechanisms for a . . . *relevant product*; and (2) a position . . . in an *investment* under which quantities of the . . . *relevant product* in question are deliverable; engages in *behaviour* with the purpose of positioning at a distorted level the price at which others have to deliver, take delivery, or defer delivery to satisfy their obligations."[48] The Code notes that price distortion "need not be the sole purpose of entering into the transaction or transactions, but must be an *actuating purpose*."

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[44] Pirrong, *supra* at 987.

[45] Perdue, *supra* at 375-6.

[46] FSA Handbook, Release 002, at §1.6.15 (December 2001).

[47] *Id.*, §1.6.10.

[48] *Id.*, at §1.6.13E.

3. Artificial Price

One CFTC Commissioner has written that, although "[p]rice artificiality is an essential ingredient of a completed manipulation," establishing artificiality is not sufficient to establish that manipulation has occurred in violation of the Act. "It is like a new cadaver at the morgue, a trigger for further inquiry but not in itself the proof of an offense."[49]

Although the concept of an artificial price appears to be straightforward and intuitive, the means for determining whether the price of a commodity is "artificial" has proved to be remarkably difficult. "Defining manipulation as the creation of an artificial price simply substitutes one unhelpful term for another."[50] Part of the difficulty stems from the fact that the futures market itself is an "artificial" creation and there is no fixed baseline against which to measure the performance of the market. Moreover, to the extent that buyers and sellers seek to bid the price of the commodity up or down in any given transaction, any resulting price from such transactions could be termed "artificial."[51]

In examining an allegation of manipulation of the price of a commodity, both the courts and the CFTC have examined the "web of prices" in the various cash and futures markets for that and related commodities. These inquiries have analyzed the relationship between the price of the affected commodity in the affected market with the contemporaneous spot and futures prices of the commodity in other markets; the price of related commodities; the relationship between the near-term and the long-term price for the commodity on the futures markets, and historical price data.[52] This effort may entail a very complex factual and economic analysis. Indeed, the complexity of the analysis required to thoroughly analyze the requisite amount of market data "may strain the competence of the regulatory agency and the budget of the respondent to the point that it is unlikely to be undertaken in particular cases."[53]

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[49] *Indiana Farm Bureau*, *supra* at 75-6 (Stone, dissenting).

[50] *Id.* at 348. In *Indiana Farm Bureau*, supra at 9, the CFTC stated, "When the aggregate forces of supply and demand bearing on a particular market are all legitimate, it follows that the price will not be artificial. On the other hand, when a price is effected [sic] by a factor which is not legitimate, the resulting price is necessarily artificial. Thus, the focus should not be as much on the ultimate price, as on the nature of the factors causing it."

Commissioner Stone took issue with the majority's statement. "To make the identification of illegitimate market forces a prerequisite for a finding of artificial price is an insufficient improvement. Legitimacy with respect to supply and demand is undefined in law and economics." *Id.* at 80 (Stone, dissenting).

[51] "[T]he determination of the 'true' economic price will turn on an after-the-fact economic analysis of the price a willing buyer and a willing seller would have paid in the absence of the manipulation. But this economic analysis is so complicated and affected by so many factors that it is often impossible to determine what the 'true' price was." Markham, *supra* at 284. *See also* Fischel and Ross, *supra* at 546 ("None of these tests distinguishes artificial prices from non-artificial prices because, whenever unusual conditions of supply and demand occur, such comparisons will demonstrate that prices are 'unusual.'").

[52] *See, e.g., Cargill v. Hardin, supra*. An exposition of the obstacles one faces in proving that a prevailing price was "artificial" is found in Stanford University Professor Jeffrey Williams's *Manipulation on Trial*, an account of one of the civil lawsuits resulting from the Hunt brothers' near-cornering of the silver market.

[53] Gray, *Economic Evidence in Manipulation Cases*, CBOT Seminar Report on Research on Speculation 108, 110 (Nov. 1980); *quoted in* Perdue, *supra* at 368 n.136.

4. Causation

The problems with proving that a trader "caused" an artificial price are closely related to the problems in defining the relevant market and in determining the alleged manipulator's intent. Since there are always two parties to any transaction in the futures market, it may be impossible to determine which party "caused" an increase in price. "Asking whether the buyer or the seller 'caused' the price, thus is useless – like trying to cut with only one blade of a scissor. . . . There simply exists no meaningful way to determine who, in the two-sided bargaining process, 'caused' the price."[54]

In most instances the spot and futures prices of a commodity at any time are determined by a multitude of factors – aggregate supply and demand, political events, logistical disturbances, to name a few. Indeed, what makes a market a market is that the various participants have differing views as to the influence of each of those factors on prices. If there were no uncertainty or difference of opinion regarding how each of those factors affected the future price of a commodity, there would not be much of a futures market. Isolating and quantifying, in retrospect, the price impact of any single one of the many factors and how the various market participants reacted to that factor, would be an impossible task in many situations.[55]

In *Volkart*, *Indiana Farm Bureau*, and *Cox*, responsibility for a price increase was placed upon the shorts, who were found culpable for failing to arrange for delivery of a substitute commodity. In situations like these, the longs will not be found to have caused the increase in price.

The conflicts in existing case law has led one observer to conclude, "major precedents concerning the evidence necessary to determine causation in a manipulation case may provide substantial legal shelter to a cornerer. Most importantly, the potential for the accused to refute causation by convincing a court or commissioners that the deliverable supply is large may allow him to escape unscathed."[56]

5. Summary

The CEA does not define the offense of "manipulation" and the case law is confusing and contradictory. Despite the extensive analysis and criticism of the current law of manipulation, no one has yet formulated an alternative standard that would satisfy all of the problems that have been identified with the current law or the proposed alternatives. And there is not much reason for optimism that additional analysis ever will find one. In the final analysis, the concept of manipulation may necessarily remain ambiguous. After struggling with the definition of manipulation during the Hunt brothers' trial for manipulating the silver market, one of the

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[54] Perdue, *supra* at 376.

[55] One of the expert witnesses in the litigation that followed the Hunt manipulation of the silver market concluded: "Most frustrating to those concerned with commodity markets, the Hunt trial did not resolve the extent to which the Hunts caused the price spike. The trial itself was filled with the ambiguity, contradictions, and inconclusiveness found in the turmoil in the silver market during 1979 and 1980." Williams, *supra* at 4.

[56] Pirrong, *supra* at 984.

lawyers for the plaintiffs commented, "[T]he flexible, open-ended concept of manipulation should continue to prevail over any fixed formula rigidly defining manipulation. Otherwise, the creation of the next new form of manipulation will be encouraged rather than deterred."[57]

One federal appellate court has likened the difficulty in defining manipulation to Supreme Court Justice Potter Stewart's legendary observation about the difficulty in defining obscenity: "Sophisticated economic justification for the distinctions made in this area of law may at times seem questionable. Sometimes the 'know it when you see it' test may appear most useful."[58]

The difficulties in defining the offense of manipulation and in proving, after-the-fact, manipulation has occurred means that it is extraordinarily difficult to prosecute claims of manipulation. One former Chief Counsel of the CFTC Division of Enforcement has written, "[U]nder present law the crime of manipulation is virtually unprosecutable, and remedies for those injured by price manipulation are difficult to obtain. Moreover, even where a prosecution is successful, the investigation and effort necessary to bring a case will involve years of work, enormous expenditures, as well as an extended trial."[59] Other former senior CFTC officials interviewed by the Subcommittee staff agreed that retrospective manipulation cases were exceedingly difficult to prosecute. Current CFTC staff interviewed by the Subcommittee staff indicated that as a general matter manipulation cases entailed extensive market analysis, required heavy use of staff resources, were generally vigorously contested by the parties, and took years to prosecute.

In light of the current state of the law, the following observation sensibly warns against heavily relying on after-the-fact prosecutions to deter manipulation:

> [T]he current precedents make it extremely difficult to find a trader guilty of manipulation even in cases in which the economic analysis suggests that the trader has indeed manipulated. Given this state of affairs, *ex post* deterrence is currently a weak bulwark against future manipulations.[60]

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[57] Williams, *supra* at xviii (Foreword of Thomas O. Gorman).

[58] *Frey v. CFTC*, 931 F.2d 1171, 1175 (7th Cir. 1991). *See also*, Lower, *Disruptions of the Futures Market: A Comment on Dealing with Market Manipulation*, 8 Yale J. on Reg. 391 (1991).

[59] Markham, *supra* at 282.

[60] Pirrong, *supra* at 959.

B. Market Oversight to Detect and Prevent Manipulation

1. CFTC Market Oversight

The goals of the CFTC's market oversight and surveillance program are to preserve the "economic functions of the futures and option markets under its jurisdiction by monitoring trading activity to detect and prevent manipulation or abusive practices, to keep the Commission informed of significant market developments, to enforce Commission and exchange speculative position limits, and to ensure compliance with Commission reporting requirements."[61] The CFTC's market surveillance program seeks to "identify situations that could pose a threat of manipulation and to initiate appropriate preventive actions. Each day, for all active futures and option contract markets, the Commission's market surveillance staff monitors the daily activities of large traders, key price relationships, and relevant supply and demand factors in a continuous review for potential market problems."[62]

In physical commodity markets, the CFTC will most closely examine those situations in which the market is most susceptible to manipulation – when the deliverable supply of the commodity is small in relation to the outstanding positions held by traders. In these circumstances, the CFTC will examine the positions held by the largest long traders, the deliverable supplies not already owned by those traders, whether the long traders are likely to demand delivery, whether the short traders are capable of making delivery, and the price of the commodity on the futures market near contract expiration as compared to the price of the commodity on the cash market.

The CFTC explains how it analyzes market information:

> Surveillance economists prepare weekly summary reports for futures and options contracts that are approaching their critical expiration periods. Regional surveillance supervisors immediately review these reports. Surveillance staff advise the Commission and senior staff of potential problems and significant market developments at weekly surveillance meetings so that they will be prepared to take prompt action when necessary.[63]

A more colorful description of the weekly surveillance meetings is found in Stephen Fay's *Beyond Greed*, a tale of the Hunt brothers' attempt to corner the silver market:

> The significant business of the CFTC takes place on Friday mornings, behind closed doors, in a gloomy, top-floor back room. The room is dominated by a large, round, laminated table, cluttered with pencils, pads, and microphones – which are there not to make the conversation but to tape it for the record. The

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[61] CFTC, *The CFTC Market Surveillance Program*, at CFTC website: http://www.cftc.gov/opa/backgrounder/opasurveill.htm.

[62] *Id.*

[63] *Id.*

> commissioners listen to the weekly surveillance briefings, in which the staff discuss price fluctuations and reveal any substantial changes in the positions of market traders and big speculators, which must be reported confidentially to the CFTC each day.[64]

According to CFTC staff, no written record is kept of these meetings and "what happens in the room stays in the room."[65]

If the CFTC believes that a market is unduly congested or there is a threat of manipulation, it may take any one or more of a variety of actions, either formal or informal, to ensure that trading remains orderly. Generally, the CFTC's oversight program obtains information from and shares information with the affected futures exchanges, and corrective actions are coordinated.

The CFTC explains the types of informal action it may take with an exchange to maintain orderly trading:

> Potential problem situations are jointly monitored and, if necessary, verbal contacts are made with the brokers or traders who are significant participants in the market in question. These contacts may be for the purpose of asking questions, confirming reported positions, alerting the brokers or traders as to the regulatory concern for the situation, or warning them to conduct their trading responsibly. This "jawboning" activity by the Commission and the exchanges has been quite effective in resolving most potential problems at an early stage.[66]

Current and former CFTC officials interviewed by the Subcommittee staff believe that "jawboning" is an effective tool to prevent manipulations in commodity markets. One former CFTC official stated that the Chairman of the Commission would make perhaps five or six telephone calls per year to "jawbone" with exchange officials, top company officers, and large traders. These officials believe that the CFTC's anti-manipulation program is far more successful as a result of this behind-the-scenes action than indicated by information on the public record, including administrative and judicial decisions in after-the-fact CFTC prosecutions.

If neither the exchanges nor jawboning by the CFTC alleviates the agency's concerns regarding the potential for manipulation, the CFTC has a wide range of "emergency powers" that it can exercise to maintain order in the markets. In an emergency the CFTC can require the liquidation of positions, establish limits on positions in the market, extend the period for delivery under futures contracts, or, in the extreme, close the market.[67] The CFTC has used these

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[64] *Beyond Greed*, supra at 109-110.

[65] Interview with Subcommittee staff.

[66] *The CFTC Market Surveillance Program.*

[67] In *Beyond Greed*, Fay notes "there is virtually nothing the CFTC cannot do" in the face of "threatened . . . or actual manipulations" to ensure the orderly operation of the market. But, writes Fay, "There is just one drawback to this panoply of regulatory power: the act omits any definition of 'manipulation' or 'squeeze' or 'corner.' Moreover,

emergency powers sparingly. "The fact that the CFTC has had to take emergency actions only four times in its history demonstrates its commitment to not intervene in markets unless all other efforts have been unsuccessful."[68]

The CFTC obtains the information it uses to analyze the futures markets from publicly available sources, daily reports provided by the exchanges, and from its large-trader reporting system. Publicly available data includes information on supply and demand conditions, price information, trading volumes and open interest data on the number of outstanding long and short contracts. The exchanges report daily to the CFTC on the daily positions and trades of the members of their clearing houses. This information identifies the firms that hold the largest positions in the market, or that clear the largest trades, but it does not identify the firms or persons that actually hold the underlying positions. To determine this latter information, the CFTC relies upon the large-trader reporting system.[69]

The CFTC recently testified before the Congress on the importance of the large-trader reporting system:

> The heart of the Commission's direct market surveillance is a large-trader reporting system, under which clearing members of exchanges, commodity brokers (called futures commission merchants, or FCMs), and foreign brokers electronically file daily reports with the Commission. These reports contain the futures and option positions of traders that hold positions above specific reporting levels set by CFTC regulations. Because a trader may carry futures positions through more than one FCM and because a customer may control more than one account, the Commission routinely collects information that enables its surveillance staff to aggregate information across FCMs and for related accounts.[70]

The CFTC devotes a significant portion of its annual budget and its personnel to market oversight. For Fiscal Year 2003, the CFTC requested a budget of $10.6 million – about 13 percent of the agency's total budget – for its Market Surveillance, Analysis, and Research program within the Division of Economic Analysis. According to the CFTC's Budget Request for FY 2003, "The primary responsibility of the Market Surveillance, Analysis, and Research program is to foster markets that accurately reflect the forces of supply and demand for the underlying commodity and are free of disruptive activity. By detecting and protecting against price manipulation, this program assists the markets in performing the vital economic functions of price discovery and risk transfer (hedging)." Under the request, "57 FTE's will be employed

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the CFTC is committed to show intent to manipulate B a difficult thing to do even in so apparently straightforward a case as Bunker and Herbert's excursion into soybeans in 1977. This is the Catch-22 of commodities regulation: the law gives the CFTC immense power, and makes it almost impossible to deploy it." *Id.* at 112.

[68] *The CFTC Market Surveillance Program.*

[69] See, CFTC, *The CFTC's Large-Trader Reporting System*; available at CFTC website, at http://www.cftc.gov/opa/backgrounder/opa-ltrs.htm.

[70] Statement of James E. Newsome, Chairman, CFTC, Hearing Before the Senate Committee on Energy and Natural Resources, *Enron Corporation's Collapse*, 107th Cong., 2nd Sess., January 29, 2002, at 27.

to detect and prevent threats of price manipulation or other major market disruptions caused by abusive trading practices."[71]

2. Market Oversight by Approved Futures Exchanges

In order for a commodity exchange to obtain CFTC approval to trade in futures contracts, the exchange must have its own market oversight and enforcement program to detect and prevent excessive speculation and market manipulation. Each of the "designated contract markets" authorized by the CFTC has established such a program, and works closely with the CFTC to prevent manipulation and other trading abuses.[72] The CFTC periodically reviews each of the approved exchanges' market surveillance and enforcement programs to ensure they remain in compliance with the standards established by the CFTC.

The NYMEX, the largest exchange for energy contracts, describes its self-regulatory program as follows:

> The New York Mercantile Exchange enforces a rigorous self-regulatory program closely monitoring and regulating floor trading activity to prevent market manipulation and other anti-competitive activity. The Exchange has taken the lead in developing and maintaining new trade surveillance enhancements including the addition of public representatives to a revamped disciplinary panel, increased penalties, and tightened recording procedures. During numerous hearings on the reauthorization of the CFTC, Exchange officials stressed the Exchange's intolerance of wrongdoing, and encouraged legislation aimed at further preserving public confidence in the markets. The Exchange's rules and procedures have been carefully honed as a result of nearly 125 years of experience in building one of the world's safest and most liquid futures and options markets. The Exchange board of directors and staff remain committed to providing the vigilance and financial support necessary to preserve the highest levels of customer confidence in the integrity of our market.[73]

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[71] For FY 2003, the CFTC requested $22.9 million for the Division of Enforcement. Only a fraction of the enforcement budget is devoted to manipulation cases. In FY 2001, for example, the CFTC filed 3 administrative complaints in manipulation cases. During the same year, the CFTC filed 7 cases involving the sale of illegal foreign currency futures or options, 25 cases involving fraud, 4 cases involving management of customer funds, and various other administrative actions. The enforcement division also works with other law enforcement agencies on a variety of financial fraud, conspiracy, and money laundering actions. CFTC, *FY 2001 Annual Report*. A comparison of the CFTC's Budget Request with its Annual Report indicates that in the normal course of business the CFTC devotes far more resources to the before-the-fact prevention of manipulation than to the after-the-fact prosecution of manipulation.

[72] See Table A.2-1 for a list of the designated contract markets currently in operation.

[73] NYMEX, *Safeguards and Standards.*

In 1998, the NYMEX Trade Practice Surveillance section, which investigates and prosecutes NYMEX rule violations, had a staff of twenty-one persons,[74] and the Market Surveillance section had a staff of fifteen.[75] The Chicago Mercantile Exchange (CME) had ten full-time employees in its market surveillance division, which is responsible for monitoring and reviewing daily price movements, volumes and open interest in CME contracts, and other futures market activity.[76] It appears that the approved exchanges, in aggregate, devote a level of resources to surveillance and enforcement that is comparable to the level of resources that the CFTC devotes to these activities.[77] Altogether, then, on the order of a hundred individuals in the government and on the designated exchanges monitor billions of dollars in commodity transactions each day.

