

## COMMENT

# AREN'T WE STILL IN THE "GARDEN OF THE FORKING PATHS"? A COMMENT ON CONSOLIDATION OF THE SEC AND CFTC\*

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I. INTRODUCTION

The United States employs a bifurcated derivative securities regulatory system that allocates jurisdiction over derivative financial instruments to two agencies, the Securities Exchange Commission (SEC) and the Commodities Futures Trade Commission (CFTC).<sup>1</sup> The SEC has jurisdiction over securities,<sup>2</sup> which, *inter alia*, can include stock and stock options, while the CFTC in general has jurisdiction over commodities futures.<sup>3</sup> The recent enactment of the Commodities Futures Modernization Act (CFMA) granted overlapping jurisdiction to both agencies of hybrid financial instruments known as securities futures.<sup>4</sup> Yet,

1. See Erika W. Nijenhuis, *Taxation of Securities Futures Contracts*, 553 PRAC. L. INST. 1097, 1104 (noting that many other countries structure their regulatory systems in a different way, presumably under one agency). The Federal Reserve Board and the Department of the Treasury also have some limited regulatory responsibilities with respect to securities. U.S. Congress, Office of Technology Assessment, *Electronic Bulls & Bears: U.S. Securities Markets & Information Technology*, Chapter 9 (Washington, DC: U.S. Government Printing Office, September 1990).

2. The Securities Exchange Act of 1934 § 27 sets forth the jurisdiction over those that violate securities’ regulations.

3. See U.S. GENERAL ACCOUNTING OFFICE (GAO), ISSUES RELATED TO THE SHAD-JOHNSON JURISDICTIONAL ACCORD, GAO/GGD-00-89, at 5 (2000).

4. *CFTC and SEC Close in on Adopting Final Rules for Single Stock Futures*, SEC. WEEK, May 27, 2002; see also Melissa Allison, *CFTC OK’s Trading of New Stock Instrument; Single-stock Rules Need SEC Action*, CHI. TRIB., July 3, 2002. While waiting

tension between the two commissions likely still exists. Unless the two agencies eventually merge they will become rooted in the “garden of the forking paths” of divergent policies and ideology despite their outward appearance of working together.<sup>5</sup> The only lasting and efficient solution is to consolidate.

Consolidation of the agencies is not a new idea.<sup>6</sup> Nevertheless, the conflict between the CFTC and the SEC continues to grow despite the passing of their joint regulations regarding the transactions of futures.<sup>7</sup> The commissions adopted these regulations pursuant to the Commodity Exchange Act (CEA), Securities Exchange Act of 1934, and the Commodity Futures Modernization Act of 2000 (CFMA). During the preliminary stages of the CFMA’s enactment, the SEC and CFTC were both concerned with duplicative or conflicting regulations on their respective markets and with their participants.<sup>8</sup>

This comment will not address securities, like ordinary stocks and bonds, which are generally under SEC jurisdiction. Instead, the focal point of this paper is on the conflict between the CFTC and SEC over the regulation of derivative instruments. The world of financial instruments can be intimidating as one wanders through the labyrinth of different acts, agencies, and various types of investments found in the markets. The first

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for final approval of the SEC, the CFTC (by the summer of 2002) had already “approved the applicability of CFTC and SEC protection, record keeping, reporting and bankruptcy rules and the applicability of the Securities Investor Protection Act of 1970 to accounts holding security futures products.” *Final Rules for Security Futures Approved by CFTC, Awaiting SEC OK*, SEC. WEEK, July 8, 2002.

5. The element of bifurcation brings to mind the short story by J.L. Borges about a man who visits his grandfather’s “garden of the forking paths” and discovers that the garden’s bifurcations are infinite. See JORGE L. BORGES, GARDEN OF THE FORKING PATHS, FICCIONES 100 (Anthony Kerrigan ed., Grove Press New York 1962). To the protagonist’s surprise, the garden of the forking paths was not really a garden at all but a book called the Garden of The Forking Paths, which really was a metaphorical representation of an infinite set of time, diverging and converging and running parallel to each other. See *id.* at 95; see also DONALD SHAW, BORGES’ NARRATIVE STRATEGY 63 (Francis Cairns Publications 1992).

6. See U.S. Congress, Office of Technology Assessment, *supra* note 1, at 177 (citing to a 1989 speech made by Justice Sporkin of the U.S. District Court, Washington, D.C. that one agency should oversee all securities related activities). The SEC wanted a merger and has asked Congress many times for jurisdiction over all security-based products (including stock-index and financial futures), which would place the CFTC back in its original role as overseer of just commodities futures. See *Chicago Mercantile Exch. v. SEC*, 883 F.2d 537, 544 (7<sup>th</sup> Cir.1989). The CFTC continued to defend its position that multiple regulatory bodies would provide more competition and experimentation, which would allow a new product to reach market if either agency approves the modification within its domain. *Id.*

7. See Commodity Futures and Modernization Act, 17 CFR §§ 1, 41, 190, 240 (2003).

8. See GAO, ISSUES RELATED TO THE SHAD-JOHNSON JURISDICTIONAL ACCORD, *supra* note 3, at 4.

section of this comment will present the background on derivatives looking at the evolution of futures markets and then explaining the terminology with respect to the various derivatives.

An understanding of the terminology is essential for the second section of this paper, the analysis, which will provide a deeper look into the respective jurisdictions of the CFTC and SEC. The focus will then shift to the inherent problems that have caused the tension between the two agencies. The final section of this paper will conclude with the arguments for and against consolidation. Implicit in the final discussion is the conclusion of why the SEC, with jurisdiction over the entire scope of derivatives, would be more efficient and how a united regulatory scheme may help curb market manipulation.

## II. BACKGROUND

### A. *The Early History of Futures Trading and Forward Contracting*

Before the dawn of futures trading,<sup>9</sup> central markets provided the forum for the buying and selling of agricultural products.<sup>10</sup> Since refrigerated storage facilities were not yet invented, farmers were forced to harvest their crops in a short time span and consequently suffered when market prices fluctuated.<sup>11</sup> The farmers learned to allocate their risk by “*forward contracting*,” which means they used executory

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9. See Commodity Futures Trading Commission Act of 1974, Pub. L. No. 93-463, 1974 U.S.C.C.A.N. (88 Stat. 1389) 5843, 5852. According to the Legislative History, the commodity exchanges can trace their roots all the way back to Twelfth Century medieval trade fairs in Europe. *Id.*

10. *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. New York Mercantile Exch.*, 456 U.S. 353, 357 (1982). The merchants at the old medieval fairs originally delivered their commodities in real time, but they eventually contracted to deliver merchandise at a later time by bringing samples of their goods as an assurance to quality. Commodity Futures Trading Commission Act of 1974, Pub. L. No. 93-463, 1974 U.S.C.C.A.N. (88 Stat. 1389) 5843, 5853. American futures markets similarly evolved in the late 1700's by forming the first centralized commodity markets for trade in eggs, vegetables, butter, and grain. *Id.*

11. *Merrill Lynch*, 456 U.S. at 357. Farmers would bring their goods (such as grain and livestock) to the regional markets only to discover that the supply of their goods exceeded the needs of the packers and millers, causing a short-term surplus. Commodity Futures Trading Commission Act of 1974, Pub. L. No. 93-463, 1974 U.S.C.C.A.N. (88 Stat. 1389) 5843, 5853. The processors, recognizing a profitable opportunity, would bid on the surplus at the lowest price, and, if the short-term demand could not absorb the excess of commodities to clear the market, the goods were hastily dumped into the street. *Id.* Consequently, much of the public would starve not too long after the fall harvest because the market prices of grain and livestock were simply unattainable. *Id.*

contracts<sup>12</sup> to fix the terms of sale before delivering the goods.<sup>13</sup> Before entering into a contract for the future delivery of goods, the producers (sellers) and buyers would agree to a price based on factors such as experience and their own subjective price expectations at the time of delivery.<sup>14</sup> Buyers and sellers at the market were skeptical as to whether the goods would even arrive on time because snow and rain made the unpaved roads impassible; thus the market price would invariably move before the contract was performed.<sup>15</sup>

If the market price declined, the seller (farmer) was at an advantage because the executory contract was worth more than the commodity covered by the contract.<sup>16</sup> In this situation the farmer would have a strong economic incentive to breach because the forward contract would now be unprofitable for him.<sup>17</sup> On the other hand, if the market price increased, the contract was more valuable to the buyer mainly because the buyer had an assurance of delivery and a tidy yield from the investment.<sup>18</sup> The transaction is called a forward from the “establishment in advance of the parties’ obligations at a pre-determined price.”<sup>19</sup>

Investors saw the opportunity to make profits due to the market price fluctuations by buying and selling the futures

12. An executory contract is defined as “a contract that remains wholly unperformed or for which there remains something still to be done on both sides, often as a component of a larger transaction and sometimes memorialized by an informal letter agreement, by a memorandum, or by oral agreement.” BLACK’S LAW DICTIONARY 712 (7th ed. 1999).