The designated exchanges have several types of regulations and programs to ensure orderly trading and prevent manipulation. First, the exchanges impose a variety of financial requirements on firms that are members of the exchange to ensure the creditworthiness of the parties trading on the exchange. One of the major advantages of purchasing exchange-traded futures contracts rather than OTC derivatives or swaps for hedging or speculation is the much greater assurance of creditworthiness that the exchange-traded instruments provide. In an OTC transaction, each party assumes the credit risk of the other party. In a transaction conducted on an approved exchange, with a clearinghouse that is capitalized by its members, the clearinghouse effectively acts as the counterparty to all transactions and so eliminates counterparty credit risk. To ensure the financial integrity of the market, the exchanges require the maintenance of sufficient margins to cover market fluctuations, and require clearing member firms to maintain sufficient capitalization to cover their operations, including the trades made on behalf of their customers.

To ensure orderly trading, the exchanges have established daily price limits for most commodity futures contracts, limiting the amount the price can increase or decrease in one day; position limits for clearing members of the exchange to ensure each clearing member has sufficient capital to cover its commitments; position limits for customers on contracts for the current delivery month to prevent commodity squeezes in the final month of the contract; and reporting requirements for customers maintaining large positions in the futures and options markets.

Like the CFTC, the exchanges have market oversight programs to ensure that trading is orderly and in compliance with financial and trading regulations. As the NYMEX explains, "daily surveillance is performed to ensure that Exchange prices reflect cash market price movements, that the futures market converges with the cash market at contract expiration, and

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[74] CFTC, *Rule Enforcement Review of the Commodity Exchange, Inc. Division of the New York Mercantile Exchange* (1999).

[75] CFTC, *Rule Enforcement Review of the Market Surveillance Program at the COMEX Division of the New York Mercantile Exchange* (1998).

[76] CFTC, *Rule Enforcement Review of the Chicago Mercantile Exchange* (1999).

[77] The New York Board of Trade has a 21-person compliance division. CFTC, *Rule Enforcement Review of the New York Cotton Exchange* (2001).

that there are no price distortions and no market manipulations."[78] Generally, the exchanges hold weekly meetings to review market conditions. Market oversight meetings may be held more frequently if unusual market conditions warrant.

In sum, the day-to-day market oversight by the approved exchanges is one of the key elements in preventing manipulation in the commodity futures markets. The exchanges devote a level of resources to market oversight and enforcement that is comparable to the level of resources the CFTC devotes to these activities, and the exchanges work closely with the CFTC to monitor the markets and take action, when necessary, to ensure that trading remains orderly and in compliance with regulations. The CFTC and exchange anti-manipulation programs work together to detect, deter, and punish market manipulation.

C. Lessons Learned from the Sumitomo Manipulation of the Copper Markets

Summary: The Sumitomo manipulation of the global copper market in the mid-1990s demonstrated the importance of monitoring over-the-counter markets and of sharing of information among regulators.

1. Sumitomo Manipulation of the Copper Markets[79]

Sumitomo is a Japanese corporation that has marketed copper metal for hundreds of years. During the time period relevant here, Sumitomo's Copper Metals Section, also known as Sumitomo's "Copper Team," was a major supplier of copper cathode to Asian manufacturers. Historically, Sumitomo extensively used the futures market to hedge against the risks presented by the volatility in copper prices.

Yasuo Hamanaka began trading in copper for Sumitomo in 1973, and was promoted to head the Copper Team in 1987. Just prior to Hamanaka's promotion, the Copper Team had begun to lose significant amounts of money from copper trades. These losses were compounded by losses incurred as a result of speculative trades made by Hamanaka and another trader in an attempt to compensate for the losses in the physical market. Hamanaka did not enter the losses from these trades on Sumitomo's normal bookkeeping system; rather he recorded the transactions in a personal notebook.

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[78] *Safeguards and Standards.*

[79] The facts regarding Sumitomo's manipulation set forth herein are taken from the Offer of Settlement agreed to by the CFTC and Sumitomo Corporation in *In re Sumitomo Corporation*, 1998 CFTC LEXIS 96, Comm. Fut. L. Rep. (CCH) &27,327 (CFTC, May 11, 1998). The facts regarding the CFTC's response are taken from an article written by Brooksley Born, CFTC Chair at the time. Born, *International Regulatory Responses to Derivatives Crises: The Role of the U.S. Commodity Futures Trading Commision*, 21 NW. J. Intl. L. & Bus. 607 (2001).

Shortly after he was promoted to head the Copper Team, Hamanaka began plotting to manipulate the copper market to recover some of Sumitomo's losses. Beginning in late 1993, Hamanaka entered into a series of unusual copper purchasing agreements with a newly-formed U.S. copper merchant firm, whereby both Sumitomo and the U.S. firm had an incentive for the transactions to be conducted at higher prices. According to the CFTC, much of the copper purchased by Sumitomo under these contracts was immediately resold to the U.S. firm's supplier and was never actually delivered to Sumitomo.[80]

As part of their scheme to manipulate the copper market, Hamanaka and his co-conspirators attempted to acquire all of the stocks of physical copper in the warehouses owned by the London Metals Exchange (LME). By November 1995, Sumitomo owned and controlled 100 percent of the copper inventory in LME warehouses, including the inventory in the newly opened LME warehouse in Long Beach, California. "As Sumitomo's copper trader knew, the concentration of ownership of all, or essentially all, of the LME warehouse stocks in the hands of cooperating market participants and the withholding of such stocks from the market would have the effect of increasing the price of copper and also creating a large backwardation. These developments allowed Sumitomo's copper trader to liquidate, lend or roll forward Sumitomo's large market holdings at the higher price or price differential and thereby earn significant profits for Sumitomo."[81] At the same time, Sumitomo had acquired and maintained large and controlling futures positions on the LME, which "bore little legitimate relationship to the marketing of physical copper to Sumitomo's customers, but rather were specifically designed to cause artificial prices and price relationships."[82]

In early 1995, the NYMEX and the CFTC became concerned about the price of copper on global markets, especially on the NYMEX and LME. Working with the NYMEX surveillance program, the CFTC surveillance staff recognized several unusual price relationships in the copper markets, such as increased volatility and the significant backwardation that had arisen due to Sumitomo's extraordinarily large physical holdings. For example, the cash price of copper on the LME had risen from about $1900 per metric ton in June 1994, to about $2500 per ton by the end of September 1994.

In addition, the CFTC and NYMEX market oversight staffs "detected unusual activity in warehouse stocks."[83] Although New York spot prices for copper were higher than the spot prices for copper on the LME in the summer and fall of 1995, inventories of copper in the LME

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[80] The *Sumitomo* settlement agreement did not name "the U.S. copper merchant" with which Sumitomo traded.

[81] *In re Sumitomo Corporation*, *supra,* at *11-12. In the futures markets for commodities that can be stored easily, such as copper, the market is generally in contango rather than backwardation, as the producers or sellers of the commodity for future delivery will obtain a market premium to compensate them for the storage costs of the commodity to be delivered in the future. The crude oil markets are an exception to this general rule, as crude oil is more difficult to store than a metal such as copper or silver, and refiners are willing to pay a slight premium for the convenience of having an assured prompt supply of crude oil to keep their refineries in continuous operation. A large backwardation in the copper or silver market therefore indicates some type of immediate supply disruption or shortage.

[82] *Id.*, at 12.

[83] Born, *supra* at 622.

warehouses – including the new LME warehouse in Long Beach – continued to increase. As the NYMEX explains, "Exchange officials and many members found this curious since exchange warehouses are intended to be the supplier or receiver of last resort. When demand for physical product is high, material should not continue to accumulate in an exchange warehouse; logically there should have been a reduction in LME stocks. . . ."[84] In late 1995, the NYMEX Vice-President called the LME warehouse inventories "a sign of sickness, not well-being," and inconsistent with rational commercial activity.[85]

Although both the NYMEX and CFTC had spotted "unusual activity," they could not discover the cause of such activity, and, as a result, were unable to take any preventive action to stop the manipulation. The NYMEX and CFTC examined the positions of traders on the NYMEX, but no unusual positions were detected. No large-trader reports had been filed.

Hamanaka and his co-conspirators had taken certain basic measures to evade NYMEX and CFTC oversight. They had acquired their futures and options positions on the LME and in the OTC markets rather than on the NYMEX in order to avoid the transparency and large-trader reporting requirements of the NYMEX and the CFTC. Indeed, Hamanaka "shunned the Comex [division of NYMEX], not only because it lacked the liquidity for the volume of trading he was doing, but also, he said in past interviews, because its regulations were too stringent."[86]

The LME did not have comparable reporting requirements, and trading was much less transparent than on the American exchanges. On the LME, traders were "allowed to meet daily margin calls with credit, rather than cash, letting them amass large positions without attracting the attention of their corporate treasurers, who would otherwise have to cut them checks. The Comex requires cash."[87]

After the Sumitomo manipulation was discovered, one NYMEX official blamed the LME's lenient regulatory philosophy:

> Unlike the strict reporting and disclosure requirements of the Exchange's COMEX and NYMEX Divisions that give those markets their transparency, the corresponding rules on the LME are considerably more lax where they exist at all. The result is an opaque market where problems like Sumitomo's have occurred with distressing regularity, including the tin market default in 1985 and a $175 million loss suffered by the Chilean copper producer Codelco in 1993 because of alleged unauthorized trading.[88]

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[84] NYMEX, *Collapse of Copper Prices Draws Attention to Differences in Oversight on the Exchange and Foreign Markets* (1996).

[85] *Id.*

[86] Stephanie Strom, *A Market Ripe for Manipulation; Laxity in London Opened Door for a Sumitomo Trader*, New York Times, July 12, 1996.

[87] *Id.*

[88] *Id.* In Chile, the losses at Codelco grew into a political scandal dubbed "Coppergate," and contributed to the fall of the Chilean government. Garth Alexander and John Waples, *Copper Meltdown*, Sunday Times, June 16, 1996.

The CFTC requested information from the U.K. Securities Investment Board (SIB), but the SIB had neither the requested information nor the inclination to co-operate with the CFTC. Reflecting some of the attitudes in London, *The Guardian* reported, "The CFTC's direct approach to investigating complaints lodged by its own members has been dubbed 'colonialism' by some market participants in London."[89] NYMEX appealed to the LME for information on the copper markets, but it too was "rebuffed."[90] In response to the complaints that the LME was too weak as a regulator, the chief executive of the LME, David E. King, "insisted that charges that it lacks regulatory zeal are merely sour grapes from the [New York Exchange], which has lost most of its market share in copper to London in recent years."[91]

According to Brooksley Born, CFTC Chair during this period, "the CFTC was frustrated in its ability to investigate the causes of the price abnormalities during 1995 because it was limited to information about the U.S. markets. At a time when Sumitomo's manipulative scheme might have been stopped before great harm was caused to copper market participants, the CFTC's hands were tied by lack of information."[92]

In the absence of specific information about trading in the copper markets, the CFTC was unable to detect or stop Hamanaka's manipulation. In April 1996, following a series of letters from the CFTC to the LME regarding the unusual activity in the copper markets, Sumitomo began its own investigation.[93] When during this internal investigation a Sumitomo clerk discovered a variety of unauthorized accounts at Merrill Lynch and other small brokerages, Sumitomo reassigned Hamanaka, who confessed to the manipulation scheme shortly afterward. At this time, however, Hamanaka had yet to unwind his futures and cash positions at the high market prices he had created. Sumitomo also informed the CFTC of the losses Sumitomo had incurred over the years as a result of Hamanaka's trading – at the time it estimated those losses at $1.8 billion. It later revised the estimate to $2.6 billion. Following Hamanaka's reassignment and subsequent dismissal, copper prices dropped nearly 30 percent – from $2,800 per metric ton to below $2,000 per metric ton.

Once Hamanaka's activities were disclosed, the CFTC again requested information from the SIB regarding Sumitomo's positions on the LME and the positions of U.S. affiliates on the London exchange as well. According to former Chair Born, "The SIB now recognized the seriousness of the situation and became more responsive to the CFTC's information requests. Nonetheless, there still remained some confusion and disagreement about what information was relevant for regulatory purposes and what information might be competitively sensitive."[94] The

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[89] Paul Murphy, *Complaints About American Regulators' London Activity*, The Guardian (London), January 30, 1996.

[90] Strom, *A Market Ripe for Manipulation; Laxity in London Opened Door for a Sumitomo Trader, supra*.

[91] *Id.*

[92] Born, *supra* at 622. (emphasis added).

[93] Suzanne McGee & Stephen E. Frank, *Metal Detection: Sumitomo Debacle is Tied to Lax Controls by Firm, Regulators*, Wall St. J., June 17, 1996. *See also* Kozinn, *supra* at 270-77.

[94] Born, *supra* at 623. In requesting information from the SIB, the CFTC invoked the "Boca Declaration," which had just been signed in March 1996. The Boca Declaration, which was prompted by the collapse of the Barings

CFTC's subsequent investigation revealed that Hamanaka had not only used the cash market for copper and the LME to achieve his price manipulation, but had "also used OTC transactions in furtherance of its manipulative scheme, both to obtain financing and to disguise the speculative nature of its transactions."[95]

Because Sumitomo had sufficient assets to cover the entire $2.6 billion loss, Sumitomo did not default on its obligations and its losses did not trigger a chain-reaction of defaults or require a take-over or bail-out. Nonetheless, according to the former CFTC Chair, "the impact of Sumitomo's activities on world copper prices did have a profound economic impact both within the U.S. and abroad. As the CFTC investigation revealed, Sumitomo manipulated the price of copper in what may well have been the most significant commodity price manipulation since the Hunt brothers' manipulation of the world market in silver in 1979 and 1980."[96] One metals trader estimated that Hamanaka's manipulation artificially raised the price of copper an average of 5 cents per pound on the spot market for five years, during which time copper was trading between 73 cents and $1.46 per pound.[97] This cost would have been passed on to copper processors and manufacturers of copper products, and ultimately, consumers.[98]

Sumitomo acknowledged the activities of Hamanaka, but claimed it had no knowledge of those activities at the time, and stated that such activities were unauthorized. Sumitomo settled with the CFTC by agreeing to cease and desist from further violations of the anti-manipulation provisions of the CEA, paying a $125 million civil penalty, and establishing a $25 million escrow fund to pay restitution to persons injured by Sumitomo's manipulative conduct. At the time, the civil penalty imposed upon Sumitomo was the largest civil penalty ever imposed by the United States government. In Japan, Hamanaka was found guilty of forgery and fraud, and sentenced to eight years in prison.

Subsequently, the CFTC found that Merrill Lynch had "aided and abetted" Sumitomo by providing more than $500 million of credit to Sumitomo, which Sumitomo used to purchase copper on the cash market and LME futures contracts. The director of the CFTC's enforcement division stated the case was "one of the most serious world-wide manipulations of a commodities market encountered in the 25-year history of the commission."[99] The CFTC complaint charged "Merrill Lynch participated in the manipulation as something it wished to bring about because

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Bank due to unauthorized trading in derivatives by one of its young employees, pledged the signatories to share information in the event of a significant financial reversal by a member of an exchange or clearing organization.

[95] *Id.*

[96] *Id.*

[97] Strom, *A Market Ripe for Manipulation; Laxity in London Opened Door for a Sumitomo Trader, supra*.

[98] Some sophisticated market players, such as George Soros, detected that copper prices were unusually high during Hamanaka's manipulations and sold short large quantities of copper. Such speculative short selling drove even more buying by Hamanaka to prop prices up. Eventually, even Soros declined to continue to trade against Hamanaka. Paul Krugman, *How Copper Came a Cropper*, The Dismal Science, July 19, 1996.

[99] Charles Gasparino, *CFTC Charges Merrill Lynch in Sumitomo Copper Scandal*, Wall Street Journal, May 21, 1999.

Merrill Lynch earned money as copper prices rose."[100] It further alleged that Merrill Lynch officials "had correctly concluded that Global and Sumitomo's warrant-taking operation was motivated by their intention to manipulate prices and spread, not by genuine commercial need, and that Global and Sumitomo were attempting to manipulate, and were successfully manipulating the world's copper markets." Although Merrill Lynch initially denied any wrongdoing, it settled the CFTC's suit by agreeing to a cease and desist order and paying a civil monetary penalty of $15 million.

In 1999, Sumitomo filed suit against J.P. Morgan Chase for its role in facilitating Hamanaka's manipulative scheme. According to papers filed by Sumitomo in the lawsuit, J.P. Morgan and its Morgan Guaranty Trust subsidiary sold "esoteric" derivatives to Sumitomo which, in reality, were no more than disguised loans. Sumitomo claimed that J.P. Morgan officials knew that Hamanaka was engaged in an illegal trading scheme, but nonetheless provided him with $735 million in credit so they could earn substantial fees and commissions.[101] In 2002, J.P. Morgan Chase agreed to pay $125 million to Sumitomo to settle the suit.[102]

The other U.S. metals trading firm alleged to have conspired with Sumitomo to manipulate copper prices, Global Minerals & Metals Corp., has contested the CFTC's charge of manipulation. The CFTC's enforcement proceedings against this company and several of its employees are on-going, but have been delayed by acrimonious pre-hearing disputes. In a ruling earlier this year, a CFTC administrative law judge stated, "From the outset, this matter has been mired in pleading, document production, and professional misconduct disputes. To date, this case has generated a total of 13 CCH-reported opinions and orders (this will be the 14th), without a hearing on the merits of the Commission's complaint in sight."[103] With respect to the merits, the judge opined, "[T]his proceeding raises a host of highly complex and interesting issues of law, economics and quantitative analysis for our consideration."[104]

The *Sumitomo* case demonstrates that even in a manipulation case in which the principal participant has admitted guilt and is serving an 8-year prison sentence for fraud and forgery, the responsible corporation in the manipulative scheme has admitted liability and paid $150 million in penalties, and two of the investment firms that financed the scheme have paid an equivalent amount, many obstacles impede proving, under current case law, that alleged conspirators in the scheme manipulated the market.

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[100] *Id.*

[101] Bank & Lender Liability Litigation Reporter, *J.P. Morgan Granted Relief in Sumitomo Case; Chase Not so Fortunate*, November 30, 2000.

[102] Bayan Rahman, J.P. Morgan Chase, *Sumitomo Settle in Copper Scandal*, National Post (f/k/a *The Financial Post*), April 2, 2002.

[103] *In re Global Minerals & Metals Corp. et. al.*, 2002 CFTC LEXIS 12, at *5, Comm. Fut. L. Rep. (CCH) &28,916 (January 23, 2002).

[104] *Id.* at 2.

2. International Agreement to Address Problems Raised by *Sumitomo*

In the wake of the Sumitomo manipulation, regulators from the three nations whose markets were principally affected by the affair – the United States, United Kingdom, and Japan – recognized the existing international understandings and framework for obtaining and sharing information on commodity trading were inadequate. Hamanaka had managed to evade detection for as long as he did by operating in the London and OTC markets, where there was much less transparency than on the regulated U.S. exchanges. In addition, by using a mix of international markets, he ensured that none of the various market authorities with jurisdiction over Hamanaka's trading activity was able to obtain a complete or accurate view of their own markets or his activities. Following the incident, CFTC Chair Born wrote, "The Sumitomo incident had confirmed that information sharing may be important to market oversight and regulation even before any enforcement actions are envisioned and that the information needed may involve the state of the market as a whole as well as the situation of particular market participants."[105]

The U.S., U.K., and Japanese regulators convened a meeting of international commodity market regulators in London in November 1996, to begin to develop a new international agreement for the sharing of market information. "The co-sponsors believed that Sumitomo's manipulation of the copper markets demonstrated that derivatives markets in international commodities involving physical delivery, such as copper, posed special regulatory issues and concerns, especially relating to the availability of deliverable supplies and susceptibility to market manipulation."[106]

The London meeting resulted in the issuance of the London Communique on Supervision of Commodity Futures Markets, which sought to address the international regulatory issues raised by the Sumitomo manipulation. The London Communique "recognized that futures contracts based on an underlying physical commodity – and particularly those requiring physical delivery – pose particular concerns for market integrity and the supervision of such markets."[107] In issuing the Communique, the regulators specifically agreed that better contract design, more effective market oversight, and regulatory measures designed to provide regulators with information on large positions in cash and OTC markets should be adopted.

Specifically, the London Communique stated the following with respect to physical commodity markets:

> Proper contract design is critical to reducing the susceptibility of such contracts to market abuses, including manipulation, and is an important complement to an appropriate market surveillance program.

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[105] Born, *supra* at 625.

[106] Born, *supra* at 626.

[107] *Id.*

> An effective market surveillance program by the market regulatory authorities is essential to ensure that commodity futures markets operate in a fair and orderly manner; and should be designed to detect, to prevent, to take corrective action with respect to, and to punish abusive conduct and should be supported by appropriate regulatory measures.
>
> Market authorities should have access to necessary information.
>
> Market authorities of related markets should share surveillance information in order to manage market disruption.
>
> Regulatory measures which facilitate the identification of large exposures should be developed. These measures may involve access to information relating to the persons holding or controlling large exposures and their related derivatives, over-the counter and cash market positions. These measures may also involve access to information on deliveries.

Following the issuance of the London Communique, international regulators continued to work to develop appropriate standards of best practice and guidelines for the design of contracts and market oversight programs. In October 1997, the regulators met again, this time in Tokyo, Japan. This international meeting resulted in the issuance of the Tokyo Communique on Supervision of Commodity Futures Markets, which contained Guidance on Standards of Best Practice for the Design and/or Review of Commodity Contracts; and Guidance on Components of Market Surveillance and Information Sharing ("Market Surveillance Guidance").

The Market Surveillance Guidance recommends that regulators routinely collect and analyze information regarding cash and OTC markets related to regulated futures markets. The Guidance states:

> Each commodity futures market and other market authorities should have a clear framework for conducting market surveillance, compliance and enforcement activities and there should be oversight of those activities.
>
> Information should be collected on a routine and non-routine basis for on-exchange and related cash and over-the-counter ("OTC") markets and should be designed to assess whether the market is functioning properly. Market authorities should have access to information that permits them to identify concentrations of positions and the composition of the market. It is acknowledged that data on related cash and OTC markets may be less immediately available than data for exchange markets. This may be an area which requires governmental powers.

The Market Surveillance Guidance also stated that the collection and analysis of market information should occur "speedily"; effective emergency powers should be available to intervene in the market to prevent or to address abusive practices or disorderly conditions; effective power should be available to discipline market members; the relevant authority should have the power to

address abusive actions by non-members; and market authorities should cooperate to share information, particularly on large exposures.

The seventeen nations that participated in the Tokyo conference also recommended the removal of domestic legal barriers to the implementation of these recommendations:

> Furthermore, in view of the fact that information is a critical tool for maintaining fair and orderly markets and ensuring market integrity in non-financial physical delivery markets with finite supply, that market authorities should seek the removal of domestic legal or other barriers to ensure, consistent with the regulatory framework of each jurisdiction, access by market authorities to information that permits them to detect and to deter abusive practices and disorderly conditions in the markets, including access to information that permits them to identify concentrations of positions and the overall composition of the market.

Former CFTC Chair Born summarized the significance of the Tokyo Communique as follows:

> The Guidances provide for the first time useful international benchmarks for the supervision of commodity derivatives markets and underscore the importance of detecting and deterring manipulative activities such as those engaged in by Sumitomo. The consensus on the need for information concerning large positions on exchange markets and related cash and OTC markets was a significant step forward in enhancing the international standards of regulation of these markets, particularly in light of the participants' commitment to work to alter their domestic laws in order to implement the provision. Furthermore, the recognition of the importance of sharing such information as part of an international effort to detect broad-based manipulation efforts in their incipiency represents substantial progress toward protecting the integrity of the global marketplace.[108]

Despite the commitments it made in the 1997 Tokyo Communique, the United States has failed to increase its oversight of or collection of information related to large positions on OTC markets. To the contrary, as explained in Appendix 2, in 2000, Congress enacted the Commodity Futures Modernization Act (CFMA), which extended the unregulated status of OTC markets for energy, metals, and financial derivatives. Economic damage to U.S. consumers, business, and the California and U.S. economies from fraud and possible price manipulation in U.S. energy markets have renewed calls for increased government oversight of energy contracts, swaps, and derivatives. Legislation has been introduced, but not yet enacted into law, to eliminate a number of the exclusions and exemptions for energy contracts from the CEA that now limit the federal government's ability to detect, deter, and punish manipulation in U.S. energy markets.

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[108] Born, *supra* at 630 (emphasis added).

APPENDIX 2

HISTORY AND CURRENT STATUS OF COMMODITY MARKET REGULATION

In the United States, the Commodity Exchange Act (CEA) is the primary federal statute governing the purchase and sale of contracts for the future delivery of crude oil. Section I of this Appendix describes the legislative history and major provisions of the CEA as it relates to the trading of contracts for future delivery of crude oil. Section II describes the recent exclusions and exemptions for energy and crude oil contracts that are traded "over-the-counter."

I. LEGISLATIVE HISTORY OF THE COMMODITY EXCHANGE ACT

"[The CFTC] chairman, William Bagley, was fond of reminding people that the CFTC had fewer 'policemen' than the Rockville, Maryland, Police Department – and this to monitor the commodity exchanges that are among the world's most complex economic institutions."
– Dan Morgan, Merchants of Grain (1980)

Summary: A fundamental purpose of the regulation of the commodities futures markets is to prevent manipulation.

A. Background on Commodities Exchanges and Need for Regulation

In 1848, as the industrial revolution was helping transform the American Midwest into productive farmland, 82 merchants founded the Chicago Board of Trade (CBOT) to be a central marketplace for producers, buyers, and sellers in the expanding grain trade. In 1865, the CBOT developed futures contracts for trading on the exchange. These standardized contracts, which provided for delivery of a standardized quantity of grain, at a specific location, on a fixed date in the future, at an agreed-upon price, afforded farmers with the price certainty and stability that enabled them to commit resources to the planting of wheat without knowing the specific prices the wheat would eventually obtain on the spot market. Similarly, these futures contracts allowed grain traders, processors, and merchandisers to protect themselves or "hedge" against price volatility while transporting, storing, and processing the grains. The trading of futures contracts attracted speculators who were willing to absorb some of these price risks in exchange for speculative gains, which brought "liquidity" to the market and reduced price fluctuations. This market innovation enabled American farmers and merchants to join in the mushrooming international trade in grains in the latter part of the nineteenth century.

Hundreds of other agricultural exchanges sprouted across the country to participate in the domestic and international markets. In 1872 in New York, a group of dairy merchants organized the "Butter and Cheese Exchange of New York," which also began trading in futures. The New York exchange soon grew to become the "Butter, Cheese and Egg Exchange," and, in 1882, to reflect the inclusion trade of poultry, groceries, dried fruits, and other produce, became simply "the New York Mercantile Exchange."

Table A.2-1
Designated Contract Markets (Active)

Exchange	Major Commodities	Comments
New York Mercantile Exchange (NYMEX)	Energy products	Founded in 1872 as the Butter and Cheese Exchange of New York.
The COMEX Division (COMEX)	Metals	Founded in 1933 from the merger of the National Metal Exchange, the Rubber Exchange of New York, the National Raw Silk Exchange, and the New York Hide Exchange. Since 1994 a subsidiary of NYMEX.
Chicago Board of Trade (CBOT)	Grains, U.S. Treasury notes and bonds, interest rates, and stock indexes	First exchange, established in 1848; began futures trading for agricultural commodities in 1865.
MidAmerica Exchange (MIDAM)	Soybeans, wheat, and corn	Subsidiary of CBOT; trades in same contracts as CBOT, but in smaller sizes.
Chicago Mercantile Exchange (CME)	Livestock, dairy products, stock indexes, interest rates, Eurodollars and other currencies	Originally formed in 1898 as the Chicago Butter and Egg Board; became the CME in 1919.
Kansas City Board of Trade (KCBT)	Wheat, natural gas, and stock indexes	Established in 1856; began futures trading for grains in 1876.
Minneapolis Grain Exchange (MGE)	Spring wheat	Established in 1881 by Minneapolis Chamber of Commerce to prevent abuses.
New York Board of Trade (NYBOT)	Coffee, cocoa, sugar, frozen concentrated orange juice, cotton, currencies, and stock indexes.	Formed in 1998 by merger of CSCE and NYCE.
Coffee, Sugar & Cocoa Exchange (CSCE)	Coffee, sugar, and cocoa	Part of NYBOT
New York Cotton Exchange (NYCE)	Cotton and frozen concentrated orange juice.	Part of NYBOT.
Merchants' Exchange (ME)	Barge freight rates and energy products	Established in 1836 as a cash exchange; in 2000 it became the ME and is now an electronic exchange.
BrokerTec Futures Exchange (BTEX)	Government Securities	Electronic trading platform.
Cantor Financial Futures Exchange (CX)	US Treasury and Agency notes	Proprietary electronic trading platform; joint venture between NY Board of Trade & Cantor Fitzgerald.
New York Futures Exchange (NYFE)	Currencies and stock indexes	Owned by NYCE.

Over time, most of the smaller exchanges could not compete with the large exchanges in New York and Chicago, and have either folded or been consolidated into the major exchanges. The last major consolidation occurred in 1994, when the New York Mercantile Exchange merged with the Commodity Exchange (COMEX), which trades in items such as gold, copper, hides, rubber, silk, silver, and tin. A list of commodity exchanges in operation today is provided in Table A.2-1.[1]

In the late nineteenth century, the commodities markets were self-regulated and rife with manipulation. To many, the commodities markets did not reflect natural forces of supply and demand or perform a valuable economic function, but rather were corrupt institutions that enabled unscrupulous speculators to control the price of basic commodities. "[T]he frequent picture of commodity exchanges was one of unbridled speculation, recurrent market manipulations, and spectacular price fluctuations. Indeed, it was a serious question with many whether the economic services of the system in the 1870's and 1880's were not outweighed by speculative excesses and abuses of the system."[2] The "shenanigans that took place year in and year out at the Chicago Board of Trade" fed into the populist resentment against the trusts, banks, and other large corporate interests toward the end of the century:

> The Board of Trade, which was created in 1848 at the instigation of Chicago's merchants, soon became a sort of international symbol of the worst elements of American free enterprise: greed; the cycle of riches and ruin, boom and bust; corruption. There was an orgy of speculation and market manipulation during the Civil War. The Board printed rules governing trading in 1869, but abuses of all kinds continued–fraud, bribery of telegraph operators to obtain confidential information (until coded messages were used), and the spreading of false rumors to influence prices. Outside the trading floor at Jackson and La Salle streets, bucket shops, not much different from bookie joints or other gambling establishments, flourished.[3]

Most attempts at cornering the market did not succeed, mainly because the markets were too large. "Memoirs of the markets are full of stories about attempted corners, and they usually have two things in common: greed and failure."[4] "Squeezes made some rich, and bankrupted others. The more severe episodes placed enormous strains on the nation's financial system. . . . Indeed, the gold corner shook the administration of Ulysses S. Grant (who was indirectly linked to the scheme) to its core and largely foreshadowed its litany of scandal."[5] The rampant corruption and manipulations undermined confidence in the futures markets. "The irresponsible

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[1] CFTC website, at http:/www.cftc.gov/dea/deadcms_table.htm.

[2] Report of the Senate Committee on Agriculture, Nutrition, and Forestry, to accompany S. 2019, Futures Trading Act of 1982, S. Rep. No. 384, 97th Cong., 2nd Sess. 11 (1982).

[3] Dan Morgan, *Merchants of Grain*, at 95 (Penguin, 1980).

[4] Stephen Fay, *Beyond Greed*, at 60 (1982).

[5] Steven Craig Pirrong, *The Economics, Law, and Public Policy of Market Power Manipulation* 2 (1996).

trading and lack of effective market regulation in the early period stirred farm resentment and opposition to futures trading that still exist to a limited extent."[6]

B. The Commodity Exchange Act

1. Grain Futures Act of 1922

"The abuses of futures trading in this early period resulted in repeated efforts of various State legislatures, from the late 1860s onward, to abolish futures trading."[7] In 1892-93 both houses of Congress passed bills that would have imposed a prohibitive tax on futures trading; final legislation was narrowly defeated on a procedural motion.[8] As farm prices rose and stabilized in the ensuing years, however, legislative efforts focused on regulation of the markets rather than their abolition.

It was not until grain prices collapsed after the First World War that federal legislation was passed to regulate the futures markets. During the First World War, the disruption of European grain production and markets drove up prices for American grain, providing handsome profits for entrepreneurial merchants and speculators. After the War ended, the high levels of production in the United States and the resumption of grain production in Europe caused wheat prices to plummet. At the same time, the overall U.S. economy had fallen into a depression. American farmers blamed their post-war plight on the excesses of the speculators, particularly the short sellers, whose speculative selling, they believed, had driven down the price of grains.[9] At Congressional hearings, farm witnesses "attacked speculators as 'predatory parasites,' thieves, gamblers, and wealthy individuals who 'live like lords and ride in high-powered automobiles and live in great residences."[10] The farmers clamored for either outright abolition of the trading of futures or, at the very least, stringent linkages between contracts for futures and the physical market.[11]

Largely as a result of the agitation from the farmers, in 1922, the Congress passed the Grain Futures Act to prevent excessive speculation and manipulation.[12] Congress set forth in the

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[6] S. Rep. No. 384, *supra* at 11.

[7] S. Rep. No. 384, *supra* at 11; Dan Morgan, *Merchants of Grain*, at 97 (Penguin, 1980).

[8] S. Rep. No. 384, *supra* at 11.

[9] See Romano, *The Political Dynamics of Derivative Securities Regulation*, 14 Yale J. on Reg. 279, 287 (1997).

[10] *Id.* at 292.

[11] *Id.*, at 291-294.

[12] The Future Trading Act, 42 Stat. 187 (1921), imposed a tax on all grain futures contracts that were not traded on a designated contract market. In *Hill v. Wallace*, 269 U.S. 44, 42 S.Ct. 453, 66 L.Ed. 822 (1922), the Supreme Court held this Act to be an unconstitutional violation of the taxing power. To remedy this constitutional defect, the next year the Congress passed the Grain Futures Act, 42 Stat. 998 (1922), with virtually the same provisions as the overturned law, but without the offending tax provision. The Grain Futures Act simply made it illegal to trade in futures contracts off a designated contract market. The Supreme Court upheld the Grain Futures Act as a constitutional exercise of the power to regulate interstate commerce in *Board of Trade v. Olsen*, 262 U.S. 1, 43 S.Ct. 479, 67 L.Ed. 839 (1923).

statute itself the purpose of the futures markets – for hedging, price discovery, and price dissemination; the importance of these markets to the national and international commerce; and the public interest in preventing excessive speculation and manipulation:

> The prices involved in such transactions are generally quoted and disseminated throughout the United States and in foreign countries as a basis for determining the prices to the producer and the consumer of commodities and the products and byproducts thereof and to facilitate the movements thereof in interstate commerce. Such transactions are utilized by shippers, dealers, millers, and others engaged in handling commodities and the products and byproducts thereof in interstate commerce as a means of hedging themselves against possible loss through fluctuations in price. The transactions and prices of commodities on such boards of trade are susceptible to excessive speculation and can be manipulated, controlled, cornered or squeezed to the detriment of the producer or the consumer and the persons handling commodities and the products and byproducts thereof in interstate commerce, rendering regulation imperative for the protection of such commerce and the national public interest therein.[13]

The 1922 Act established much of the framework for the regulation of the commodities exchanges in effect today. The Act required all grain futures contracts to be traded on a designated contract market,[14] and authorized the Secretary of Agriculture to designate a board of trade as a "contract market" if the board satisfied a number of conditions set forth in the statute. Among these conditions were for the board of trade to require members of the exchange to keep records of their transactions, to prevent "false or misleading or knowingly inaccurate reports concerning crop or market information," and to prevent the "manipulation of prices and the cornering of any commodity."[15] The Act provided the government – a commission made up of the Secretary of Agriculture, the Secretary of Commerce, and the Attorney General – with the authority to revoke the designation of any board that failed to comply with the conditions of its designation as a contract market.