13. *Merrill Lynch*, 456 U.S. at 357. See also GAO, ACCOUNTING OFFICE REPORT TO THE CONGRESSIONAL REQUESTERS, ISSUES RELATED TO THE COMMODITY EXCHANGE ACT, GAO-97-50, 4 (Apr. 1997) (noting that the reduction in risk of financial loss is a form of hedging and “the transparent means of determining commodity prices based on supply and demand factors” is “called price discovery”). Producers used forward contracting to solve availability and demand problems, but still fell prey to financial losses from rapid price fluctuations due to their crops failing, economic panics, and insufficient storage and transportation. Commodity Futures Trading Commission Act of 1974, Pub. L. No. 93-463, 1974 U.S.C.C.A.N. (88 Stat. 1389) 5843, 5853.

14. *Merrill Lynch*, 456 U.S. at 357. Agricultural futures trading evolved in the United States because there was an economic need for centralized pricing and a way to spread the risks on larger scale. Commodity Futures Trading Commission Act of 1974, Pub. L. No. 93-463, 1974 U.S.C.C.A.N. (88 Stat. 1389) 5843, 5853. Chicago initiated it in the main stream of surplus grain marketing, and then at New York in the distribution and export of cotton. See *Id.*

15. *Merrill Lynch*, 456 U.S. at 357.

16. *Id.*

17. *Allenberg Cotton Co., Inc. v. Pittman*, 419 U.S. 20, 27 n.8 (1974) (noting that a cotton farmer who is obligated to deliver cotton for a price lower than on the spot market may want to sell the cotton elsewhere).

18. *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. New York Mercantile Exch.*, 456 U.S. 353, 357 (1982).

19. Norman M. Feder, *Deconstructing Over-the-Counter-Derivatives*, 2002 COLUM. BUS. L. REV. 677, 699 (2002).

contracts.<sup>20</sup> Normally, if the futures markets were efficient then the price of a future would be very close to the price of the cash commodity to satisfy delivery.<sup>21</sup> However, if a speculator believed the price was to decrease, he would agree to a future sale at the current market price with the intent to buy the underlying commodity at a lower price on or before the date of delivery.<sup>22</sup> In this case, when the speculator “went short” and the price increased, he would lose.<sup>23</sup> However, the speculator could profit if he “went long” and the price increased because, rather than taking delivery, he would resell the forward contract at a greater price.<sup>24</sup>

Futures assisted farmers because they could protect the fruits of their labor by taking a “short” position in the futures market against a price decline while the processor of the farmer’s food could concurrently protect itself by taking a “long” position against a price increase.<sup>25</sup> The futures contracts softened the impact of a surplus situation due to supply in excess of demand because the farmers could sell the commodity for future delivery thereby decreasing price fluctuation.<sup>26</sup> Nevertheless, these early periods allowed big market players to manipulate<sup>27</sup> markets forcing impressive price fluctuations, unchecked speculation, and already low market prices to become further depressed.<sup>28</sup> The abusive trading encouraged farm resentment and ultimately led to state, and then federal, regulation.<sup>29</sup>

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20. *Merrill Lynch*, 456 U.S. at 357.

21. *Cargill, Inc. v. Hardin*, 452 F.2d 1154, 1157 (8th Cir. 1971).

22. Commodity Futures Trading Commission Act of 1974, Pub. L. No. 93-463, 1974 U.S.C.C.A.N. (88 Stat. 1389) 5843, 5854.

23. *Id.* In other words the investor was speculating that the market would go down.

24. *Merrill Lynch*, 456 U.S. at 357-58. For example, if the price of wheat increased causing upward pressure on the price of the future, then the speculator who went long profits because he can either (a) take delivery of the lower priced wheat, or (b) offset the long contract in the market by dumping the contract at a higher price. *Cargill, Inc.*, 452 F.2d at 1157.

25. *Cargill, Inc.*, 452 F.2d at 1157.

26. *Id.* at 1157-58.

27. While manipulation usually includes an “intentional wrongdoing,” the most common “definition is that behavior is manipulative when ‘conduct has been intentionally engaged in which has resulted in a price which does not reflect basic forces of supply and demand.’” Frank Easterbrook, *Monopoly, Manipulation, and the Regulation of Futures Markets*, 59 J. BUS. S117 (1986) (citing *Cargill, Inc. v. Hardin*, 452 F.2d at 1163).

28. Commodity Futures Trading Commission Act of 1974, Pub. L. No. 93-463, 1974 U.S.C.C.A.N. (88 Stat. 1389) 5843, 5854.

29. *Id.*

B. *From The Grain Futures Act to the Commodity Exchange Act*

The original purpose of the Grain Futures Act (GFA),<sup>30</sup> based on the Commerce Clause of the Constitution, was for the Government, rather than individual traders, to interact with the exchanges themselves.<sup>31</sup>

The GFA required that the exchanges take on the burden of preventing price manipulation by their members so that they could receive a federal license or be “designated” as a “contract market.”<sup>32</sup> If the exchanges failed to meet this requirement, then they would lose their designation.<sup>33</sup> The Secretary of Agriculture was appointed to investigate into the boards of trade, and, after several investigations into these market price manipulations, he suggested a number of recommendations to Congress for additional legislation on the matter.<sup>34</sup>

Under these amendments the legislation was renamed the Commodity Exchange Act (CEA) and thus resulted in an expansion in regulatory scope to cotton, grains, as well as other specified commodities.<sup>35</sup> The CEA granted broad authority in an

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30. The Grain Futures Act was a replacement of the Futures Trading Act of 1921 that had its basis on the taxing power under the Constitution. *Id.* at 5855. The Supreme Court ruled that the tax of \$ .20 per bushel of wheat placed on futures transactions not made on future markets was unconstitutional (*see generally* Hill v. Wallace, 259 U.S. 44 (1922)), and Congress subsequently passed the Grain Futures Act in 1992. B. Peter Pashigian, *The Political Economy of Futures Market Regulation*, 50 J. BUS. S55, S56 (1986). Congress reintroduced the Grain Futures Act based on the commerce clause, and it was found constitutional. Commodity Futures Trading Commission Act of 1974, Pub. L. No. 93-463, 1974 U.S.C.C.A.N. (88 Stat. 1389) 5843, 5855. The Grain Futures Act excluded the taxing provisions that were against the law but reenacted the statute’s regulatory provisions. *See* GAO, ISSUES RELATED TO THE COMMODITY FUTURES TRADING COMMISSION’S REAUTHORIZATION, GAO-99-74, 53 n.1 (May 1999).