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[13] 7 U.S.C.A. § 5 (1999).

[14] In making off-exchange transactions in futures illegal, Congress intended to stop the "bucketing" of orders in "bucket shops." A "bucket shop" would take a customer order for a futures transaction but not place the order on the exchange; as the counter-party to the customer's transaction the bucket shop would attempt to profit from price movements adverse to the customer. Bucket shops also would offset orders from customers with opposing positions against each other, thereby short-circuiting the open outcry price discovery mechanism of the exchange. Both practices exposed the customers to additional costs and risks of default. *See, e.g.*, Markham, *supra* at n139 and accompanying text.

[15] 7 U.S.C.A. § 7 (1999).

2. Commodity Exchange Act

In 1936, Congress enacted the Commodity Exchange Act (CEA) to rename and expand the scope of the original Grain Futures Act to include not only grain but various other commodities, including cotton, butter, and eggs.[16] The exchanges that traded these commodities opposed the regulation of their markets as unnecessary, and, in what became a typical objection to the various proposed expansions of the markets regulated by the CEA, predicted dire consequences if these markets were regulated (see box). Experience, however, has proved such fears to be unfounded.

Congress also strengthened the anti-manipulation provisions of the Act. In response to the 1936 Supreme Court decision in *Wallace v. Cutten*[17], in which the Court held the Grain Futures Act did not permit after-the-fact criminal prosecutions for violations of the anti-manipulation provisions, Congress made manipulation a misdemeanor punishable by a fine of $10,000 and imprisonment of up to one year.[18]

Butter & Egg and Cotton Exchanges Opposed Regulation under the CEA

Although farmers and dairy producers supported the regulation of butter and egg futures, the butter and egg exchanges opposed it. Romano, *supra*. The President of the Chicago Mercantile Exchange testified the legislation was not needed to "insure the free flow of butter and eggs from the farm to the table of the consumer." The President of the New York Mercantile Exchange predicted the bill would "undoubtedly curtail trading in futures to such an extent that future boards on commodity exchanges handling butter and eggs will practically become useless." The exchanges requested further study before legislation was enacted. Hearings Before the Senate Committee on Agriculture and Forestry, *To Amend the Grain Futures Act*, 74th Cong., 2nd Sess., April 21, 22, and 23 (1936).

Phelan Beale, General Counsel for the Cotton Exchange, testified "it would be a grievous error to include cotton in a bill that primarily was drawn to apply to grain." He asked the Committee to further study the issue so that "through no inadvertence nor sins of omission or commission may the greatest commodity in the United States and the greatest export of the United States be impaired." Hearings Before the House Committee on Agriculture, *Regulation of Commodity Exchanges*, 74th Cong., 1st Sess., 45-46, February 5, 7, and 8, 1935.

[16] 49 Stat. 1491 (1936).

[17] 298 U.S. 229 (1936).

[18] 49 Stat. 1498, 1499 (1936)

The Congress also added an anti-fraud provision (see box), which to this date has remained essentially unchanged.[19]

3. 1968 Amendments

In 1968, Congress again expanded the Act and strengthened the anti-manipulation and anti-fraud provisions.[20] The 1968 amendments brought several additional commodities, such as live cattle and pork bellies, within the scope of the Act. It empowered the Secretary of Agriculture to disapprove rules adopted by a contract market that would violate the Act or the regulations established thereunder, and also required the contract markets to enforce all of its rules that were not disapproved by the Secretary of Agriculture. The amendments made a violation of the anti-manipulation and anti-fraud provisions a felony rather than a misdemeanor, with a maximum prison term of five years.

The CEA Anti-Fraud Provision

Section 4b of the CEA makes it unlawful for any person, in connection with the sale of or order for any contract for future delivery that is used for hedging, price discovery, or actual delivery of such commodity, to: (i) cheat or defraud, or attempt to cheat or defraud, another person; (ii) willfully make any false statement to another person or create a false record; (iii) willfully deceive or attempt to deceive another person; or (iv) to bucket any such orders, offset such orders against orders of other persons, or willfully and knowingly become the buyer or seller of sell or buy orders without the consent of the other party.

4. 1974 Amendments: Creation of CFTC

Initially, jurisdiction over the commodities markets was provided to the Department of Agriculture because the commodities markets were centered around a limited number of agricultural products. By the 1970s, a number of futures markets in other products had developed, such as coffee, sugar, cocoa, lumber, and plywood, plus various metals, including the volatile silver market, and foreign currencies. In 1974, Congress concluded the need to regulate these commodity markets was no less than the need to regulate the agricultural markets already within the Act:

> A person trading in one of the then unregulated futures markets needed the same protection afforded to those trading in the regulated markets. Whether a commodity was grown, mined, or created, or whether it was produced in the United States or outside the United States made little difference to those in this country who bought, sold, processed, or used the commodity, or to the United States consumers whose prices were affected by the futures market in that commodity.[21]

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[19] 7 U.S.C.A. §6b (1999).

[20] 82 Stat. 26 (1968).

[21] S. Rep. No. 384, *supra* at 13.

Accordingly, Congress overhauled the CEA and expanded its coverage to include a broad range of futures contracts, not just the agricultural commodities already specified in the statute.[22]

Coffee & Sugar and Cocoa Exchanges and Silver Companies Opposed Regulation Under the CEA

The New York Coffee and Sugar Exchange and the New York Cocoa Exchange (both are now part of the New York Board of Trade) opposed the regulation of their markets. One representative testified these exchanges were "more than adequately regulated" under their own rules and the "good sound judgment" of their officers and governing boards. He perceived "no reason" for regulation under the CEA. The exchanges predicted that regulation would drive these futures markets overseas, causing the United States and the City of New York "to lose substantial employment opportunities and taxable revenues," and "would increase the volatility of commodity prices passed on to consumers in the United States." *Commodity Futures Trading Commission Act*, Hearings Before the Senate Committee on Agriculture and Forestry, 93rd Cong., 2nd Sess, Pt. 2, 464, 465 (1974).

Today, the New York Board of Trade states it is "the world's premier futures and options markets" for cocoa, coffee, cotton, frozen concentrated orange juice, and sugar. New York Board of Trade, Agricultural Futures & Options.

Several companies trading in silver opposed the regulation of futures contracts for silver. Even as the Hunt brothers were active in the silver market, the Chairman of Mocatta Metals, the largest U.S. silver bullion dealer, testified there were "no major scandals or improprieties affecting trading on the major international commodity exchanges necessitating emergency amelioration," and urged more study of the issue. Mocatta predicted full CFTC regulation "could upset the markets for international commodities and materially reduce the vitality of U.S. participation in those markets, thereby causing those commodities to flow away from our shores and to be most costly to acquire for consumption in the U.S." 1974 Senate Hearings, *supra*, at Part. 3, 797 (Statement of Dr. Henry G. Jarecki).

[22] The commodities listed in the statute are wheat, cotton, rice, corn, oats, barley, rye, flaxseed, grain sorghums, mill feeds, butter, eggs, Solanum tuberosum (Irish potatoes), wool, wool tops, fats and oils (including lard, tallow, cottonseed oil, peanut oil, soybean oil, and all other fats and oils), cottonseed meal, cottonseed, peanuts, soybeans, soybean meal, livestock, livestock products, and frozen concentrated orange juice. 7 U.S.C.A. §1a(4) (West Supp. 2002). In 1958, as a result of the numerous manipulations of the onion market, the Congress prohibited all futures in onions. Pub. L. 85-839, §1, Aug. 28, 1958, 72 Stat. 1013; 7 U.S.C.A. §13-1 (West 1999). *See* Markham, *supra* at 318 ("Perhaps the most manipulated market of all was onions.").

The 1974 Amendments expanded the Act to include "all other goods and articles . . . and all services, rights, and interests in which contracts for future delivery are presently or in the future dealt in."

In expanding the scope of the Act, Congress reiterated the purpose of the Act to prevent fraud and manipulation and control speculation in the commodity markets:

> The fundamental purpose of the Commodity Exchange Act is to ensure fair practice and honest dealing on the commodity exchange and to provide a measure of control over those forms of speculative activity which too often demoralize markets to the injury of producers and consumers and the exchanges themselves.[23]

The legislation transferred the authority of the Secretary of Agriculture to the new Commodity Futures Trading Commission (CFTC), an independent 5-member regulatory agency. The 1974 Amendments increased the maximum fine for a violation of the anti-manipulation prohibition from $10,000 to $100,000.[24]

Congress also clarified that this expansion of CEA coverage did not extend to certain financial transactions. During the debate over the 1974 amendments, the Treasury Department had expressed concern that the proposed language to broaden the Act could be read to encompass the existing trade in currency futures between large banks and other sophisticated institutions. Congress responded by enacting the "Treasury Amendment," which exempted from the Act "transactions in foreign currency, security warrants, security rights, resales of installment loan contracts, repurchase options, government securities, or mortgages and mortgage purchase commitments, unless such transactions involve the sale thereof for future delivery conducted on a board of trade."[25]

The Senate report on the 1974 legislation explained the rationale underlying the Treasury Amendment:

> [T]he Committee included an amendment to clarify that the provisions of the bill are not applicable to trading in foreign currencies and certain enumerated financial instruments unless such trading is conducted on a formally organized futures exchange. A great deal of the trading in foreign currency in the United States is carried out through an informal network of banks and tellers. The Committee believes that this market is more properly supervised by the bank regulatory agencies and that, therefore, regulation under this legislation is unnecessary.[26]

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[23] S. Rept. No. 93-1131, 93rd Cong., 2nd Sess. (1974).

[24] Pub.L. 93-463, §212(d)(1) (1974). In 1978, Congress increased the maximum financial penalty for manipulation to $500,000, Pub.L. 95-405, §19(1). The maximum penalty was increased to $1,000,000 in 1992. Pub.L. 102-546 §212(a).

[25] 7 U.S.C.A. §2(i) (1999).

[26] S.Rep. No. 93-1131 (1974).

In the mid-1970s, following the extreme price volatility in the energy sector resulting from the Arab oil embargo, a new market for energy futures emerged. In 1978, NYMEX offered futures contracts in heating oil, and over the next several years NYMEX proposed a variety of futures contracts in other petroleum products. In 1983, NYMEX began trading in the WTI futures contract.[27]

Today, the vast majority of futures contracts traded on the exchange are unrelated to agriculture. Whereas as recently as the early 1970s, most of the approximately 13 million futures contracts traded annually on domestic boards of trade involved agricultural commodities, in 1999, nearly 600 million futures contracts were traded annually in the U.S., but with only a small fraction – about 11 percent – related to agriculture. [28]

In 1980, in a case involving the question of whether the CEA provided a private right of action, the U.S. Court of Appeals for the Second Circuit traced the history of the CEA and observed how the Act had been strengthened over the years to match the needs of the evolving futures markets:

> The history of congressional concern with commodity futures trading has thus been one of steady expansion in coverage and strengthening of regulation. In 1936, 1968, and 1974 new commodities came under the CEA. In each of these years the power of the regulatory authority were augmented, and penalties were either extended, increased, or both. The question of Congressional intent with respect to private sanctions under the Act must be considered against this background of increasingly strong regulation designed to insure the existence of fair and orderly markets.[29]

Although one of the main purposes of the CEA was to discourage and punish market manipulation, manipulations and attempts at manipulation of the commodity markets have continued. In 1982, following the Hunt brothers' attempts to corner the silver market, one observer commented:

> The nineteenth-century grain market in Chicago was littered with examples of attempted squeezes and corners; to a lesser extent it still is. Rings and corners in the stock market ended with the Great Crash and the establishment of the Securities and Exchange Commission in 1934. But commodities remained a temptation to the corner men. In the last generation corners were attempted in eggs, onions, vegetable oil, soybeans, and potatoes. The fact that market manipulation is now illegal does not stop people trying.[30]

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[27] See John Elting Treat, ed., *Energy Futures, Trading Opportunities for the 1990s*, 20-23 (1990).

[28] Chicago Board of Trade, *Action in the Marketplace*, at 2.

[29] *Leist v. Simplot*, 638.F.2d 283, 296 (2d Cir. 1980), *aff'd sub nom. Merrill Lynch, Pierce, Fenner & Smith v. Curran*, 456 U.S. 353 (1982).

[30] Stephen Fay, *Beyond Greed*, at 60 (1982). For a list of federal manipulation cases decided between 1940 and 1989, see Markham, *Manipulation of Commodity Futures Prices – The Unprosecutable Crime*, 8 Yale J. on Reg. 281 (1991) ("The commodity futures market has been beset by large-scale manipulations since its beginning.")

More recent history demonstrates that manipulations are not "simply relics of the distant past."[31] Allegedly, the Hunt brothers squeezed the soybean market in 1977, as well as the silver market a couple of years later. The Feruzzis allegedly squeezed the CBOT soybean market in the late 1980s. "In 1991, the eminent investment bank and primary government securities dealer Salomon Brothers successfully cornered several issues of Treasury notes, thereby causing huge disruptions in the world's financial market and throwing a cloud of suspicion over it that has yet to dissipate completely."[32] As discussed in Appendix 1, the Sumitomo Corporation manipulated the price of copper in the mid-1990s, causing as much as a 30 percent rise in copper prices. And as discussed in the main section of this report, in 2000, a U.S. refiner reportedly obtained a large financial settlement from Arcadia, a crude oil trading company, in a lawsuit over alleged manipulation of the crude oil market.

II. OVER-THE-COUNTER ENERGY DERIVATIVES: EXCLUSIONS AND EXEMPTIONS FROM COMMODITY EXCHANGE ACT

"With the CFTC's withdrawal from regulating many of the more popular derivatives in the late 1980s and early 1990s, it appeared that dealers in those financial products had found a virtually regulation-free promised land."
–Philip McBride Johnson, former Chairman, CFTC (1999)

Summary: Congress and the CFTC imposed much less regulation on the trade of over-the-counter derivatives than for futures contracts.

The CEA provides the CFTC with jurisdiction over "agreements . . . and transactions involving contracts of sale of a commodity for future delivery traded or executed on a contract market . . . or any other board of trade, exchange, or market." Neither the original Grain Futures Act of 1922, nor any of the subsequent amendments, defined or set forth the elements of a "futures contract" or the term "future delivery." Rather, the term "future delivery" is defined only in reference to that which it is not – a "forward contract." The CEA's definition of "future delivery" merely states, "The term 'future delivery' does not include any sale of any cash commodity for deferred shipment or delivery."[33]

The distinctions between "future contracts," or "contracts for future delivery," and "forward contracts" have never been settled. A key issue that arose after the 1974 expansion of the CEA and the enactment of the Treasury amendment was the extent to which the swaps and other over-the-counter derivatives that were coming into widespread use in the1980s could be considered contracts for future delivery within the scope of the CEA. Many of the OTC derivatives, such as swaps, call for one or both parties to make a stream of payments to the other party over a specified period of time. If these OTC derivatives were to fall within the definition of a contract for future delivery, then they would have become legally suspect because they were not being traded on an approved exchange. In the 1980s, as large corporations and financial

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[31] Steven Craig Pirrong, *The Economics, Law, and Public Policy of Market Power Manipulation* (1996) at 3.

[32] Id. *See also* Nicholas Dunbar, *Inventing Money* 109-112 (2001).

[33] 7 U.S.C.A. § 1a(19) (Supp. 2002).

institutions increasingly used OTC derivatives to manage financial risks, the uncertainty of the legal status of these instruments became a significant concern. From then to the present, the CFTC, other federal agencies with jurisdiction over financial instruments, the financial community, the oil industry, other commodity traders, and Congress have debated the extent to which these instruments should be regulated under the CEA

A. 1989 Swaps Policy Statement: Exemption for Certain OTC Swap Transactions

In 1989, in response to the call for more legal certainty, the CFTC issued a "Swaps Policy Statement" to clarify that it would not seek to regulate certain OTC swap transactions.[34] A swap transaction is essentially "an agreement between two parties to exchange a series of cash flows measured by different interest rates, exchange rates, or prices with payments calculated by reference to a principal base (notional amount)."[35] Financial swaps are used by corporations and financial institutions to hedge exposure to changing interest or currency exchange rates, or, on the other side of such a transaction, to speculate on interest or currency exchange rates. Commodity swaps are structured similarly to interest rate or currency swaps, except that payments are calculated in reference to the price of a specified commodity, such as crude oil.

In its 1989 Swaps Policy Statement, the CFTC held that although swap transactions had elements of futures contracts, most swap transactions were sufficiently distinguishable from futures contracts to conclude they were "not appropriately regulated as such under the Act and its regulations." The CFTC set forth a number of criteria a swap transaction must meet to qualify for this exemption from regulation: (1) the swap agreement must not be fully standardized, meaning the terms must be negotiated by the parties and their terms must be "individually tailored;" (2) the swap agreement may not be terminated through an exchange-style offset with other swap agreements of opposite positions, and may be terminated only with the consent of the counterparty; (3) the swap agreement cannot be supported by the credit of a clearing organization, as futures contracts are supported on an exchange, and each party to the agreement must assume the credit risk of the other party; (4) the transaction must be undertaken in conjunction with a line of business, such as that conducted by a large corporation, commercial or investment bank, insurance company, or governmental entity; and (5) the swap transactions sought to be exempted may not be marketed to the public.

The 1989 Swaps Policy Statement, however, did not end the debate over the status of these types of contracts. The CFTC did not declare in its policy statement that swap transactions were excluded from regulation under the CEA; it only stated the CFTC had chosen not to regulate them "*at this time*." The CFTC's action left open the possibility that swap transactions could be regulated at some time in the future. This concern was heightened the very next year, when controversy erupted over the applicability of the CEA to the Brent market.

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[34] 54 Fed. Reg. 30,694 (1989).

[35] *Id.*

B. Exemptions for Certain Brent Crude Oil Contracts

1. The *Transnor* Decision

In April 1990, Judge William Conner, United States District Judge for the Southern District of New York, ruling on a motion for summary judgment in the case of *Transnor v. BP,*[36] held that 15-day Brent contracts were future contracts within the meaning of the CEA. As explained in more detail in Section III of the main report, these contracts provide for the delivery of a cargo of Brent crude oil, fully loaded at the Sullom Voe terminal in the North Sea, at a specified month in the future. They are used for hedging, price discovery, and speculation, as well as for physical delivery of crude oil.

In *Transnor*, the plaintiff, a Bermuda-based oil trading company, alleged that several North Sea oil producers – BP, Shell, Conoco, and Exxon – had conspired to sell Brent crude oil at below-market prices in order to lower the tax imposed on their Brent production.[37] In December 1985, Transnor purchased, at an average price of $24.50 per barrel, two 15-day Brent contracts for the delivery of two Brent cargoes (500,000 barrels per cargo) in March 1986. In early 1986, an OPEC price war erupted, and the price of crude oil plummeted. By the end of March, the price of Brent had fallen to $13.80 per barrel. Transnor refused to take delivery of the crude oil and filed suit against the four producers of Brent crude for $230 million in damages, claiming that they were partially responsible for the fall in price. Transnor alleged the Brent producers conspired to fix prices, in violation of the Sherman Antitrust Act, and manipulated the price of 15-day Brent contracts, in violation of the CEA.

In his ruling, Judge Conner first addressed the question of whether principles of comity and international law compelled the court to decline to exercise jurisdiction. The judge found that although the British government had expressed an intention to promulgate some binding regulations applicable to the Brent market, it had not actually issued any. The court concluded "application of U.S. antitrust and commodity laws does not create either an actual or potential conflict with existing British government regulation of Brent market transactions. That a conflict may arise in the future should the British government act is too uncertain to weigh against the exercise of jurisdiction."[38] The court went on to find that the parties' ties to the United States were "stronger than those to the United Kingdom," the alleged conduct "clearly impacted U.S. commerce," there were "issues of fact as to whether defendants intended to affect U.S. commerce or should reasonably have foreseen such an impact," and "the U.S. is an important locus, if not the hub, of defendants' alleged manipulation."[39] In sum, the court held, "with all factors considered, both a quantitative and a qualitative tally favor the exercise of jurisdiction by this Court – a result which should not affront British interests."[40]

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[36] 738 F. Supp. 1472 (S.D.N.Y. 1990).

[37] Shell and BP settled with *Transnor* and were dismissed from the case. Shortly after filing suit, Transnor's oil trading operations went bankrupt.

[38] 738 F.Supp. at 1477.

[39] *Id.* at 1477-1478.

[40] *Id.*

After rejecting the defendants' arguments to dismiss the plaintiff's antitrust claims, the court turned to the defendants' contention that 15-day Brent contracts were in reality "contracts of sale of a commodity for future delivery" – i.e., forward contracts – and therefore not within the scope of the CEA. In analyzing this claim, the court first reviewed the administrative and case law on the differences between futures contracts and forward contracts, and then examined the nature of the 15-day Brent market.

"Once distinguished by unique features, futures and forwards contracts have begun to share certain characteristics due to increasingly complex and dynamic commercial realities," the court stated. "The predominant distinction between the two remains the intention of the parties and the overall effect of the transaction." In forward contracts, delivery of a physical commodity occurs, but is delayed or deferred for convenience or necessity.[41] "By contrast, futures contracts are undertaken primarily to assume or shift price risk without transferring the underlying commodity. As a result, futures contracts providing for delivery may be satisfied either by delivery or offset."[42] In determining whether physical delivery is, in fact, intended, the courts and the CFTC look both to the terms of the contract and to the practices of the parties.[43]

In examining the 15-day Brent contract, the *Transnor* court found it had elements of both a futures contract and a forward contract. The court concluded that although the 15-day Brent contract embodied a binding commitment to buy or sell crude oil, physical delivery was not generally contemplated by the parties, and occurred only in a minority of transactions in the 15-day market. Thus, the court held the 15-day contracts were not forward contracts:

> Moreover, the high degree of standardization of terms such as quantity, grade, delivery terms, currency of payment and unit of measure, which facilitate offset, bookout and other clearing techniques available on the Brent market, further evidence the investment purpose of Brent trading. The 15-day Brent market does not remotely resemble the commercial trading originally exempted from the Act. While this Court recognizes that commercial transactions have increased in complexity since the predecessor to the CEA was enacted, the interests of Brent participants, which include investment and brokerage houses, do not parallel those of the farmer who sold grain or the elevator operator who bought it for deferred delivery, so that each could benefit from a guaranteed price.[44]

The court then concluded the 15-day Brent contracts were futures contracts covered by the CEA:

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[41] The leading appellate case discussing these distinctions is *Commodity Futures Trading Comm. v. Co Petro Marketing Group, Inc.*, 680 F.2d 573(9th Cir. 1982).

[42] *Transnor*, 738 F.Supp. at 1489.

[43] Judge Conner also stated that language in an agreement requiring future delivery of the underlying commodity does not mandate the classification of the agreement as a forward contract, if the delivery requirement is not expected to be enforced. "This Court concludes that even where there is no 'right' of offset, the 'opportunity' to offset and a tacit expectation and common practice of offsetting suffices to deem the transaction a futures contract." *Id.* at 1492.

[44] *Id.* at 1491.

> Most importantly, the Brent contracts were undertaken mainly to assume or shift price risk without transferring the underlying commodity. Defendants acknowledge that the volume of Brent contract trading greatly exceeded the amount of physical oil available to satisfy such contracts. The volume of contracts traded and the high standardization of the contracts demonstrate the essential investment character of the 15-day Brent market. 'With an eye toward [their] underlying purpose,' the Court concludes that Transnor's 15-day Brent transactions constitute futures contracts.[45]

With respect to Transnor's assertions, the court found there were issues of material fact, and denied the motion for summary judgment.[46]

2. Industry Response to *Transnor*

The *Transnor* decision opened up a can of worms for oil companies and traders in the Brent market – whether the CFTC would begin to regulate the hitherto unregulated 15-day Brent market, and whether the Brent contracts were legally invalid under the CEA because they had not been traded on an approved exchange. NYMEX President Patrick Thompson reflected the market's worry over the ruling, stating the *Transnor* decision "creates a concern that these are off-exchange futures contracts, which are illegal under Section 4(a) of the Commodity Exchange Act. If this holding stands, the 15-day Brent market would have to be discontinued in the U.S."[47]

At the time the *Transnor* decision was issued, the CEA did not provide the CFTC with any flexibility as to how futures contracts were to be regulated. Under the CEA as it then existed, once an instrument was determined to be a futures contract, it was required to be traded on an approved exchange in accordance with all of the rules and regulations regarding exchange-traded contracts, or else be considered illegal. As the *Transnor* decision highlighted, this "all or nothing" regulatory scheme, which had existed since the original Act was passed in 1922, may have been adequate to deal with conventional contracts for the sale or delivery of agricultural commodities, but it did not provide any flexibility as to how to best deal with the swaps, derivatives, hybrids, and other novel financial instruments that had developed since the early 1980s.

The participants in the Brent market reacted swiftly. Several major oil companies and traders, including Shell, stopped trading 15-day Brent contracts with American firms; others, such as Exxon, suspended all trading in 15-day Brent contracts.[48] "The Transnor case has

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[45] *Id.* at 1492.

[46] The remaining defendants, Conoco and Exxon, settled approximately one month later. The terms of the settlement were sealed. Platt's Oilgram News, *Brent 15-Day Market Case Settled; Terms Expected to be Sealed, Say Lawyers*, May 23, 1990. The New York Times, *Suit on Price of Crude Oil is Settled*, May 23, 1990.

[47] Platt's Oilgram News, *NYMEX President Warns Forward Market Players of Risk From Transnor Ruling*, May 15, 1990. Thompson stated NYMEX would support a clarification by the CFTC that provided an exclusion from regulation of the 15-day Brent market for "true commercial interests."

[48] Platts Oilgram Price Report, *Basin Users Turn to ARCO Portion*, May 2, 1990; Steven Butler, *Nervous Trading in a Market Held in Limbo*, Financial Times (London), May 3, 1990.

scared Brent's traders," reported *The Economist*. "Many have quit the Brent market altogether, hedging instead on America's NYMEX and London's International Petroleum Exchange, the two big official oil-futures exchanges."[49]

Within days of Judge Conner's decision, lobbyists descended upon the CFTC, seeking to mitigate the ruling.[50] "What the CFTC will do next is uncertain," an article in *Platts* stated, "but the lobbyists reportedly were urging the CFTC to state that it will not regulate the 15-day Brent market. One source said the judge's ruling did not mandate that the CFTC regulate Brent trade. Instead, it stated only that Brent trade was not 'forward' trading as defined by the Commodities Exchange Act, but instead is 'futures' trading."[51]

The British government promptly weighed in against the *Transnor* decision too. In a letter sent to the CFTC less than two weeks after the decision, Britain's Department of Trade and Industry (DTI) stated that the decision could be interpreted to mean that all trading in 15-day Brent contracts, even such trading between British persons within British territory, was subject to the U.S. commodities laws. This interpretation, according to the DTI, was "in the British government's view, contrary to international law and damaging to the British national interest." The DTI expressed particular concern that trades of 15-day Brent contracts within the U.K. could be declared illegal or void in the U.S. The DTI proposed an urgent meeting with the CFTC to resolve the issue.[52]

In response to the concern over the *Transnor* decision, the CFTC immediately began "an examination" of the Brent issue.[53] "The probe appears to be triggered as much by pressure from Brent market participants as by Conner's ruling," *Platts* reported.

Seven days after the *Transnor* decision, the CFTC announced it was "considering actions appropriate to maintain United States commercial access" to the Brent market and committed

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[49] The Economist, *Oil Trading; Brent Blues*, April 28, 1990. Because of the lack of transparency of the Brent physical market, it is not possible to determine with any degree of accuracy just how much the market was affected by the *Transnor* decision. One British publication reported that by the time the *Transnor* case was settled, about six weeks after the ruling, the 15-day Brent market had lost "at least two thirds of its liquidity." Larry Black, The Independent (London), *Firms in Brent Oil Trial Agree to Settle Out of Court*, May 23, 1990. In his dissent from the CFTC's subsequent decision to exempt 15-day Brent contracts from regulation, Commissioner West quoted from several articles by *Petroleum Argus*, a leading price reporting service, that despite the *Transnor* decision Brent trading in April 1990 was higher than in April 1989 and not much lower than in April 1988, and that Brent trading had been steadily increasing since June 1990. CFTC, *Statutory Interpretation Concerning Forward Transactions*, Dissent of Commissioner West, Commodity Futures Law Reports, Commerce Clearing House ¶24,925 (October, 1990).

[50] Platts Oilgram Price Report, *Companies Still Sorting Transnor Impact; Brent Market Liquidity Impacted*, April 24, 1990.

[51] *Id.*

[52] Platts Oilgram News, *UK Agency Expresses Concern Over Conner Ruling on Brent Trading,* May 2, 1990; The Financial Times (London), *Britain Challenges US Jurisdiction Claim over Brent Crude Oil Market*, May 2, 1990.

[53] Robert Di Nardo, Platts Oilgram Price Report, *CFTC Begins Study of Brent Market Trading*, April 25, 1990.

itself to act "as expeditiously as possible."[54] According to *Platts*, "The CFTC issued its advisory in response to calls from Brent players who have been uncertain whether they can continue to trade paper Brent from the US after a ruling by a federal district court last week . . . that the Brent 15-day contract is a futures contract."[55]

3. CFTC: 15-Day Brent Contracts are Forward Contracts

In response to the concerns of oil companies and traders, financial institutions, and the British Government, CFTC Chairwoman Wendy Gramm quickly concluded the CFTC should not assert authority over the Brent market. In a speech to the Futures Industry Institute on May 2, 1990, Chairwoman Gramm "indicated aversion to regulating the 15-day Brent market," stating it is "not true that any instrument with a bit of futurity is a futures contract and therefore within the CFTC's jurisdiction."[56]

Shortly afterwards, in mid-May, the CFTC reaffirmed that position. The CFTC and the British Department of Trade and Industry issued a joint release stating, "The Brent market is an international market and cannot be regarded as or regulated as if it were exclusively a U.S. market."[57] Concurrently, the CFTC staff sent a letter to the companies that had contacted the CFTC on the *Transnor* decision, stating:

> As represented to the staff, it is our understanding that the market in 15-day Brent contracts among other things involves negotiated transactions between commercial parties, each of whom has the capacity to make or take delivery of Brent crude oil. These contracts are not offered or sold to the general public. Based on these representations the Task Force is of the view that these contracts fall within the category of transactions encompassed by the so-called forward contract exclusion.[58]

The letter went on to say that the CFTC likely would issue a formal interpretation of the CEA consistent with this view, and, in the meantime, "the staff will not recommend to the Commission any enforcement action under the Commodity Exchange Act or regulations there under based solely upon the activity of engaging in transactions involving such contracts."[59]

In late September 1990, the CFTC issued, by a three to one vote, a formal "statutory interpretation" to make clear that 15-day Brent transactions "are excluded from regulation under

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[54] CFTC Advisory No. 31-90, April 25, 1990; Platts Oilgram Price Report, *CFTC Looking to Act Quickly on Brent Market*, April 26, 1990.

[55] *Id.*

[56] Platt's Oilgram Price Report, *Gramm Speaks Out on Brent Regulation*, May 3, 1990.

[57] CFTC New Release No. 3248-90, May 16, 1990; Hattie A. Wicks, The Oil Daily, *U.S., British Agencies Reject Plans to Regulate Brent Forward Market*, May 17, 1990.

[58] The Oil Daily, *CFTC Outlines its View of Brent Trade*, May 17, 1990.

[59] *Id.*

the [CEA] as sales of cash commodities for deferred shipment or delivery."[60] In determining that the 15-day contracts were forward contracts, the CFTC stated "it is significant that the transactions create specific delivery obligations. Moreover, the delivery obligations of these transactions create substantial economic risk of a commercial nature to the parties required to make or take delivery there under," such as theft, damage, or deterioration of the crude oil to be delivered. The CFTC majority noted that obligations for sale or delivery under the 15-day contracts were not discharged through "exchange-style offset," but rather could be cancelled only through individually negotiated agreements with the other parties in the distribution chain. "Under these circumstances," the majority concluded, "the Commission is of the view that transactions of this type which are entered into between commercial participants in connection with their business, which create specific delivery obligations that impose substantial economic risks of a commercial nature to these participants, but which may involve, in certain circumstances, string or chain deliveries of the type described above, are within the scope of the [forward contract] exclusion from the Commission's regulatory jurisdiction."[61]

Commissioner Fowler C. West dissented. Commissioner West questioned whether the market had been so severely disrupted as to warrant such extraordinarily quick action on a complex issue. He questioned whether the majority's action, which he termed a significant change from existing law, was more properly classified as a rulemaking, which would require notice-and-comment, rather than a statutory interpretation accompanied by a media advisory.

Commissioner West's dissent referenced the comments of the Chicago Board of Trade (CBT), which noted that the current methods for clearing and settlement in the 15-day Brent market were really the same as the antiquated clearing and settlement methods previously used on the CBT more than 70 years ago, before the CBT created a clearing corporation for all trades on the exchange. "The CBT stated that at the time Congress first restricted futures trading to designated exchanges, CBT used a 'ring' method of clearing and settlement closely resembling today's Brent market. CBT argues that 'rather than distinguishing 15-day Brent contracts from futures contracts, the daisy chains, book-outs and cancellation agreements of circles and loops confirm that the 15-day Brent market is composed of the very kind of transactions intended to be regulated as futures contracts.'"[63]

The dissent also noted that the 15-day contracts were highly standardized, and that many of the companies urging the CFTC not to regulate the 15-day Brent market as a futures market had stated that these contracts were used for hedging and price discovery, which is the primary

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[60] 55 Fed. Reg. 39188 (Sept. 25, 1990). On June 29, 1990, the CFTC had issued a draft statutory interpretation to the same effect. The draft statutory interpretation was not published in the Federal Register, the usual manner for public notice, but rather announced in a CFTC advisory, CFTC Advisory No. 49-90, June 29, 1990, which was sent only to several media outlets. The Advisory stated that a copy of the draft interpretation was available from the Commission's Office of Communication and Education Services, and that public comments were invited until July 13, 1990. About a dozen comments were received.

[61] *Id.*

[63] West Dissent, at 10.

purpose of the futures markets.[64] He also observed that traders in the 15-day Brent market included speculators and traders who had no intention of ever taking or making delivery. "Those commenters seem to want the Commission to exclude from regulation even those hedging and pricing activities which Congress determined the Commission should regulate under the Commodity Exchange Act."[65]

In conclusion, he wrote, "Broadening the applicability of the forward contract exclusion to include transactions by traders who are speculators, who are not contemplating delivery, who are using generally standardized contracts, who routinely offset their positions and who do not use the underlying commodity itself is an erroneous interpretation of the Act."

Although he disagreed with the majority's conclusion that the 15-day Brent contracts were forward rather than futures contracts, Commissioner West did not believe the 15-day contracts needed to be traded on designated U.S. exchanges. He suggested several alternatives for the treatment of the 15-day Brent market that, in his opinion, would preserve the legal validity of these contracts without changing the meaning of the forward contract exclusion. His preferred alternative would be for Congress to provide the CFTC with the authority to exempt certain transactions from the exchange-trading requirement:

> The cleanest way for the Commission to permit such markets to operate without contract market designation would be for it to have the authority to exempt certain transactions by rule, regulation or order from the exchange trading limitation of Section 4(a) of the Act, when in the public interest to do so. The Brent situation may demonstrate the desirability of such authority. Congress could provide the Commission such exemptive authority, and the Commission could then exercise that authority in a manner recognizing historic concerns about fraud and manipulation.[66]

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[64] *See*, *e.g.*, Comment Letter of Phibro Energy, Inc., May 2, 1990 ("The participation by such entities in these markets provides price protection for the participants both in the Brent and related physical markets and adds significantly to the market's depth, liquidity, pricing efficiency and pricing transparency."); Comment Letter of Mobil Oil Corp., May 2, 1990 ("Because of its relevance in the pricing of a wide variety of international crude oils equity producers, refiners and traders also enter into 15-day Brent contracts to manage their price exposure in the market); Comment Letter of Bear Stearns, April 30, 1990 ("The Brent crude oil market is used regularly by Bear Stearns for its commercial needs, including as a hedging mechanism for non-U.S. oil that, in Bear Stearns' view, cannot be as efficiently protected under the New York Mercantile Exchange's futures contract which is sensitive to domestic economic developments."); *see also* Comment Letter of Mobil Oil Corp. on Regulation of Hybrid and Related Instruments, April 11, 1990 ("Mobil and other major participants in these markets often enter into transactions to manage price risk, rather than to transfer ownership of the underlying product.").