31. Commodity Futures Trading Commission Act of 1974, Pub. L. No. 93-463, 1974 U.S.C.C.A.N. (88 Stat. 1389) 5843, 5855.

32. Commodity Futures Trading Commission Act of 1974, Pub. L. No. 93-463, 1974 U.S.C.C.A.N. (88 Stat. 1389) 5843, 5855. In order to qualify for designation as a commodities market, a commodity exchange must meet the following conditions and requirements: “(1) disseminating market information, (2) preventing dissemination of false information, (3) preventing manipulations, and (4) maintaining records and providing reports.” GAO, ISSUES RELATED TO THE COMMODITY FUTURES TRADING COMMISSION’S REAUTHORIZATION, *supra* note 30, at 53. Note that at the time of the Grain Futures Act, the U.S. was facing one of two periods during the 1920’s where large stocks of wheat carried forward from previous years applied extreme downward pressure on wheat prices. *See generally* R.R. Enfield, *The World’s Wheat Situation*, 41 ECON. J. 550, 552 (1931).

33. Commodity Futures Trading Commission Act of 1974, Pub. L. No. 93-463, 1974 U.S.C.C.A.N. (88 Stat. 1389) 5843, 5855.

34. *See* GAO, ISSUES RELATED TO THE COMMODITY FUTURES TRADING COMMISSION’S REAUTHORIZATION, *supra* note 30, at 53.

35. *See* GAO, ISSUES RELATED TO THE COMMODITY FUTURES TRADING COMMISSION’S

attempt to check the cheating, fraud, and fictitious transactions in futures (e.g. bucket shops),<sup>36</sup> and the CEA also gave authority to criminally prosecute price manipulation.<sup>37</sup> In 1968, livestock, livestock products, and frozen orange juice were included in the scope of CEA regulation; in the early 1970's precious metals were added to this reach as well, but, because they were not covered under the act, they were not under federal regulation.<sup>38</sup> By 1974 the CEA was amended again so that all futures contracts, regardless of the underlying commodity, were to fall under the range of federal regulation.<sup>39</sup> In this same year, the CFTC was also enacted under the amendment to the CEA.<sup>40</sup>

### C. Derivatives in General

Alan Greenspan, the current Chairman of the Federal Reserve, has partially attributed the substantial increase in American wealth and productivity to the U.S. derivatives markets.<sup>41</sup> The term derivative basically means a contract or security whose price or value *derives* from the underlying asset.<sup>42</sup>

Corporations that are risk-averse can protect themselves from variations in currency rates, interest rates, and commodity

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REAUTHORIZATION, *supra* note 30, at 53.

36. Bucket shops are firms that accept orders for futures contracts thus giving the appearance of conducting a legitimate transaction, but they do not actually carry out the order in the futures market. GAO, THE COMMODITY EXCHANGE ACT: LEGAL AND REGULATORY ISSUES REMAIN (GAO-97-50, Apr. 1997), at 5 n.10. Bucket shops are notorious for closing up shop and filing for bankruptcy once the price of the future moves against them. *Id.*

37. *Id.* at 5. See also *NRT Metals, Inc. v. Manhattan Metals (Non-Ferrous) Ltd.*, 576 F.Supp. 1046, 1049-50 (S.D.N.Y. 1983) (citing S. REP. NO. 850, 95th Cong. 2d Session 12, reprinted in 1978 U.S.C.C.A.N. 2087, 2100). The General Accounting Office defined price manipulation as "the distortion of market prices for economic gain. The distortion typically involves creating artificial prices that do not reflect supply and demand conditions, or creating a false picture of supply and demand conditions to cause a desired price movement and/or reaction by other market participants." GAO, THE COMMODITY EXCHANGE ACT: LEGAL AND REGULATORY ISSUES REMAIN, *supra* note 36, at 6 n.13.

38. Commodity Futures Trading Commission Act of 1974, Pub. L. No. 93-463, 1974 U.S.C.C.A.N. (88 Stat. 1389) 5843, 5855-56. See also GAO, THE COMMODITY EXCHANGE ACT: LEGAL AND REGULATORY ISSUES REMAIN, *supra* note 36, at 5.

39. GAO, THE COMMODITY EXCHANGE ACT: LEGAL AND REGULATORY ISSUES REMAIN, *supra* note 36, at 5.

40. *Id.* The CFTC and its jurisdiction is discussed more in depth in the analysis portion of this comment.

41. See CONG. REC. S11,925 (daily ed. Dec. 15, 2000) (statement of Sen. Lugar). Of course, many investors can attest to the fact that the market, until recently, had been in decline over the past three years. Yet markets and wealth, in the aggregate, have increased throughout history in absolute terms.

42. Bernard J. Karol, *An Overview of Derivatives as Risk Management Tools*, 1 STAN. J. L. BUS & FIN. 195 (1995).

and real estate price changes by using derivatives.<sup>43</sup> Derivatives help companies break-up, sever, and sell their financial risk.<sup>44</sup> A company will use a broker/dealer to purchase or write what is known as a derivative contract.<sup>45</sup> This allows the business organization to keep those risks it feels comfortable managing and transfer the remaining risks to another party who is more willing to accept and manage them.<sup>46</sup>

Financial risk can be managed a couple of ways. One way of managing financial risk is by using “on-balance-sheet” transactions such as moving production outside of the U.S.<sup>47</sup> Another way to manage financial risk is by off-balance-sheet instruments such as forwards, futures, swaps, and options.<sup>48</sup> These four off-balance-sheet instruments were analogized to “LEGO’s” building blocks for children, because the investor can “build instruments from one another” or “combine the instruments into larger creations that appear (but appearances deceive) altogether ‘new’”.<sup>49</sup>

### 1. Forward Contracts

In a forward contract<sup>50</sup>, as noted previously, the owner is obligated to buy a specific asset on a specified date at a price (exercise price) that was agreed to at the formation of the contract.<sup>51</sup> The seller wants the market price on the date of delivery to be less than the agreed price, and the buyer wants for the price to be higher.<sup>52</sup> The contract owner will earn a positive

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43. Henry Hu, *Hedging Expectations: “Derivative Reality” and the Law and Finance of the Corporate Objective*, 73 TEX. L. REV. 985, 986 (1995).

44. See Thomas F. Siems, 10 *Misconceptions about Financial Derivatives*, USA TODAY MAG., Mar. 1998, at 16.

45. See Suzanne E. Bish, *A Guide to Narrow the Derivatives’ Understanding Gap and Reduce Losses: How to Increase Knowledge, Controls, and Reporting*, 58 OHIO ST. L.J. 539, 545-46 (1997).

46. *Id.* A derivative is defined in Barron’s Dictionary of Financial Investment Terms defines derivative as “a contract whose value is based on performance of an underlying financial asset, index, or other investment.” BARRON’S DICTIONARY 136 (4th ed. 1995).

47. CLIFFORD SMITH, CHARLES SMITHSON & D. SYKES WILFORD, *Managing Financial Risk*, Chapter 23, THE REVOLUTION IN CORPORATE FINANCE 351 (Joel M. Stern & Donald H. Chew, Jr. eds., Blackwell Publ’g 2003) (1982).

48. *Id.*

49. See *id.* The LEGO analogy was originally made in an earlier article by Charles Smithson. See *id.* at 351 n.12.

50. See *supra* note 13 and accompanying text (discussing the evolution of futures).

51. See CHARLES W. SMITHSON ET AL., *MANAGING FINANCIAL RISK: GUIDE TO DERIVATIVE PRODUCTS, FINANCIAL ENGINEERING, AND VALUE MAXIMIZATION* 32 (Irwin Prof’l Publ’g 1995) (1990).