[65] West Dissent, at 12.

[66] West Dissent, at p.19. In an unusual move for a federal regulatory agency, the CFTC majority – Chairwoman Gramm and Commissioners Kalo Hineman and William Albrecht – blocked the official publication of Commissioner West's views. As a result of the majority's action, in 1992, Congress amended the CEA to require the publication of all dissenting opinions. "Whenever the Commission issues for official publication any opinion, release, rule, order, interpretation, or other determination on a matter, the Commission shall provide that any dissenting, concurring, or separate opinion by any Commissioner on the matter be published in full along with the

A couple of months later, "still steamed" about the majority's handling of the Brent issue, Commissioner West again took issue with the majority's actions.[67] In a public speech, Commissioner West expanded his criticisms of the procedures used by the majority for its new interpretation of the forward contract exclusion:

> While the standard notice and public comment procedures of rulemaking were not followed in issuing the statutory interpretation, some dozen comments were received. Even though the Commission issued a press release inviting comments on the draft statutory interpretation, this severely limited opening in the decision-making process occurred only after some individual commissioners became concerned about the scope of the interpretation's coverage and insisted that some public participation was necessary. Those instincts were correct and should have been followed farther.
>
> At the very least the Commission, as an expert agency, is obligated to take its own hard look at an issue. This was not done. Instead, the majority of the Commission seems to have relied on the representations of parties with a substantial stake in the outcome of our action. . . . The Commission has not made its own independent study of [the Brent] market, nor has it taken appropriate steps to seek out the views of those parties who might oppose the proposition that Brent transactions are forward contracts, as it likely would have obtained in a rulemaking. These were the minimum steps that we should have taken.[68]

Commissioner West again stated that the Brent contracts were "largely indistinguishable from futures contracts." Furthermore, he warned: "The Commission may soon be paying a price for its politically expedient statutory interpretation. I doubt that its new forward contract exemption can be restricted to large international oil and trading firms represented by influential lawyers. The public, down the road, will suffer from this fit of de-regulation, no matter how well-intended. I believe Congress expects us to have more concern for the public."[69]

Later, the North American Administrators Association (NASAA), representing "the 50 state securities agencies responsible for investor protection and the efficient functioning of the capital markets at the grassroots level," characterized the CFTC's response to the *Transnor* as "quick, but beyond its authority and misguided. In its attempt to calm oil traders, producers, and

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Commission opinion, release, rule, order, interpretation, or determination." 7 U.S.C.A. §4a(h)(3) (West 1999 & Supp 2002).

[67] Securities Week, *CFTC May Not Be Able to Live Down "Mistake" on Brent Oil Decision*, December 3, 1990.

[68] Remarks by Commissioner Fowler C. West, CFTC, *The Brent Issue: More Than A Statutory Interpretation*, Before the Committee on Commodities and Futures Law, New York State Bar Association, November 29, 1990.

[69] *Id.*

purchasers, the CFTC went too far."[70] The state regulators viewed the CFTC's statutory interpretation as incorrect and dangerous:

> The CFTC's solution was a bad one. It decided to "overrule" the Transnor court and, in effect, create an exemption. Since it lacked exemptive authority, however, it chose to alter the traditional definitional elements of a futures contract. The Commission arbitrarily announced, under the guise of merely "interpreting" the law, that a new standard now existed. As a result, the CFTC interpreted away its own jurisdiction and disclaimed authority over a broad category of products. The Commission seemed not to care that by changing the definition of a futures contract, the new criteria threatened to shield fraud in the trading of other commodities – a hefty price to pay for helping the oil companies.[71]

Shortly after he left the CFTC, Commissioner William Albrecht provided this description of the reasoning underlying the CFTC's Brent interpretation:

> [Hybrids, swaps and Brent contracts] had some, but not all, of the characteristics of a futures contract. The law, however, did not contemplate the existence of a partial futures contract – it was a futures contract or it was not. In each case, however, the Commission found a way to rule that it would not regulate these instruments, even though they did contain futures or options-like components. The Commission believed there was not need to extend its regulatory system to these instruments, either because they were regulated elsewhere (hybrids) or the participants did not need the type of regulation provided by the CFTC (swaps and Brent oil contracts).[72]

Philip McBride Johnson, Chairman of the CFTC in the early 1980s, has since criticized the CFTC's Brent interpretation for muddying the test for when an instrument is a futures contract under the CEA: "[T]he historical litmus test which was coldly objective (no delivery? not a forward contract) has been displaced by a devotion to form and process."[73] The former Chairman also described the relief in the financial markets that followed the CFTC's 1989 swaps policy statement and 1990 Brent statutory interpretation: "With the CFTC's withdrawal from regulating many of the more popular derivatives in the late 1980s and early 1990s, it appeared that dealers in those financial products had found a virtually regulation-free promised land."[74]

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[70] Hearing Before the House Subcommittee on Environment, Credit, and Rural Development, Committee on Agriculture, *To Amend the Commodity Exchange Act to Ensure the Continued Application of The Act's Antifraud and Antimanipulation Protections*, Statement of Wayne Klein, on behalf of NASAA, June 30, 1993.

[71] *Id.*

[72] William P. Albrecht, *Regulation of Exchange-Traded and OTC Derivatives: The Need for a Comparative Institution Approach*, 21 Iowa J. Corp. L. 111, 125 (1995).

[73] Philip McBride Johnson, *Derivatives*, at 40 (1999).

[74] *Id.*

C. Exemptions for Energy Contracts

1. Futures Trading Practices Act of 1992

Summary: Congress provided the CFTC with discretion to exempt certain swaps and energy contracts that could be considered to be futures contracts from CEA requirements.

Although the CFTC quickly countered the *Transnor* decision with its statutory interpretation relating to the Brent market, the CFTC's actions did not eliminate the concern that another court could declare certain derivatives, including swaps and energy contracts, illegal under the CEA because they were not traded on a designated futures exchange.[75] Firms and traders pressed Congress for a statutory amendment to the CEA to ensure it would not be interpreted by courts in a manner that would invalidate existing contracts and markets.

In 1992, Congress enacted the Futures Trading Practices Act (FTPA) to amend the CEA to provide the CFTC with discretion to determine that future contracts – or other instruments that might be considered to be futures contracts – did not have to be traded on a designated futures exchange. The Conference Report accompanying the 1992 Act explains the rationale for the exemptive authority:

> [T]he conferees recognized the need to create legal certainty for a number of existing categories of instruments which trade today outside of the forum of a designated contract market. These instruments may contain some features similar to those of regulated exchange-traded products but are sufficiently different in their purpose, function, design, or other characteristics that, as a matter of policy, traditional futures regulation and the limitation of trading to the floor of an exchange may be unnecessary to protect the public interest and may create an inappropriate burden on commerce.[76]

The FTPA established the principle that although a contract may have some features of a futures contract, it does not necessarily have to be traded on a designated exchange. It provided the CFTC with the flexibility to determine the appropriate level of regulation for novel types of financial instruments, such as swaps and derivatives, that were becoming popular in the market.[77]

The report of the Senate Committee on Agriculture, Nutrition, and Forestry accompanying the Senate bill explained that in order to foster the development of new financial instruments the CFTC needed to have the flexibility to determine whether such new instruments that had some elements of a futures contract need be traded on an approved exchange:

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[75] See, e.g., Securities Week, *Legislation Needed to Resolve Ambiguities Left by Transnor Settlement*, May 28, 1990; Business Law Brief, *Brent Litigation Settled*, June 1, 1990.

[76] H.R. Rept. No. 102-978, 102nd Cong., 2nd Sess. 81 (1992).

[77] P.L. 102-546, 106 Stat. 3590 (1992).

> Since 1974, when Congress created the CFTC, the principle of "functional" regulation was intended to govern the introduction of new financial instruments: "the CFTC would * * * regulate markets and instruments that would serve a hedging and price discovery function and the SEC would regulate markets and instruments with an underlying investment purpose." S.Rep. No. 384, 97th Cong., 2nd Sess. 22 (1982).
>
> But increasingly, this principle has become blurred as novel "hybrid" instruments are developed. Bonds – a traditional security – can be transformed to offer a return indexed to the price of a commodity like oil or gold. The final product may have significant attributes of a commodity option or future.
>
> This lack of clarity over the extent of CFTC jurisdiction with respect to new "hybrids" and the statutory requirement that all futures contracts must trade on designated contract markets have combined to create a legal cloud that may inhibit the emergence or development of many such markets. Under current law, the CFTC has the power to permit a commodity option to trade off exchange in accordance with CFTC rules, but the CFTC has no authority to exempt any futures product from the exchange-trading requirement. This disparate treatment could prevent the CFTC from permitting the introduction of many economically useful new products to the marketplace.[78]

Generally, the FTPA authorized the CFTC to exempt various swap and hybrid transactions from the exchange-trading requirements and other provisions of the CEA. Specifically, the FTPA authorized the CFTC, either on its own initiative or upon application of any person, to exempt from the exchange-trading requirement, or any other requirement of the CEA, "any agreement, transaction, or class thereof" between "appropriate persons."[79] The types of agreements that Congress intended the CFTC to initially exempt under this authority included a variety of OTC derivatives, such as non-standardized swap agreements, "hybrid instruments that are predominantly securities or depository instruments," forward contracts, and bank deposits and accounts. The "appropriate persons" who could be authorized to trade in these instruments off-exchange included large commercial institutions, such as banks, savings associations, insurance companies, investment companies, commodity pools, large corporations, employee benefit plans, governmental entities, securities brokers, and futures merchants and brokers.

Congress qualified this broad exemptive authority in several respects. First, the Conference Report emphasized that the exemptive authority should be applied narrowly to the four specified categories of instruments – swaps, hybrids, forward contracts, and bank deposits

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[78] S. Rep. No. 102-22, 102nd Cong., 1st Sess.6 (1991).

[79] Section 4(c)(1) of the CEA, as amended by the FTPA, provides the CFTC with authority to exempt from the CEA, "any agreement, contract, or transaction (or class thereof) *that is otherwise subject to subsection (a)* . . ." (emphasis added). The contracts that are "otherwise subject to subsection (a)" are futures contracts "for the purchase or sale of a commodity for future delivery," which, under the CEA, "does not include any sale of any cash commodity for deferred shipment or delivery," i.e., a forward contract. 7 U.S.C.A. §§1a(11), 6(a), (c) (West 1999 & Supp. 2000).

and accounts. The conferees stated that any further exemptions should be granted only after further study and deliberation by Congress:

> The goal of providing the Commission with broad exemptive powers is not to prompt a wide-scale deregulation of markets falling within the ambit of the Act. Rather, it is to give the Commission a means of providing certainty and stability to existing and emerging markets so that financial innovation and market development can proceed in an effective and competitive manner. Except as discussed below, the Conferees do not intend for the Commission to use this authority to grant broad exemptions from the Act for instruments or markets before these studies are completed and Congress has ultimately decided the issues raised by them.[80]

The conferees specifically directed the CFTC to consider whether to grant the 15-day Brent market an exemption under this new authority:

> One court has found transactions in the Brent crude oil market to be futures contracts. See *Transnor (Bermuda) Limited v. BP North America Petroleum*, 738 F.Supp. 1472 (1990). In response, the Commission has issued a statutory interpretation to the effect that certain transactions in that market qualify as sales of cash commodities for deferred shipment or delivery, that is, forward contracts, and, as such, are not subject to regulation under the Act.
>
> Many markets of this nature are international in scope; foreign parties are already engaging in such transactions free of restraints imposed by the Act that may create competitive disadvantages for U.S. participants.
>
> Without expressing a view regarding the applicability of the Commission's statutory interpretation, the Conferees encourage the Commission to review this situation and these contracts to determine whether exemptive or other actions should be taken.[81]

Second, in determining whether to grant any exemption, Congress intended that the CFTC nonetheless be able to effectively regulate the affected markets within its jurisdiction. Before granting any exemption, the CFTC was required to find that such exemption would be "consistent with the public interest" and the purposes of the Act, and "will not have a material adverse affect on the ability of the Commission or any contract market to discharge its regulatory or self-regulatory duties under this Act."

The Conference Report emphasized that in granting exemptive authority for certain instruments it was not making any determination that such instruments were futures within the scope of the Act, and that in making any determination to exempt instruments from the exchange-trading requirement the CFTC need not make any such determination. "Rather, this

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[80] H.R. Rept. No. 102-978, at 81.

[81] *Id.* at 82.

provision provides flexibility for the Commission to provide legal certainty to novel instruments where the determination as to jurisdiction is not straightforward."[82]

Passage of the FTPA reduced the importance of categorizing financial instruments as futures or forward contracts. Under the FTPA, even if an instrument is classified as a futures contract within the jurisdiction of the CFTC, as opposed to a forward contract outside of the scope of the CEA, the CFTC may determine that the exchange-trading requirement or other requirements of the CEA do not apply.

2. CFTC Exemption for Energy Contracts

Summary: The CFTC exempted energy contracts between large companies from the exchange-trading requirement and the anti-fraud provisions of the CEA.

a. CFTC Order Granting Exemption

The Futures Trading Practices Act was signed into law on October 28, 1992. Two and a half weeks later, on the 16th of November, nine crude oil, natural gas, and other energy businesses filed with the CFTC an application for an exemption under the new Act from the exchange-trading requirement for certain transactions in energy contracts.[83]

On January 21, 1993, on the final day of the Administration of President George H.W. Bush, the CFTC approved a final rule exempting certain non-standardized swap agreements from the requirement that all futures contracts be traded on a designated exchange.[84] At the same time, it issued a proposed order granting a similar exemption to large commercial participants in various energy contracts.[85]

On April 20, 1993, the CFTC approved, by a 2 to 1 vote, a final order granting an exemption for energy contracts from the exchange-trading requirement of the CEA, "thereby formalizing with an express order a previous interpretative order which stemmed from the Brent Oil-Transnor dispute."[86] The CFTC's final order applied only to contracts among a limited class

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[82] *Id.*

[83] The nine firms were BP Oil Company, Coastal Corporation, Conoco Inc., Enron Gas Services Corp., J. Aron & Company, Koch Industries, Inc., Mobil Sales and Supply Corp., Phibro Energy Division of Solomon Inc., and Phillips Petroleum Company. Hearing Before the House Subcommittee on Environment, Credit, and Rural Development, Committee on Agriculture, *To Amend the Commodity Exchange Act to Ensure the Continued Application of the Act's Antifraud and Antimanipulation Protections*, June 30, 1993, at 132.

[84] 55 Fed. Reg. 5587 (1993). The CFTC's rule adopted the same definition of "swap agreement" that is used in the Bankruptcy Code, 11 U.S.C. 101 (55), and limited the exemption's applicability to a subset of "appropriate persons" that were termed by the rule as "eligible swap participants." The swap agreements that were eligible for the exemption could not be "part of a fungible class of agreements that are standardized as to their material economic terms."

[85] 58 Fed. Reg. 6250 (1993).

[86] Securities Week, *CFTC Has Split Vote Over Regulatory Exemption for Forward Energy Contracts*, April 19, 1993; 58 Fed. Reg. 21286 (1993).

of large commercial participants who were "appropriate persons" under the FTPA, such as a bank, trust company, large corporation, securities broker-dealer, or a futures commission merchant. To qualify for the exemption, these commercial participants must, in connection with their business activities incur risks, in addition to price risks, related to the underlying physical commodities, such as the risks of damage in transit, and the participants in the transaction also must be able to make or take delivery of the commodity.

The final order was not limited to Brent contracts, but applied to a broad class of energy contracts "for the purchase and sale of crude oil, condensates, natural gas, natural gas liquids or their derivatives which are used primarily as an energy source." To qualify for the exemption, such contracts must be: (1) between covered commercial participants; (2) individually negotiated; and (3) impose binding obligations to make and receive delivery of the underlying commodity. With respect to the latter condition, the CFTC's order stated that there must be "no right of either party to effect a cash settlement of their obligations without the consent of the other party . . . *provided, however*, that the parties may enter into a subsequent book out, book transfer, or other such contract which provides for the settlement of the obligation in a manner other than by physical delivery of the commodity specified in the contract."[87]

Although the final order exempted these energy contracts from the exchange-trading requirement, the CFTC stated it would continue to apply the basic statutory authorities under sections 6(c), 6c, 6(d), and 9(a)(2) of the CEA to prevent manipulation.[88] The CFTC stated that these anti-manipulation provisions will continue to apply, "to the extent that these provisions prohibit manipulation of the market price of any commodity in interstate commerce or for future delivery on or subject to the rules of any contract market . . ."

In the most controversial aspect of its decision, the CFTC stated that the anti-fraud provisions of the CEA would *not* continue to apply to energy contracts. The CFTC majority stated that most comments agreed with the views expressed by one commenter, that "'given the commercial characteristics of these transactions and the significant requirements to be 'commercial participants' and 'appropriate persons,' the [commenter] * * * does not believe that

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[87] In a reference to the daisy-chain method of settling 15-day Brent contracts, the CFTC explicitly clarified that the obligation to take delivery could be satisfied "regardless of whether the buyer lifts or otherwise takes delivery of the cargo or receives pipeline delivery, or as part of a subsequent contract, passes title to another intermediate purchaser in a 'chain,' 'string' or 'circle' within a 'chain.'"

[88] Section 6(c) provides the CFTC with authority to issue a show cause order and conduct a subsequent administrative hearing to prohibit any person from trading if there is reason to believe the person has manipulated, attempted to manipulate, or is manipulating or attempting to manipulate the market price of any commodity. 7 U.S.C.A. §§9, 15 (West 1999 & Supp. 2002).