52. Karol, *supra* note 42, at 196.

return if, at maturity, actual price exceeds the exercise price.<sup>53</sup> Two other notable characteristics of forward contracts are the following: (a) the credit or default risk is two-sided in that the movement of the underlying asset will determine whether the owner receives or makes a payment, and (b) payments only matter at maturity – no payments are necessary at the beginning or throughout the term of the contract.<sup>54</sup> In hopes that commodities would move more rapidly and more freely through the merchandizing chain, Congress did not include forward contracts in the CEA.<sup>55</sup>

## 2. Futures Contracts

Again, commodities futures have been around for hundreds of years, but financial futures are relatively new. A futures contract<sup>56</sup> is similar to a forward contract in that “it obligates its owner to purchase a specified asset at a specified exercise price<sup>57</sup> on the contract maturity date.”<sup>58</sup>

There are three important differences between a forward contract and a futures contract. First, the credit or default risk is sharply reduced because futures are “marked to market.”<sup>59</sup> This means that if the futures contract changes in value then the change is realized at the end of the trading day.<sup>60</sup>

Second, the futures contract is not intended to expire with delivery, while forward contracts are expected to involve delivery at a later date.<sup>61</sup> Third, futures contracts have standardized contract terms, which make the futures (1) readily transferable, and, as a consequence (2) tradable on public exchanges.<sup>62</sup> The

53. SMITH, SMITHSON & WILFORD, *supra* note 47, at 352.

54. *Id.*

55. See GAO, ISSUES RELATED TO THE COMMODITY FUTURES TRADING COMMISSION'S REAUTHORIZATION, *supra* note 30, at 39.

56. The CEA does not define the term “futures contract”; therefore, the definition has been created through judicial and agency interpretations. GAO, ISSUES RELATED TO THE SHAD-JOHNSON JURISDICTIONAL ACCORD, *supra* note 3, at 14 n.35. This has created some legal uncertainty. GAO, ISSUES RELATED TO THE SHAD-JOHNSON JURISDICTIONAL ACCORD, *supra* note 3, at 14 n.35. The analysis portion of this comment covers much this area more in depth.

57. The specified exercise price is often called the “spot price.” SMITHSON, *supra* note 52, at 185, 196.

58. SMITH, SMITHSON & WILFORD, *supra* note 47, at 351-52.

59. *Id.* at 352.

60. *Id.* Recall that the change in value of a forward contract is expressed only at the maturity date. *Id.*

61. GAO, ISSUES RELATED TO THE COMMODITY FUTURES TRADING COMMISSION'S REAUTHORIZATION, *supra* note 30, at 38

62. Roberta Romano, *A Thumbnail Sketch of Derivative Securities and Their Regulation*, 55 MD. L. REV. 1, 10 (1996).

trading on a public exchange serves a key role in that it is no longer necessary for one party to examine the credit risk of another party. Parties wishing to buy or sell need only enter into a contract with the exchange, and thus they only need examine credit risk of the exchange.<sup>63</sup>

### 3. Swap Contracts

Swap contracts<sup>64</sup> are one of the newest types of derivatives in finance and are at most a complex way of stringing together a series of forward contracts.<sup>65</sup> Some of the earliest swaps were interest rate swaps.<sup>66</sup> A party may enter payout cash flows on a fixed interest rate in exchange for cash flows on a floating interest rate.<sup>67</sup> The two parties of a swap contract are required to exchange, or swap, some specified cash flow at specified intervals.<sup>68</sup>

Yet, the primary difference between a swap and a forward is that, since the swap is a series of forwards strung together, the credit risk is reduced because there are multiple maturity dates rather than just one maturity date (as is the case with a forward contract).<sup>69</sup> Interestingly, “[a] swap does not affect the obligations or benefits of the underlying asset to which the agreed-upon payments relate. It is a side agreement based on the value of the underlying asset.”<sup>70</sup>

The OTC (over-the-counter) swap market has evolved due to the limitations of the standardized futures and options.<sup>71</sup> The equity swaps on the OTC derivative markets can be prepared on

63. SMITH, SMITHSON & WILFORD, *supra* note 47, at 353.

64. The CFTC Rule 35.1(b)(1) defines a swap agreement as the following: an agreement . . . which is a rate swap agreement, basis swap, forward rate agreement, commodity swap, interest rate option, forward foreign exchange agreement, rate cap agreement, rate floor agreement, rate collar agreement, currency swap agreement, cross-currency rate swap agreement, currency option, or other similar agreement (including any option to enter into any of the foregoing); any combination of the foregoing; or a master agreement for any of the foregoing together with all supplements thereto. 17 C.F.R. § 35.1(b)(1) (2003).

65. SMITH, SMITHSON & WILFORD, *supra* note 47, at 354.

66. Karol, *supra* note 42, at 199. These types of contracts occur when “[a] borrower with a fixed-rate obligation (but desiring a floating rate exposure) and another borrower with a floating rate obligation (but desiring a fixed rate) would each agree to make interest payments to the other based on the desired exposure to a certain agreed-upon or ‘notional’ amount.” Karol, *supra* note 42, at 199.

67. SMITH, SMITHSON & WILFORD, *supra* note 47, at 354.

68. Karol, *supra* note 42, at 199.

69. SMITH, SMITHSON & WILFORD, *supra* note 47, at 354.

70. Karol, *supra* note 42, at 199.

71. Karol, *supra* note 42, at 198.

almost any stock index or single stock.<sup>72</sup>

#### 4. Option Contract

Options are often purchased in such mundane transactions that consumers are not aware that they are purchasing an option.<sup>73</sup> In a financial option contract, the owner is given the right to either buy or sell the asset.<sup>74</sup> This is different from the owner of forward, future, or swap contract because in those contracts there is an *obligation* for the contract owner to buy, sell or swap.<sup>75</sup>

The option contracts are contracts where the buyer, also known as the holder, gives an amount called the premium to the seller, who is also known as the writer.<sup>76</sup> The buyer pays so that he can have a right to buy from the writer what is deemed a “call,” or, if he elects not to buy, he can sell or “put” to the writer the asset at the price the parties had agreed to before a designated time.<sup>77</sup> In other words a call option gives the owner the right to buy an asset at a specified future date and price, which is agreed upon the day of purchase, while the put gives the owner the right to sell an asset at a specified date.<sup>78</sup> It should be emphasized that in the case of the option, *no obligation* exists for the buyer: he merely has the *right* to purchase the asset.<sup>79</sup> The seller, on the other hand, who sells a call on common stock makes a promise to deliver shares if he is *obligated* to do so by the option call holder.<sup>80</sup>

72. GAO, ISSUES RELATED TO THE SHAD-JOHNSON JURISDICTIONAL ACCORD, *supra* note 3, at 2.

73. ROBERT KOLB, UNDERSTANDING OPTIONS 1 (1995). An example of a typical option can occur when a consumer purchases an automobile and chooses to add equipment “at extra cost.” *Id.* In this way an option just means an opportunity to select or choose. *Id.* A financial option is a more narrow type of option that is offered through a financial contract. *Id.*

74. STEPHEN ROSS, RANDOLPH W. WESTERFIELD & JEFFREY JAFFE, CORPORATE FINANCE 612 (6th ed., 2002). Perhaps a more succinct way to explain the option is as “a *side-bet* . . . a contract that affects the two parties to it without affecting the corporation or other shareholders.” WILLIAM A. KLEIN & JOHN C. COFFEE, BUSINESS ORGANIZATION AND FINANCE, LEGAL AND ECONOMIC PRINCIPLES 286 (8th ed., 2002).

75. ROSS, WESTERFIELD & JAFFEE, *supra* note 75, at 612.

76. *Id.*

77. Karol, *supra* note 42, at 195.

78. *Id.*

79. ROSS, WESTERFIELD & JAFFEE, *supra* note 75, at 612.

80. *Id.* Professors Ross, Westerfield, and Jaffe note that qualitatively, an option can be valued as a “function of five variables: (1) The current price of the underlying asset, which for stock options is the price of a share of common stock (2) The exercise price (3) The time to expiration date (4) The variance of the underlying asset (5) The risk-free interest rate.” ROSS, WESTERFIELD & JAFFEE, *supra* note 75, at 625. An “American” option is the type that is exercisable prior to maturity as well as at maturity, while the

Options and futures, individually, are actually quite different in structure. Yet they compete for the same types of investors because of their similar uses in hedging and speculating.<sup>81</sup> Options have grown to be advantageous for the following reasons: (i) call options are less expensive than the underlying stock because it costs less to make the trade; (ii) put options are normally less than the underlying goods as well; (iii) investors can earn more price action in options rather than stock itself due to the high volatility of options; (iv) investors can use the options to carefully adjust the risk in their portfolios by strategically buying or selling the option given the risk of the market at that particular time; (v) transaction costs are normally lower; and (vi) the tax code may favor trading options over trading the underlying stock.<sup>82</sup>

Like futures contracts, options exchanges can attribute their success to the standardized contract.<sup>83</sup> If the financial market is liquid, a trader can speedily trade the good at an equitable price because the liquidity of the market provides for efficiency and cost-effective trades accompanied with high volume.<sup>84</sup> The standardized contract has advanced the liquidity because the contract calls for a specific time, a day of expiration, and since the trading times are well known among traders, they can easily find each other in the marketplace.<sup>85</sup>

## 5. Futures Options

The futures option, also known as an option of futures, is a special class of options where the underlying asset is itself a futures contract.<sup>86</sup> Futures options alone contain a wide range of goods that include debt instruments, foreign currency, precious

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“Bermuda” option is only exercisable at certain times. Karol, *supra* note 42 at 195-96. The “European” option is another option that is somewhat different from the American because it can only exercised on the expiration date. Karol, *supra* note 42, at 195-96.

81. Securities and Exchange Commission, Jurisdiction, Pub. L. No. 97-303, 1982 U.S.C.C.A.N. (96 Stat. 1409) 2780, 2784 n.8.

82. KOLB, *supra* note 74, at 6. The relevant sections that provide treatment in the Internal Revenue Code are §1234B, Gains or Losses From Securities Futures Contracts, and §1256, Contracts Marked to Market. I.R.C. §§ 1234B, 1256 (2000). Generally, an investor that disposes of an option by selling it, exercising the option, or letting it expire will either profit or lose from the transaction. *Id.* at § 1234B(a)(1). The Code treats a profit or loss from the option as a capital gain or loss. *Id.* at § 1256(a)(3). This puts options profits and losses subject to the regular capital gains and loss rules. KOLB, *supra* note 74, at 27. If the loss is a long term capital loss, then it can qualify for favorable tax treatment. KOLB, *supra* note 74, at 27.

83. KOLB, *supra* note 74, at 7.

84. *Id.*

85. *Id.*

86. *Id.* at 9.

metals, petroleum products, and agricultural products.<sup>87</sup>

The Chicago Board of Trade (CBOT) and the Chicago Mercantile Exchange (CME) essentially control the futures market because they make up the largest share of trading of futures options.<sup>88</sup> Both of these boards are self-regulatory organizations (SRO's),<sup>89</sup> and they trade options on financial as well as agricultural products.<sup>90</sup>

#### D. *Advantages of Derivatives*

##### 1. Avoiding Risk

The use of derivatives is to allocate risk rather than to create wealth (capital formation).<sup>91</sup> They can serve many purposes, but their primary function is merely the shifting of price risk.<sup>92</sup> Modern portfolio theory holds that risk should be managed, rather than avoided, and the best strategy is to diversify the risk within a portfolio.<sup>93</sup> Financial markets will operate at the highest level when every possible mixture of risk and return has been presented so that investors can create a portfolio to match each preference and taste. Thus, professional investors, in conjunction with the exchanges, invent new types of securities to fill those preferences.<sup>94</sup> The prudent investor is aware that a high rate of

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87. *Id.* "In general, each futures exchange trades options on its own active futures contracts." *Id.* at 14. "Therefore, the variety of options on futures is almost as diverse as futures contracts themselves." *Id.*

88. KOLB, *supra* note 74, at 14. Together they comprise about 80% of the market.

89. GAO, ISSUES RELATED TO THE SHAD-JOHNSON JURISDICTIONAL ACCORD, *supra* note 3, at 7. A self-regulatory organization is a private member that has the power to adopt and enforce rules against its members under federal law. GAO, ISSUES RELATED TO THE SHAD-JOHNSON JURISDICTIONAL ACCORD, *supra* note 3, at 7 n.15. Self-regulatory organizations are an important piece of the internal regulation of the futures industry and include members such as the NASD (the National Association of Securities Dealers), the NFA (National Futures Association) and all of the futures and securities exchanges in the U.S. *Id.*

90. KOLB, *supra* note 74, at 14.

91. *Chairman Lauds New CFTC-SEC Ties*, SEC. INDUS. NEWS, Nov. 4, 2002, at 3. In an interview with Security Industry News, CFTC Chairman James Newsome clarified that futures contracts are mainly for allocating risk. *Id.* Mr. Newsome further stated that security futures, a special future discussed *infra*, provide a more targeted approach to managing risk by using single stock futures or narrow stock index futures. *Id.*

92. Karol, *supra* note 42, at 196.

93. See ROBERT S. PINDYCK & DANIEL L. RUBINFELD, MICROECONOMICS 159 (4th ed. 1998) (1995). The three ways consumers normally reduce risk are "diversification, insurance, and obtaining more information about choices and payoffs." *Id.* Derivatives can fall into the first category of diversification and possibly the second as a type of insurance, or hedging, against risk.

94. Chicago Mercantile Exch. v. SEC, 883 F.2d 537, 544 (7<sup>th</sup> Cir. 1989) (citing Dennis W. Carlton, *Futures Markets: Their Purpose, Their History, Their Growth, Their*

return is normally accompanied by a high amount of risk.<sup>95</sup>

## 2. Hedging

Hedging is the technique used where investors reduce risks associated with holding financial instruments such as options or even stocks themselves.<sup>96</sup> Investors will buy options not only to speculate on the increase or decrease in price (such as an optimist buying a call and a pessimist buying a put), but also to hedge against price changes.<sup>97</sup> Multinational companies often resort to hedging to reduce variations in income due to fluctuating exchange rates.<sup>98</sup> A basic way of explaining the hedging technique is as follows<sup>99</sup>:

If company A, headquartered in Houston, sells X amount of a good in foreign country Z, company A will want to reduce the variation of income due to fluctuating interest rates.<sup>100</sup> The best way to guard against the fluctuating interest rates would be to borrow funds from the local bank in foreign country Z's own currency. By doing so, company A has taken a position equal and opposite to the gains made. If the value of the local country Z's

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*Successes and Failures*, 4 J. Futures Markets 237 (1984).

95. Frank H. Easterbrook, *Derivative Securities and Corporate Governance*, 69 U. CHI. L. REV. 733, 736 (2002). Judge Easterbrook stated that, “[d]erivatives also attract the gullible such as the treasurer of Orange County, who thought that he could get four times the market return without bearing abnormal risk. Wrong. High return goes with high risk.” *Id.*

96. The Supreme Court has classified futures traders into two general classifications: “trade” hedging customers, and speculators. *See* Merrill Lynch, Pierce, Fenner & Smith, Inc. v. New York Mercantile Exch., 456 U.S. 353, 359 n.11 (1982) (defining the “trade” customer as the one “who seeks, at low cost, to protect himself or his company against possible loss due to adverse price fluctuations in the market place,” compared to speculators “. . . who seek financial gain by taking positions in volatile markets”).

97. *See* ROBERTA ROMANO, FOUNDATIONS OF CORPORATE LAW 141 (Foundation Press 1993).

98. JAMIE PRATT, FINANCIAL ACCOUNTING IN AN ECONOMIC CONTEXT 265-66 (John Wiley & Sons, Inc. 2003).

99. *See id.* (this hypothetical is an extrapolation from computations on recognition of exchange gains and losses).