Section 6c authorizes the CFTC to bring an action in federal court to obtain a temporary or permanent injunction or restraining order whenever it appears that any person has violated or is about to violate any provision of the CEA or CFTC rule. 7 U.S.C.A. §13a-1 (West Supp. 2002).

Section 6(d) authorizes the CFTC to issue cease and desist orders in manipulation cases, and levy civil penalties for failure to obey such orders. *Id.* at §13b.

Section 9(a)(2) makes manipulation of or attempts to manipulate the price of a commodity a felony punishable by a fine of up to $1,000,000 and imprisonment of up to five years. *Id.* at §13.

section 4[4b] of the Act (anti-fraud) should be applied to Energy Contracts.'" The majority stated, "In this particular instance, the Commission concurs with the commenters that it need not retain section 4b authority, to whatever extent that section of the Act would otherwise be applicable to these transactions."

In his concurring opinion, Acting Chairman William Albrecht explained the CFTC "has never regulated this market, nor has sought to regulate it." Further, he stated, "The Commission is not aware of fraudulent practices perpetrated against the general public by the participants in this market, nor indeed have any of the commercial participants in this market complained to the Commission of any fraudulent practices by other participants." Because this market "is characterized by principal to principal transactions between large sophisticated commercial entities," the Acting Chairman wrote, "there generally do not appear to be any concerns about the ability of these market participants to perform their obligations." Acting Chairman Albrecht wrote, "There does not appear to be any reason sufficient to justify commission regulation, nor any necessity for the Commission to involve itself in this market."

Just before the CFTC's final vote granting this exemption, the Acting Chairman emphasized his view that the CFTC had no knowledge of the energy markets and therefore had no ability to monitor those markets. "In fact," Albrect stated, "the CFTC does not and cannot supervise this market."[89]

Commissioner Sheila Bair dissented from the majority's "failure to retain the general anti-fraud provisions contained in section 4b and 4o of the Commodity Exchange Act." She criticized the majority's reasoning in several ways. First, she wrote, the Commission "has never recognized an exemption to its jurisdiction based solely on the 'commerciality' of the participants, nor can I see any policy reason why commercial firms engaging in futures transactions should not have the basic protection of our anti-fraud provisions."

Commissioner Bair also disagreed with the majority's position that sophisticated market participants do not need the anti-fraud protections of the CFTC, arguing that "if we are to rationalize exemptions from anti-fraud and other components of our regulatory scheme on the basis of 'sophistication' of market users, we might as well close our doors tomorrow, because approximately 98% of users of regulated, exchange-traded futures" would meet the eligibility requirements of the exemption.

Commissioner Bair stated that the exemption from the anti-fraud provisions went far beyond what was necessary in the case at hand and set a "dangerous precedent":

> What is especially frustrating to me is that we do not need to paint ourselves into this corner. The main reason why the CFTC sought general exemptive authority in last year's reauthorization was so that we would have the flexibility to craft appropriately tailored exemptive relief based on public policy considerations, instead of having to deal with the "all or nothing" jurisdictional decisions we had to make in the past. Yet, we are still following this "all or nothing" approach,

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[89] Alan Kovski, *CFTC Exempts Cash Market from Controls*, The Oil Daily, April 14, 1993.

> when in my view, we should be carefully weighing individual aspects of our regulatory structure and making a reasoned determination as to which requirements should and should not apply to a particular class of transactions. And, for the reasons I have stated, I do not believe the case has been made for providing an exemption from basic anti-fraud provisions.

A *Washington Post* article also sounded this cautionary note as to the potential effect of this exemption for energy contracts:

> The CFTC's decision not to regulate energy contracts means the federal government will have no way of monitoring these growing markets in which huge sums of dollars change hands every year. If a big player failed to make good on a contract, the other participant might suffer such huge losses that it, too, would default on contracts, sending the ripples throughout the financial system.[90]

At the time of this CFTC decision in 1993, the collapse of Enron and the evidence of fraud and manipulation in energy markets in the late 1990s were still several years in the future.

b. Congressional Hearings on CFTC Order

Barely a week after the CFTC granted the exemptions for energy contracts, Representative Glenn English, Chairman of the House Agriculture Subcommittee with jurisdiction over the CFTC, held a hearing on the CFTC's decision to exempt these contracts from the CEA's anti-fraud provisions.[91]

Acting Chairman Albrecht defended the Commission's position, contending that retention of anti-fraud authority over the energy markets would actually be worse for the public than granting the exemption. Retention of this authority, in his view, "would inject the illusion of Commission supervision into a market where there is none. In that regard, some may take comfort from the coverage of 4b [anti-fraud authority], but it would be cold comfort indeed without the benefits of any ongoing regulation. After all, the Commission just does not have the resources necessary to adequately regulate these markets. In short, the benefits of extending the coverage of 4b to this market are not apparent."[92]

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[90] Jerry Knight, *Energy Firm Finds Ally, Director in CFTC Ex-Chief*, The Washington Post, April 17, 1993.

[91] John M. Doyle, *House Chairman Slams CFTC Exemption of Off Exchange Energy Contracts*, The Associated Press, April 28, 1993.

[92] Statement of Dr. William P. Albrecht, Acting Chairman, CFTC, Hearing Before the House Subcommittee on Environment, Credit, and Rural Development, Committee on Agriculture, *Review of the Commodity Futures Trading Commission's Discretion to Exempt Certain Transactions from Antifraud Provisions of the Commodity Exchange Act* (hereinafter House April 1993 Hearing), April 28, 1993, at 53.

Dr. Albrecht also voiced the concern that regulation would drive markets overseas: "I am concerned that maintaining section 4b authority over this market would provide little, if any, benefit, and perhaps cause very real harm. If section 4b remains an issue, some international commercial participants will continue to refuse to do business with U.S. energy firms, and some U.S. firms will set up off-shore branches. In short, retaining 4b authority will damage U.S. international competitiveness." *Id.*

Acting Chairman Albrecht made it clear that, in his view, the CFTC should maintain minimal regulatory authority over the energy markets:

> The genius of [the FTPA] authority is that it frees us from the increasingly meaningless debate over whether something is a future or not. Instead, we can concentrate on designing the appropriate regulatory scheme for products that have futures-like characteristics.
>
> We can consider how much regulation by the CFTC is needed based upon the characteristics of the market, such as the customer base, the market's purpose, the potential for fraud, and the availability of other governmental oversight.
>
> For some products, such as the energy contracts under discussion today, this may mean almost no oversight by the CFTC. For others, such as swaps, we've decided to maintain more oversight.[93]

Albrect noted that the participants in the energy markets "are large commercial entities, well aware of their contractual rights and legal remedies," so that they neither needed nor wanted the protections afforded by the statute. "This market has been in operation for over a century, and has gotten along just fine without CFTC oversight," he testified.[94]

Commissioner Bair, who dissented from the CFTC's decision, told the House Subcommittee, "To my knowledge, it is unprecedented for the Commission to provide relief from antifraud protections for transactions that are not subject to the jurisdiction of another regulator."[95]

NASAA, the organization representing the securities agencies of the 50 states, informed the Subcommittee of its concerns regarding "a more general (and disturbing) trend at the CFTC – that is, increasingly inadequate and lax oversight of the commodities markets."[96] NASAA described the energy contract exemption as:

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[93] House April 1993 Hearing, *supra* at 11.

[94] *Id.*

[95] Prior to the decision, several senior CFTC officials had raised concerns with the proposed exemption from the anti-fraud requirements. The CFTC's Director of Enforcement commented there was no precedent in the securities laws for an exception to the anti-fraud protections, stating that "we are not aware of any Securities and Exchange Commission exemption that excludes securities products from anti-fraud jurisdiction." Memorandum from Dennis Klejna, Director, Division of Enforcement, to Gerry Gay, Director, Division of Economic Analysis, April 8, 1993, *reprinted in* Hearing Before the House Subcommittee on Environment, Credit, and Rural Development, Committee on Agriculture, *Amend the Commodity Exchange Act to Ensure the Continued Application of The Act's Antifraud and Antimanipulation Protections* (hereinafter House June 1993 Hearing), June 30, 1993, at 6-7.

Similarly, the Director of the Division of Trading and Markets wrote, "To my knowledge, the Commission has never before exempted transactions in products subject to its jurisdiction from the anti-fraud provisions of the Act unless another regulatory regime clearly applied to such transactions." Memo from Andrea M. Corcoran, Division of Trading and Markets, to Files, *Exemption for Certain Contracts in Energy Products*, April 9, 1993, reprinted in House April 1993 Hearing, *supra* at 85-87.

[96] Testimony of Wayne Klein, NASAA, House June 1993 Hearing, at 144, 147.

> just the latest example of what perhaps may be best characterized as the agency's "reluctance to regulate," even in the face of blatant threats to investors and the integrity of the markets. Worse yet, the Commission has vigorously guarded what it believes to be its "turf," only to turn around and severely limit its own regulatory role. This minimalist approach seems to be one of 'we won't police the area but we don't want anyone else to either.'
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> * * *
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> I am deeply concerned that during the past several years, the CFTC has embarked on a course of abandoning and repudiating its responsibilities to protect the integrity of the categories of energy products from the anti-fraud and anti-manipulation provisions of the CEA is the most recent, and a most egregious, example of this new course. Without active and vigorous oversight, the markets under the CFTC's exclusive jurisdiction invite fraud and abusive trading.[97]

Chairman English took issue with the rationale that large sophisticated players in the market did not need the CEA's protections against fraud:

> I've heard, 'Well, these are big boys. Let them take care of themselves.' I would suggest to you, before this thing is done, as a consequence of your actions, there are going to be some little people that are going to get hurt, too. They may be big in our part of the country, but they're little in this world, and it seems like, that any time when the big people get hurt, they have to fall someplace, and they fall on an awful lot of little people. The little folks end up bearing a good deal of this burden.[98]

Near the end of the hearing, Chairman English expressed his frustration with the CFTC's position:

> It brings us down to the real question of 'What in God's name is the CFTC all about?' If it's not – if we can't even count on the CFTC to protect the public from fraud, if we can't depend on the CFTC not to give away the store, from the standpoint of giving blanket – not exemptions, exclusions – that's an outrage. . . . [w]hen it comes down to opening the door to fraud, that's simply going too far. That's not deregulation, that's just blatant irresponsibility. . . . In the 18 years I've been in Congress, this is the most irresponsible decision I've come across.[99]

Immediately after the hearing, Chairman English "told reporters the acting head of the agency 'would do a real service to the country' if he resigned."[100]

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[97] *Id.*

[98] House April 1993 Hearing, *supra* at 22.

[99] *Id.*, at 44-45. At this hearing Chairman English revealed that during the rulemaking process on the exemption for swap agreements the CFTC had intended to exempt those swap agreements from the anti-fraud provisions as well. Chairman English recounted that when this decision "was barreling down the track about 90 miles an hour," he telephoned Chairwoman Gramm to express his "grave concerns" about this aspect of the decision. *Id.* at 23. The CFTC decided not to include the removal of anti-fraud authority in the final swap agreement exemption.

Two months later, Chairman English held another hearing on the same subject, this time focusing on legislation he had introduced to overturn the CFTC's energy contract order insofar as it exempted such contracts from the CEA's anti-fraud provisions. His bill also would have prohibited the CFTC from granting any exemptions under the FTPA to the anti-fraud and anti-manipulation provisions of the CEA.

In testimony opposing the legislation, the CFTC majority reiterated the rationale it had previously stated in its order and at the prior hearing. But the CFTC went even further, extending its exemptive reasoning to the CEA's anti-manipulation provisions as well. Writing for himself and Commissioner Dial, Acting Chairman Albrecht stated there was no need to retain anti-manipulation authority over the energy markets:

> The concerns raised about eliminating Commission flexibility with regard to anti-fraud jurisdiction also apply to manipulation jurisdiction. There does not appear to be a need for retaining this authority, there will not be significant benefits gained by retaining it generally and there are very real burdens to be placed on the exempt markets.[101]

During this hearing, the CFTC made it clear that it intended to apply the 1990 Brent Statutory Interpretation to the Brent market, and therefore *exclude* the 15-day Brent contracts from all regulation under the CEA, rather than consider them merely *exempt* energy contracts under the new 1993 energy contracts exemption. This distinction between *excluded* forwards contracts, which are not subject to the CEA at all, and *exempt* derivatives contracts, which are subject to a limited form of regulation, first appeared following the CFTC's creation of the 1993 energy contract exemption. This distinction has become increasingly significant following enactment of the Commodity Futures Modernization Act of 2000, which bases a number of provisions upon this distinction.

Commissioner Bair, who opposed the CFTC's broad energy contract exemption, still supported the Brent exclusion. In her testimony in support of Chairman English's bill, she wrote that the bill "will achieve the important goal of ensuring that the anti-fraud and anti-manipulation protections of the Act continue to apply to transactions exempted by the Commission from other regulatory requirements. Preserving such authority in no way implies that particular types of exempted off-exchange transactions such as traditional swaps or 15-day Brent Oil contracts are in fact future contracts subject to CFTC jurisdiction."[102]

Kenneth Raisler, an attorney representing the Energy Group – the nine companies that had applied for the energy contracts exemption – testified that although the Energy Group was "adamantly opposed to fraud in any market," repealing the exemption from the anti-fraud provision would not be effective. According to these companies, the CFTC did not have the ability to regulate energy markets. "In our view, application of the CFTC's antifraud jurisdiction

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[100] John M. Doyle, *House Chairman Slams CFTC Exemption of Off Exchange Energy Contracts*, The Associated Press, April 28, 1993.

[101] House June 1993 Hearing, *supra* at 101.

[102] *Id.* at 104-5.

only confuses the picture. The CFTC has never overseen or been involved in policing these markets. I believe that is just a critically important point. Without the staff or the expertise, retaining antifraud jurisdiction could create a misleading impression about the CFTC's abilities."[103]

The Chairman of the Chicago Board of Trade, Patrick Arbor, testified as to the higher burden of proof the various CFTC exemptions imposed for claims of fraud and manipulation in the energy markets:

> Under the swaps exemption, anyone manipulating the price of an exempt swap would not violate the CEA unless that manipulation effected a ripple manipulation on a futures exchange or in the cash market as a whole. The swaps exemption also may be illusory or at least cumbersome when it comes to fraud. Any fraud action would require the complaining party to prove first that the swap is a futures contract and second that fraud occurred. Other than shielding wrongdoing, no reason exists to make the complaining party make a double showing. The energy contract exemption has the same flaw in the manipulation area as the swaps exemption and contains no antifraud provision.[104]

Chairman English's bill was reported out of his subcommittee, but made it no further in the legislative process.

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[103] House June 1993 Hearing, *supra* at 121. In an exchange with Rep. Jim Nussle (R-Iowa), Mr. Raisler confirmed that the Energy Group wanted no regulation at all of energy contracts under the federal commodity laws, regardless of the CFTC's abilities:

> Mr. NUSSLE: OK, but the bottom line though is that the real remedy that you are prescribing in the alternative of this legislation is the civil courts. You are basically saying let the buyers beware, let the market beware, and you are on your own, you take care of it on your own. You have to investigate it, you have to uncover it, you have to be aware of it, and then you have to prosecute it.
>
> Mr. RAISLER: And let me point out, as a general matter in this country the buying and selling of goods, whether they be energy or any other kind of product, find themselves with that remedy, yes.
>
> * * *
>
> Mr. NUSSLE: And the Government has no place regulating or monitoring that particular transaction, in your opinion?
>
> Mr. RAISLER: The Government never has, and so we see no reason for them to start now.

Id. at 131.

[104] Statement of Patrick H. Arbor, Chairman, CBOT, Hearing *To Amend the Commodity Exchange Act to Ensure the Continued Application of the Act's Antifraud and Antimanipulation Protections*, June 30, 1993, at 134-5 (emphasis added).

D. The Commodity Futures Modernization Act of 2000

1. Regulatory Uncertainty Following the FTPA

Although the Congress attempted to clarify the legal status of certain derivative and swap instruments with the passage of the FTPA in 1992, subsequent events led to continued uncertainty and renewed calls for Congressional clarification. Most of these issues concerned the regulation of financial swaps and derivatives. Concerns intensified after a 1995 CFTC enforcement proceeding alleging market manipulation by MG Refining and Marketing, Inc. and MG Futures, Inc., the CFTC again sought to define "all the essential elements of a futures contract." Although the CFTC indicated it did not intend to change the meaning of a futures contract under the CEA, and did not seek to impose new regulations upon the swaps and derivatives industry, the CFTC's action nonetheless raised anew the concerns that these instruments could someday be declared unenforceable as illegal futures contracts.[105]

A "concept release" issued by the CFTC in May 1998, to "reexamin[e] its approach to the over-the counter derivatives market" also caused alarm in the financial community.[106] Although the CFTC stated that the release "in no way alters the current status of any instrument or transaction" under the CEA, the industry viewed it as the beginning of an attempt to increase the CFTC's role in regulating aspects of the OTC derivatives markets. "Until the Concept Release," the Swap Dealers told Congress, "the CFTC appeared to have worked on the assumption that a contract is subject to their jurisdiction if they determine it to be a futures contract, and is not subject to the Act until then. But under the Concept Release, the CFTC moved to the other side and asserted that all derivatives are automatically subject to its jurisdiction, unless it affirmatively states otherwise."[107] In response to concerns voiced by the financial industry, in the Agriculture Appropriations Act for fiscal year 1999, Congress imposed a six-month moratorium on the CFTC's rulemaking authority in this area.

The rapid development of computerized trading systems for OTC derivatives complicated the regulatory picture as well. The CFTC's existing swap exemption only applied to swaps that were not entered into on an exchange. The question arose as to whether computerized OTC trading systems that automatically facilitated negotiations between multiple parties were more akin to the trading floor of an exchange or more like electronic communication systems, such as telephones and fax machines. To many, analysis based on such distinctions elevated form over substance. "Market participants . . . have argued that the means to execute a swap agreement

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[105] See, e.g., Statement Submitted on Behalf of The International Swaps and Derivatives Association, Inc., to the Senate Committee on Agriculture, Nutrition, and Forestry, 105th Cong., 2nd Sess., July 28, 1998. ("The possibility that some or a substantial category of privately negotiated derivatives transactions may be interpreted, even inadvertently, to be futures contracts also raises serious concerns with respect to those transactions falling outside the scope of the current or a future revised Swaps Exemption, particularly equity swaps and other swaps based on the prices of securities.").

[106] *Id.*

[107] *Id.*

(computer systems rather than telephonic systems) should not alter the regulatory status of the agreement."[108]

This and other regulatory issues were addressed in the Report of The President's Working Group on Financial Markets, Over-the-Counter Derivatives Markets and the Commodity Exchange Act, which was prepared jointly by the Department of the Treasury, the Board of Governors of the Federal Reserve System, SEC, and CFTC, and issued in November 1999. "A cloud of legal uncertainty has hung over the OTC derivatives markets in the United States in recent years," the Report stated, "which, if not addressed, could discourage innovation and growth of these important markets and damage U.S. leadership in these arenas by driving transactions off-shore."

The President's Working Group issued a number of recommendations for the treatment of financial instruments, including a CEA exclusion for bilateral swap agreements between certain participants (termed "eligible swap participants"),[109] and a CEA exclusion for certain types of electronic trading systems involving those same participants. The Working Group was clear, however, that any exclusions from the CEA should be limited to "markets that are not readily susceptible to manipulation and that do not currently serve a significant price discovery function." To this extent, the Report stated that the recommended exclusions "should not extend to any swap agreement that involves a non-financial commodity with a finite supply." The Working Group explained:

> Due to the characteristics of markets for non-financial commodities with finite supplies, however, the Working Group is unanimously recommending that the exclusion not be extended to agreements involving such commodities. For example, in the case of agricultural commodities, production is seasonal and volatile, and the underlying commodity is perishable, factors that make the markets for these products susceptible to supply and pricing distortions and to manipulation. There have also been several well-known efforts to manipulate the prices of certain metals by attempting to corner the cash or futures markets. Moreover, the cash market for many non-financial commodities is dependent on the futures market for price discovery. The CFTC should, however, retain its current authority to grant exemptions for derivatives involving non-financial commodities, as it did in 1993 for energy products, where exemptions are in the public interest and otherwise consistent with the CEA.[110]

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[108] U.S. Department of the Treasury, the Board of Governors of the Federal Reserve System, Securities Exchange Commission, and Commodity Futures Trading Commission, *Report of The President's Working Group on Financial Markets, Over-the-Counter Derivatives Markets and the Commodity Exchange Act* (November 1999), at 14.

[109] The "eligible swap participants" who could qualify for this exclusion would be regulated financial institutions, large corporations, certain pension funds, state and local governments, and individuals with significant assets.

[110] *Id.* at 16-17. In footnotes, the Working Group added that "nothing in this report should be construed to affect the scope of exemptions that are currently in effect," and recommended the CFTC "retain its current exemptive authority for these [non-financial commodity] derivatives."

2. Enactment of Commodity Futures Modernization Act

a. Summary of Relevant Provisions

In 2000, Congress enacted the Commodity Futures Modernization Act (CFMA). The CFMA overhauled the entire regulatory framework for the regulation of financial and energy derivatives under the CEA. Consistent with the recommendations of the President's Working Group, the CFMA sought to clarify the exclusion of various financial derivatives from the scope of the CEA, and to establish a tiered regulatory system for the commodities and derivatives within the scope of the CEA, with the degree of regulation dependent upon the type of product (such as financial, agricultural, energy or metals), the type of market (such as designated exchanges, bilateral negotiation, multilateral negotiation, or electronic exchange), and the type of participant in the marketplace (such as retail customer, sophisticated player, or speculator). Generally, the CFMA subjects markets that restrict trading to professional traders or commercial participants and trade in products that are less susceptible to manipulation to less regulation than markets with a broader range of participants or with commodities in finite supply.

The CFMA resolved the longstanding concern regarding the legal enforceability of OTC derivatives that were not traded on an approved exchange. The CEA now provides that no swap agreement between eligible contract participants shall be unenforceable under the CEA or any other law based on a failure to comply with any exclusion or exemption from any provision of the CEA.[111]

A significant number of provisions in the CFMA address issues related to the regulatory treatment of a variety of financial instruments. Most of these complex provisions are not directly relevant to the issue of the regulation of energy contracts under the CEA. Accordingly, this report examines the provisions of the CFMA only insofar as they relate to or are entangled with issues regarding the regulation of energy contracts, such as those involving crude oil. Table A.2-2 provides a summary of the regulation of energy derivatives under the CFMA. Table A.2-3 identifies the key dates in the regulation of the commodity markets up to and including the enactment of the CFMA.

[111] 7 U.S.C.A. §25 (West Supp. 2002).

Table A.2-2
REGULATION OF FUTURES MARKETS AND OTC DERIVATIVES UNDER CFMA OF 2000

	CEA Statutory Provisions		*CFTC Regulatory Provisions*			
Type of Commodity Market	***Anti-Fraud***	***Anti-Manipulation***	***Large-Trader Reporting***	***Position Limits***	***Price Limits***	***Margin Requirements***
Agricultural – Futures must be traded on approved exchanges	Yes	Yes	Yes	Yes	Yes	Yes
Energy/Metals (Exempt Commodities)						
• Trading on approved exchanges	Yes	Yes	Yes	Yes	Yes	Yes
• Over-the-counter trading						
Swaps between ECPs, individually negotiated, not on a trading facility	No	No	No	No	No	No
One-to-Many ("Enron Online"), between ECPs, not on a trading facility	Not if an ECE	6(c), 9(a)(2) 6(d), 6c, 8a,	No	No	No	No
Many-to-Many, between ECEs on an electronic trading facility	Yes	6(c), 9(a)(2)	No	No	No	No
Financial (Excluded Commodity)						
• Trading on approved exchanges	Yes	Yes	Yes	Yes	Yes	Yes
• Over-the-counter trading between ECPs not on a trading facility, and trading between principals on an electronic trading facility are excluded from CEA	No	No	No	No	No	No

Table A.2-2 : Explanation of Terms

- **Eligible Contract Participant (ECP) (§1a(12)):**

Financial institutions; regulated insurance companies; corporations with more than $10 million in assets (or more than $1 million if the transaction is for risk-management purposes); ERISA employee benefit plans with more than $5 million in assets; regulated broker-dealers; qualified futures commission merchants; individuals with more than $10 million in assets (or more than $5 million if the transaction is for risk-management purposes); government entities; and registered investment or commodity trading advisors.

- **Eligible Commercial Entity (ECE) (§1a(11)) :**

(A) An ECP that is a financial institution; regulated insurance company; corporation with more than $10 million in assets (or more than $5 million if the transaction is for risk-management purposes); regulated broker-dealer; qualified futures commission merchant that: (i) has an ability to make or take delivery of the underlying commodity; (ii) incurs risks, in addition to price risks, related to the commodity; or (iii) is a dealer that regularly provides risk management, market-making, or hedging services; or (B) An ECP other than a natural person or State or local government that (i) regularly enters into purchase, sale, or derivative transactions in the commodity; and (ii) meets the large asset thresholds in the Act.

- **Trading Facility (§1a(33)):**

A physical or electronic facility or system in which multiple participants have the ability to execute or trade agreements or contracts by accepting bids and offers made by other participants that are open to multiple participants in the facility or system. Does not include a facility or system that enables participants to negotiate the terms of and enter into bilateral transactions as a result of communications between the parties and not from the interaction of multiple offers and bids through an automated trade matching system.

- **Electronic Trading Facility (§1a(10)):**

A trading facility that operates through an electronic or telecommunications network, and that maintains an automated audit trail of bids, offers, and the matching of orders or the execution of transactions on the facility.

- **Anti-Manipulation Provisions of the CEA:**

§6(c): For manipulating or attempting to manipulate the price of a commodity, authorizes CFTC to prohibit a person from trading on approved exchanges and to issue civil penalties up to $100,000 or triple the monetary gain from the violation, plus restitution.

§9(a)(2): Makes manipulation or attempted manipulation a felony punishable by a fine of not more than $1 million, and imprisonment for not more than 5 years.

§6(d): Authorizes CFTC to issuance cease and desist orders for manipulation or attempts at manipulation.

§6c: Authorizes CFTC to seek and federal district courts to issue injunctions, restraining orders, writes of mandamus to ensure compliance with the provisions of the CEA

§8a: Authorizes CFTC is register future commission merchants, brokers and others under the CEA.

Table A.2-3

KEY DATES IN U.S. COMMODITY MARKET REGULATION

1848	Chicago Board of Trade established.
1922	Grain Futures Act requires grain futures contracts to be traded on regulated exchanges.
1936	Commodity Exchange Act (CEA) expands law to more agricultural commodities, strengthens anti-manipulation penalties, and prohibits fraud.
1974	CEA is expanded to non-agricultural commodities. Commodity Futures Trade Commission (CFTC) is established to oversee trading.
1989	CFTC Swaps Policy Statement states CFTC will not regulate certain swaps traded "over the counter" (OTC) outside regulated exchanges.
1990	Transnor court finds Brent contracts are futures contracts subject to CEA; CFTC finds Brent contracts are forward contracts exempt from CEA.
1992	Futures Trading Practices Act enables CFTC to exempt energy contracts, including Brent contracts, and financial derivatives from some CEA rules.
1993	CFTC issues rule exempting certain energy contracts and financial derivatives from CEA requirement to trade on regulated exchanges and from CEA anti-fraud provisions.
1995	Sumitomo manipulation of copper market exposed.
1998	Tokyo Communiqué issued by 17 countries, including the United States, pledging to increase commodity information sharing and OTC oversight.
2000	Commodity Futures Modernization Act (CFMA) codifies exclusions and exemptions for certain energy contracts and financial derivatives from CEA and CFTC oversight.

Prepared by U.S. Senate Permanent Subcommittee on Investigations, February 2003.

(i) Categories of Participants

One of the criteria used by the CFMA for determining the level of regulation under the CEA is the nature of person involved in the transaction. Generally, the Act only provides exclusions and exemptions for transactions between large institutions or individuals with large personal assets, who are either (1) deemed to be sufficiently sophisticated to be able to protect their own interest, or (2) subject to another regulatory scheme, such as the banking or securities laws. For transactions and markets in which the general public or small businesses participate, the full regulatory apparatus of the CEA still applies.

Most of the exclusions and exemptions provided by the CFMA apply to those large organizations that qualify as an "eligible contract participant" ("ECP"), the definition of which includes financial institutions; insurance companies; corporations, trusts, and partnerships with total assets greater than $10 million; large pension benefit plans, governmental entities, natural persons with assets greater than $5 million who are entering the transaction for risk management purposes, and certain others.[112]

A subset of "eligible contract participants" qualify for further exemptions and exclusions. An "eligible commercial entity" is an eligible contract participant that (i) has the ability to make or take delivery of the commodity; (ii) incurs commodity risks in addition to price risks; or (iii) is a dealer in either the commodity or derivatives transactions involving that commodity.[113] In essence, this category applies to large traders that make or take delivery of a physical commodity, such as, for example, energy trading companies like Enron, Williams Company, Duke Energy, and El Paso Corporation.

(ii) Categories of Commodities.

The CFMA also created three categories of commodities.

"Excluded commodities" are a variety of financial derivatives, including interest rate, currency, equity, debt, credit, weather, economic index, and other derivatives based on one or more commodities for which there is no cash market or whose price levels are not within the control of any party to the transaction.

Under the CEA as amended by the CFMA, an "exempt commodity" is "a commodity that is not an excluded commodity or an agricultural commodity."[114] This category includes, for example, metals and energy products.

The third category of commodities is "agricultural commodities." Although it is used in the definition of "exempt commodity," the term "agricultural commodity" is not

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[112] The CFMA's definition of ECP is based upon the CFTC's definition of "eligible swap participant" used for the 1993 swap exemption, but is slightly broader. See 17 CFR Part 35.

[113] 7 U.S.C.A. §1a(11) (West Supp. 2002).

[114] 7 U.S.C.A. §1a(14) (West Supp. 2002).

defined. Logically, it refers to the list of agricultural commodities traditionally within the jurisdiction of the CEA under section 1a of the Act. It is unclear, however, whether or not the term encompasses any additional agricultural commodities. Generally, the regulatory framework for the futures markets for agricultural commodities was not altered by the CFMA.

(iii) Excluded OTC Derivative Transactions

Section 2(d) excludes from the CEA all agreements, contracts, and transactions in "excluded commodities" between "eligible contract participants" that are not executed on a "trading facility."[115] A "trading facility" is defined as a physical or electronic exchange.[116] Roughly speaking, this section excludes from the CEA financial derivatives that are traded over-the-counter, not on an approved futures exchange, among large institutions or corporations.

(iv) Excluded Swap Transactions

Section 2(g) excludes from the CEA all agreements, contracts, and transactions "in a commodity other than an agricultural commodity" between "eligible contract participants" that are individually negotiated by the parties and that are "not executed or traded on a trading facility."[117] These are referred to as "excluded swap transactions." Unlike the provision excluding certain OTC derivative transactions, which applies only to excluded commodities, which are basically financial in nature, this provision applies to all commodities other than agricultural commodities, which means that agreements, contracts, and transactions in energy and metals individually negotiated, not on an exchange, by large corporations and institutions can qualify for the exclusion for swap transactions.

(v) Transactions in Exempt Commodities: Section 2(h)

Section 2(h)(1) of the CEA was meant to exempt from regulation dealer markets and facilities, such as "Enron Online," in which one organization acts as the counterparty to many or all of the other participants in the market. Section 2(h)(1) provides that all agreements, contracts, and transactions in an "exempt commodity" – which includes energy and metals – between "eligible contract participants" and "not entered into on a trading facility" are generally exempted from the requirements of the CEA. Unlike the

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[115] 7 U.S.C.A. § 2(d)(1) (West Supp. 2002). Section 2(d)(2) provides a further exclusion for certain "principal-to-principal" transactions in excluded commodities on an electronic exchange. *Id.*

[116] "The term 'trading facility' means a person or group of persons that constitutes, maintains, or provides a physical or electronic facility or system in which multiple participants have the ability to execute or trade agreements, contracts, or transactions by accepting bids and offers made by other participants that are open to multiple participants in the facility or system." 7 U.S.C.A. §1a(33) (West Supp. 2002). An "electronic trading facility" is a trading facility that "operates by means of an electronic or telecommunications network" and maintains an audit trail of bids, offers, orders, and transactions on the facility. *Id.* at §1a(10).

[117] 7 U.S.C.A. § 2(g) (West Supp. 2002).

swap transaction exclusion, this exemption applies even if the agreement, contract, or transaction is not individually negotiated.

Some of the CEA provisions, including anti-fraud and anti-manipulation provisions, still apply to most of these transactions. However, the agreements, contracts, and transactions in these commodities between "eligible commercial entities" – meaning those eligible contract participants that can make or take delivery, incur commodity risks, and are commodity dealers – are not subject to the CEA anti-fraud provisions. This special exemption from the CEA anti-fraud provisions essentially codifies the CFTC's 1993 energy contract exemption from the exchange-trading and anti-fraud provisions of the CEA.

Section 2(h)(3) is designed to allow large market participants to trade amongst themselves on electronic trading facilities with little government oversight. This section provides an exemption for agreements, contracts, and transactions involving "exempt commodities," such as energy or metals, that are executed or traded on an "electronic trading facility," and entered into on a principal-to-principal basis between "eligible commercial entities."

A reduced number of CEA provisions apply to transactions on these facilities. For example, a number of the CEA's statutory proscriptions against manipulation apply to these transactions. The proscription against fraud in connection with commodity option transactions applies as well. These facilities must keep trading records for five years, make such records available for inspection by the CFTC, and provide other data upon "special call" by the CFTC. In addition, if the CFTC determines that the facility performs a significant price discovery function for the underlying commodity, the facility must disseminate price, volume, and other trading data in a timely manner as the CFTC determines is appropriate. The CFTC has not yet proposed a rule to implement this provision of the CFMA.

One of the sources of confusion following the passage of the CFMA is the inconsistency between sections 2(g) and 2(h)(1) – whereas §2(g) totally excludes energy and metals swaps that are individually negotiated from the CEA, §2(h)(1) exempts energy and metals transactions from the exchange-trading and other requirements but generally applies the anti-fraud and anti-manipulation provisions to over-the-counter transactions in these commodities. It is not clear whether the exclusion provision takes precedence over the exemption provision, or vice versa.

Moreover, to the extent that a negotiation over price can be considered "an individual negotiation," it would appear that sections 2(g) and 2(h)(1) cover the same transactions and are in direct conflict regarding the applicability of the CEA's anti-fraud and anti-manipulation provisions. The CFTC staff has told the Subcommittee staff that the CFTC interprets the term "individual negotiation" to include price negotiations; under this interpretation there is no difference between sections 2(g) and 2(h)(1). Under this interpretation, all instruments traded under 2(h)(1) on "one-to-many" facilities or through dealer-brokers could be considered excluded swaps.

b. Outstanding Issues

The CFMA created a complex statutory and regulatory scheme that perpetuates different degrees of CFTC oversight for energy contracts, swaps, and other derivatives, depending on the size of the parties to the transaction and the type of market in which the contracts are traded. As other parts of this Report demonstrate, however, as the risk-transference and price discovery functions of the over-the-counter markets and approved futures exchanges have become increasingly intertwined, these distinctions make less and less sense. It hardly makes sense to allow participants to operate in one market in a manner that is not allowed in another.

Moreover, as other parts of this Report demonstrate, the operation of both the OTC markets and the approved futures exchanges can have significant impacts upon consumers and businesses that may not trade at all on either market. Both markets perform a vital economic function for the American economy as a whole, and the behavior of the participants in these markets affects not only other market participants, but potentially millions of persons outside of those markets. Whether or not large institutions need or desire governmental oversight to protect themselves from each other, governmental oversight is necessary to ensure the markets are operating efficiently and effectively in the public interest. Accordingly, as the OTC energy markets now perform economically identical functions to the designated futures exchanges trading energy contracts, the distinctions created in the CFMA between large institutions and other types of traders, and between OTC markets and approved futures markets, no longer is sound public policy as applied to these energy markets.