100. It is important to remember that exchange rates fluctuate on a daily basis. Therefore, when company X sells a certain amount of goods in the foreign country throughout the month and needs to accrue those earnings either at the end of the month, quarter, or year, the sales on some days will be worth more and some less (in company A's own currency) depending on the exchange rates when the sales were made. The way for companies to reduce risk if the exchange rates prove to be unfavorable, is to use the hedging technique.

currency strengthens, then company A is covered by the loans it has taken out. Either way, company A, like many multinationals,<sup>101</sup> will be able to recognize the gain made from the trade without having to fear interest rate fluctuations.<sup>102</sup>

The distinction between the jurisdiction of the SEC and CFTC has even been referred to as the difference between capital formation and regulating hedging.<sup>103</sup> Congress envisioned the role of regulating hedging when it created the CFTC in 1974 and gave it functions that previously belonged to the Department of Agriculture because futures had gone beyond the realm of just commodities as they expanded into financial markets.<sup>104</sup> Volatility in price drives the demand for hedging, which can be done through financial instruments like options or futures contracts.<sup>105</sup>

### 3. Less Transaction Costs

Another reason derivatives contracts have become so popular is that the transaction costs are much smaller than the costs of trading the underlying stocks in equivalent volumes.<sup>106</sup> Trading futures derivatives can be faster and less expensive than trading in the stock market.

## III. ANALYSIS

Even after a somewhat comprehensive look at the different types of derivatives, they are, to say the least, a very complex group of securities. However, the U.S. securities regulatory system historically tried to categorize them as either "(i)

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101. Hedging is commonly practiced by U.S. multinationals, such as General Motors, who holds long-term debts payable in Canadian Dollars, Australian dollars, Swiss francs, Japanese yen, German marks, Spanish pesetas, Belgian francs, and British pounds, as well as other currencies. *See* PRATT, *supra* note 99, at 266.

102. More specific types of hedging include a micro hedge (when a financial institution is hedging the interest-rate risk for a specific asset it is holding) and a macro hedge (when a company will hedge against its entire portfolio.) *See* FREDERIC S. MISHKIN, *THE ECONOMICS OF MONEY, BANKING, AND FINANCIAL MARKETS* 359 (Addison-Wesley 1998).

103. *Chicago Mercantile Exch. v. SEC*, 883 F.2d 537, 543 (7th Cir. 1989).

104. *See id.*

105. Robert S. Pindyck, *The Dynamics of Commodity Spot and Futures Markets: A Primer*, 22 *ENERGY J.* 1, 2 (2001). A physical way to hedge is by increasing inventory. *Id.*

106. *Bd. of Trade of the City of Chicago v. SEC*, 187 F.3d 713, 716 (7th Cir. 1999). For example, a pension fund that wants to switch from stocks to the equivalent of a mixed stock and bond portfolio, without incurring the costs of trading the stocks, can accomplish this by selling a futures contract on an index.

securities or (ii) futures or options on commodities, subject to the respective jurisdictions of the SEC and the CFTC.”<sup>107</sup> The problem with this overly simplified categorization is that few of the derivatives used in today’s markets fit neatly into either category.<sup>108</sup> Justice Easterbrook of the Seventh Circuit Court of Appeals has correctly analogized the categorization dilemma as trying to decide “whether tetrahedrons belong in square or round holes.”<sup>109</sup>

The first half of the analysis portion of this comment will review the two commissions and their respective jurisdictions in more depth. The second half of the analysis will break down the conflict between the agencies and the reasons for the conflict.

### A. Regulatory Commissions

#### 1. Creation and Jurisdiction of the CFTC

The CFTC, like the SEC, has a five-member commission in which presidentially-appointed chairpersons govern for terms of five years each.<sup>110</sup> Some of the responsibilities of the commissioners include approving SRO (self-regulatory organization) rules, amending existing rules, and authorizing enforcement actions.<sup>111</sup> By providing federal oversight to the self-regulated futures exchanges,<sup>112</sup> the CFTC generally administers and thus promotes market efficiency and protection of investors from fraud.<sup>113</sup>

The principal base of the CFTC’s power comes from the

107. Karol, *supra* note 42, at 205-6.

108. *Id.*

109. *Id.* (citing to Justice Easterbrook’s comment in *Chicago Mercantile Exch. v. SEC*, 883 F.2d 537, on the lack of definition found in the statutes over the definitions of “contracts” and “options”).

110. GAO, SEC AND CFTC FINES FOLLOW UP: COLLECTION PROGRAMS ARE IMPROVING, BUT FURTHER STEPS ARE WARRANTED (GAO-03-795, July 2003), at 6.

111. *Id.* The CFTC overlooks the SRO’s involved with futures markets, who play a vital role in regulating the markets to insure that members are in compliance, such as the Chicago Board Options Exchange, Chicago Board of Trade, Chicago Mercantile Exchange, National Futures Association, and the New York Mercantile Exchange. *Id.* at 1 n.2, 2 n.3. For an in depth comparison of the SEC and CFTC programs, see generally GAO, ADMINISTRATIVE LAW JUDGES: COMPARISON OF SEC AND CFTC PROGRAMS (GAO/GGD-96-27 Nov. 1995).

112. GAO, FUTURES MARKETS: HEIGHTENED AUDIT TRAIL STANDARDS NOT MET BUT PROGRESS CONTINUES (GAO/GGD-96-177 Sept. 1996), at 3.

113. GAO, RESULTS ACT: OBSERVATIONS ON CFTC’S FISCAL YEAR 2000 ANNUAL PERFORMANCE PLAN (GAO/GGD-99-51, Mar. 1999), at 2. The public policy underlying the CEA is protection of “the public interest in the proper functioning of the futures and option markets’ price discovery and risk-shifting functions.” *Id.*

Commodity Futures Trading Commission Act, passed in 1974.<sup>114</sup> This act, which is an amendment made to the statute already amended in 1934 and 1968, gives the Commission more power by expanding the Commission's coverage and by adding more penalties against potential violators.<sup>115</sup> The CFTC also has the ability to step in and investigate complaints against those who may have violated the CEA, such as a futures commission merchant.<sup>116</sup>

If the enforcement division of CFTC believes that a law has been violated, they will prepare a memorandum for the Commission setting forth the purported violations.<sup>117</sup> If the Commission determines that sufficient evidence has been presented such that further action is necessary, then the commission will authorize the filing of a civil suit.<sup>118</sup> The suit can be brought either in federal district court or before an appointed administrative law judge.<sup>119</sup> Both the administrative law judge and the federal district court judge have the power to suspend the violator from the futures industry, issue fines and disgorgements, and finally, order restitution.<sup>120</sup>

As is usually the case, statutory definitions play an important role in defining the scope of CFTC jurisdiction. Before Congress inserted Section 201, the term "commodity", as defined under the CEA, consisted of specific agricultural commodities, and, the Secretary of Agriculture originally designated the contracts markets.<sup>121</sup> Section 201 of the bill expanded the term "commodity" to encompass *all goods and articles*, save for onions, plus other services, rights, and interests somehow connected to the future delivery of goods.<sup>122</sup> The new definition provided the CFTC with *exclusive jurisdiction* over all futures transactions including options trading in commodities (but not options on securities).<sup>123</sup> Futures contracts have to meet the approval CFTC

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114. See Commodity Futures Trading Commission Act of 1974, Pub. L. No. 93-463, 1974 U.S.C.C.A.N. (88 Stat. 1389) 5843, 5852 (added an entirely new section authorizing the creation of national futures associations).

115. *Id.* at 1389, 1395, 1412 (each amended separate sections of the CEA).

116. *Id.* at § 106, 88 Stat. 1393-1395 (adding § 14 of the CEA, codified as subsequently amended, 7 U.S.C. § 18 (1976 ed. & Supp.IV)).

117. GAO, SEC AND CFTC FINES FOLLOW-UP, *supra* note 111, at 6.

118. *Id.*

119. *Id.*

120. *Id.*

121. See Commodity Futures Trading Commission Act of 1974, Pub. L. No. 93-463, 1974 U.S.C.C.A.N. (88 Stat. 1389) 5843, 5852.

122. *Id.*

123. See *id.* Unless they involved the sale for future delivery conducted on a board of trade, transactions in foreign currency, security warrants and rights, resales of

before being traded, and the exchanges proposing a contract must act in accordance with CFTC regulations to be authorized as boards of trade.<sup>124</sup>

## 2. Creation and Jurisdiction of the SEC

A thorough analysis of the evolution of the SEC and all the types of securities that fall under its jurisdiction, as noted *supra*, is beyond the scope of this paper. This sub-section will however present a little on the background of the SEC and its regulatory power with respect to derivatives securities.

The SEC has had the power to regulate trade in securities, the securities exchanges, and market professionals who use those exchanges, since the Securities Exchange Act was enacted in 1934.<sup>125</sup> Due to the severe problems caused by the stock market crash of 1929, a number of securities laws were created to curb detrimental activities such as insider trading,<sup>126</sup> highly leveraged speculation, and market manipulation by the market players.<sup>127</sup> Through Section 14(a), Congress gave authorization to the SEC to promulgate rules that govern private conduct in order to protect investors.<sup>128</sup> Congress purposefully left the definition of “security” broad so that it could reach a wide range of instruments.<sup>129</sup> Under the Securities Exchange Act of 1934, the

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installment loan contracts, repurchase options, government securities or mortgages, and mortgage purchase commitments are not subject to the Act. *Id.*

124. See Commodity Futures Trading Commission Act of 1974, Pub. L. No. 93-463, 1974 U.S.C.C.A.N. (88 Stat. 1389) 5843, 5852.

125. Securities and Exchange Commission, Jurisdiction, Pub. L. No. 97-303, 1982 U.S.C.C.A.N. (96 Stat. 1409) 2780, 2784 n.8. For an excellent discussion on legal transactions that fall out of the jurisdiction of the SEC in the form of venture capital distributions among limited partners, see Paul Gompers and Josh Lerner, *Venture Capital Distributions: Short-Run and Long-Run Reactions*, 53 J. FIN. 2162 (1998).

126. 7 C.F.R. § 420.10b-5 (2000) (Rule 10b-5 of the Securities Exchange Act 1934 sets forth the violations for insider trading).

127. Securities and Exchange Commission, Jurisdiction, Pub. L. No. 97-303, 1982 U.S.C.C.A.N. (96 Stat. 1409) 2780, 2784 n.8.

128. MELVIN A. EISENBERG, CORPORATIONS AND OTHER BUSINESS ORGANIZATIONS (8th ed. 2000).

129. Securities and Exchange Commission, Jurisdiction, Pub. L. No. 97-303, 1982 U.S.C.C.A.N. (96 Stat. 1409) 2780, 2784 n.8. The Congressional Record notes that “the definition of ‘security’ under the federal securities laws includes, among other things, stocks, bonds, notes, investment contracts, “any instrument known as a ‘security,’” and any certificate of interest or participation in or right to purchase a security.” *Id.* Security is defined in the Securities Exchange Act as “any note, stock, treasury stock, . . . any put, call, straddle, option, or privilege on any security . . . or group or index of securities (including any interest therein or based on the value thereof), . . . or in general, any instrument commonly known as a ‘security.’” 15 U.S.C. §78c(a)(10)(2000). The definition, although somewhat circular, also includes “any certificate of interest or participation in . . . or warrant or right to subscribe to or purchase, any of the foregoing . . .” *Id.* Note the similarity to the definition of “security future” in the CFMA. See Nijenhuis, *supra*

definition of “security” does not expressly incorporate the word “option”; however, the SEC took jurisdiction over options trading because “a call option on a security is a ‘right to purchase’ a security, and both put and call options on securities are considered instruments ‘commonly known as’ securities.”<sup>130</sup> The SEC expanded its authority under §§5, 6, 10, 15, 19, and 23 of the Securities Exchange Act of 1934 to include options.<sup>131</sup> The reason why options play an important yet controversial part to the SEC–CFTC controversy is that they can be used to accomplish the same result as some types of futures.<sup>132</sup>

### B. Regulatory Problems for the CFTC

The jurisdictional issues between the SEC and CFTC have been attributed to a lack of clear statutory definitions, but the overall scope of the CEA can be summarized as follows. The Act, under § 2(a)(1)(A) provides the CFTC with exclusive jurisdiction over “accounts, agreements . . . and transactions involving contracts of sale of a commodity for future delivery . . .”<sup>133</sup> Again, the futures contracts transactions can only take place on the CFTC approved board of trade.<sup>134</sup> Cash forward contracts are not included in this section and thus fall outside the scope of the Act and CFTC jurisdiction.<sup>135</sup> This results in courts trying to define forward contracts, which has become more difficult as markets mature.<sup>136</sup>

#### 1. Forward Contract is Not Defined by the Commodities Exchange Act

Since there are no statutory definitions of either a futures or a forward contract in the CEA, the definition was judicially

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note 1.

130. Securities and Exchange Commission, Jurisdiction, Pub. L. No. 97-303, 1982 U.S.C.A.N. (96 Stat. 1409) 2780, 2784 n.8.

131. *See id.* The SEC also has plenary and specific power under the §9 to set terms and conditions of exchange trading of options. *Id.*

132. *CFTC and SEC Close in on Adopting Final Rules for Single Stock Futures*, SEC WEEK, May 27, 2002. Essentially options traders are concerned that a security future may offer a “quicker, less expensive alternative to creating ‘synthetic futures’ using two options contracts.” *Id.*

133. 7 U.S.C. § 2 (2000). *See also* CFTC Notices – Commodity Futures Trading Commission: Statutory Interpretation Concerning Forward Transactions (Tuesday, September 25, 1990).

134. 55 Fed. Reg. 39188, at 39190 (Sept. 25, 1990).

135. *Id.*

136. Inevitably, when this issue is litigated, one side will normally argue that they were dealing a cash forward and the other side will argue that it was a future. *Transnor (Bermuda) Ltd. v. BP N. America Petroleum*, 738 F. Supp. 1472, 1489 (S.D.N.Y. 1990).

created in the case *In re Stovall*.<sup>137</sup> The respondent, Stovall, a floor broker on the Chicago Board of Trade as well as the president of his own registered futures commission merchant, was charged with willfully violating the Commodity Exchange act by “engaging in a course of business in which [he] solicited and accepted orders which he represented to be for contracts for purchase and sale of cash commodities” but were instead “contracts for the purchase and sale of commodities for future delivery.”<sup>138</sup>

In determining whether the contracts were contracts of sale or commodities for future delivery, the Commission identified three main elements, and arguably a fourth, for commodity futures:

Commodity futures transactions involve [1] standardized contracts for the purchase or sale of commodities which provide for future, as opposed to immediate delivery, and [2] which are directly or indirectly offered to the general public and [3] are secured by earnest money . . . [4] [and] are entered into primarily for the purpose of shifting the risk of change in value of commodities, rather than transferring ownership of the actual commodities.<sup>139</sup>

The Commission made it very clear that the above elements were by no means exhaustive but were rather factors that will be considered on a case by case basis and given a totality of the circumstances approach.<sup>140</sup>

The Commission, in *Stovall*, also noted that the Stovall clients testified they were not interested in taking or making deliveries of the cash commodity but were instead just speculating even though the language of the contract called for delivery of the commodity.<sup>141</sup> The commission cited to *Tcherepnin v. Knight* and appeared to be recognizing substance over form by looking to the parties’ intent.<sup>142</sup>

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137. See *In re Stovall*, [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) p. 20,941, at 23,775, (CFTC Dec. 6, 1979).

138. *Id.*

139. *Id.*

140. *Id.* The Commission stated, “we will look at each operation in context and will not hesitate to look behind whatever label the parties may give to the instrument.” *Id.*

141. *Id.*

142. *Id.*

The judicial view of examining each transaction as a whole rather than by the *Stovall* factors was reiterated by the Ninth Circuit in *Commodity Futures Trading Commission v. Co Petro Marketing Group*, where the court used *Stovall* as precedence to hold that motor fuel agency agreements were off-exchange futures contracts not permitted by the Commodities Exchange Act.<sup>143</sup> Co Petro was both a gas retailer as well as a petroleum product broker who bought and sold gas by the hundreds of thousands of gallons each month.<sup>144</sup> In addition to distributing gas commercially and to retail users, Co Petro sold motor fuel agency agreements (contracts for the future purchase of petroleum products), and Co Petro, through sales agents and newspaper advertisements, promoted the contracts to the general public at length.<sup>145</sup>

The Ninth Circuit expressly stated that the transactions would be looked at as a whole:

In determining whether a particular contract is a contract of sale of a commodity for future delivery over which the commission has regulatory jurisdiction . . . , no bright-line definition or list of characterizing elements is determinative. The transaction must be viewed as a whole with a critical eye toward its underlying purpose.<sup>146</sup>

The court examined the other factors of futures contracts, but ultimately held that the forward contracts exclusion is narrow and thus unavailable for contracts where future delivery of the good was not expected.<sup>147</sup> Other courts have followed in step with the Ninth Circuit in looking at the totality of the circumstances.<sup>148</sup>

Another case in this line of distinction, albeit much less influential than *Stovall* or *Co Petro*, was *Transor Ltd. v. BP*

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143. See *CFTC v. Petro Mktg. Group, Inc.*, 680 F.2d 573 (9th Cir. 1982). See also Alton B. Harris, *The CFTC and Derivative Products: Purposeful Ambiguity and Jurisdictional Reach*, 71 CHI.-KENT L. REV. 1117, 1124 (1996).

144. *Petro Mktg. Group, Inc.*, 680 F.2d at 576.

145. *Id.*

146. *Id.* at 581.

147. *Id.* at 579. See Harris, *supra* note 144, at 1124.

148. See *Lachmund v. ADM Investor Services, Inc.*, 191 F.3d 777, 787 (7th Cir. 1999) (looking at totality of the circumstances such as the relationship between parties, course of dealing, and language of the contract). See also *The Andersons, Inc. v. Horton Farms, Inc.*, 166 F.3d 308, 319-320 (6th Cir. 1998) (looking at substance of contract over form of the contract and on whether delivery of the commodity in the contract was even considered).

*North America Petroleum*.<sup>149</sup> In *Transor*, the plaintiff, a company incorporated in Bermuda that refused to take delivery for two oil cargoes (futures) due to a decrease in their market value, sued British Petroleum, Conoco, Shell Oil, and Exxon, among others, under provisions of the CEA and the Clayton Act (anti-trust violations).<sup>150</sup>

Transor argued that the defendants conspired to cause a decrease in crude oil by selling of Brent Oil at prices less than what the market would bear.<sup>151</sup> The defendants first argued that Transor lacked standing, and secondly they argued that the contracts were “cash forward contracts” that did not fall under the purview of the CEA and thus the CFTC.<sup>152</sup>

The New York District Court disagreed with the defendant and held that the transactions were in fact futures contracts under the scope of the CEA and subject to the CFTC.<sup>153</sup> In noting that the distinctive features separating futures from forward contracts were diminishing due to the complexity of commercial transactions, the court stated “[t]he predominant distinction between the two remains the intention of the parties and the overall effect of the transaction.”<sup>154</sup>

In *Nagel v. ADM Investor Services, Inc.*, Judge Easterbrook completely threw out the multi-factor approach listed above because, among other things, the phrase “contract for future delivery” has a technical meaning, the approach ignores the statutory text, and finally the test creates undesirable uncertainty.<sup>155</sup> Judge Easterbrook’s recent definition of a futures contract was provided in *Board of Trade of the City of Chicago v. Securities Exchange Commission*, a case where the SEC attempted to deny approval of futures contracts that were based on the Dow Jones Utilities and Transportation Averages.<sup>156</sup> Justice Easterbrook, writing for the Seventh Circuit Court of Appeals, defined a futures contract as follows:

A futures contract, roughly speaking, is a fungible promise to buy or sell a particular commodity at a fixed date in the future. Futures contracts are

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149. 738 F.Supp 1472 (S.D.N.Y. 1990).

150. *Id.* at 1475.

151. *Id.* at 1475.

152. *Id.* at 1489.

153. *Id.* at 1489-91.

154. *Id.* at 1489.

155. *Nagel v. ADM Investor Servs., Inc.*, 65 F. Supp. 2d 740, 750-52 (N.D. Ill. 1999), *aff'd*, 217 F.3d 436 (7th Cir. 2000) (“Nagel II”).

156. *Bd. of Trade of Chicago v. SEC*, 187 F.3d 713, 717 (7th Cir. 1999).

fungible because they have standard terms and each side's obligations are guaranteed by a clearing house. Contracts are entered into without prepayment, although the markets and clearing house will set margin to protect their own interest. Trading occurs in 'the contract' not in the commodity.<sup>157</sup>

In relying on this definition, the Seventh Circuit went on to hold that the SEC could not reject a futures contract merely because the small sample of stocks on the indexes are not themselves a considerable segment. The court further held that there was not sufficient evidence to determine that trading in the proposed contracts futures contracts were in violation of the rule against a futures contract on a single security.<sup>158</sup>

The preceding cases exemplify the uncertainty in the line of distinction between forward and future contracts. The bottom line is that the courts will nearly always look at the parties' intent and focus on the substance over the form of the contract.

## 2. The Line Distinguishing Forwards from Futures Is Further Blurred Due to Innovative Derivatives

The markets' ability to create new and innovative derivative securities exacerbates the issue of not having a statutory definition. As futures trading has increased in popularity and the markets have matured,<sup>159</sup> the types of derivative securities introduced into the market have become progressively more innovative.<sup>160</sup> As stated in the previous section, futures and forwards have been differentiated based on whether the parties intended for delivery when they made the contract.<sup>161</sup> More specifically, "[f]orwards served primarily a commercial function

157. *Id.* at 715 (citing *Chicago Mercantile Exchange v. SEC*, 883 F.2d 537, 542 (7th Cir.1989); see also *Dunn v. CFTC*, 519 U.S. 465, 471-72 (1997).

158. *Bd. of Trade of Chicago*, 187 F.3d at 720-22.

159. See GAO, THE COMMODITY EXCHANGE ACT: ISSUES RELATED TO THE REGULATION OF ELECTRONIC TRADING SYSTEM (GAO/GGD 00-99, May 2000), at 5 (noting that the annual trading of U.S. futures exchanges is up 93 percent from 1989 to 1993).

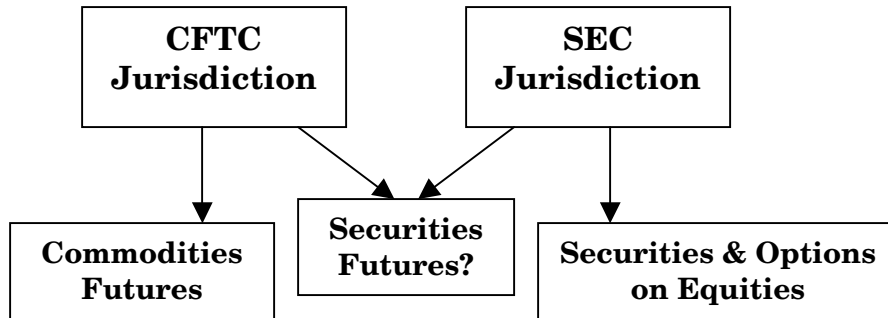
160. KOLB, *supra* note 74, at 1. In 1992, Merton Miller commented on the rapid change in the in financial instruments: "[S]o rapid has been the pace of innovation in financial instruments . . . over the last 20 years that nothing could have prepared [a Rip Van Winkle type] to understand such now commonplace notions as swaps and swaptions, index futures, program trading, butterfly spread . . . – to name just a few . . . exotic ones." MERTON H. MILLER, *Financial Innovation: Achievements and Prospects*, in THE REVOLUTION IN CORPORATE FINANCE 337 (Joel M. Stern and Donald Chew eds., 2003).

161. See GAO, THE COMMODITY EXCHANGE ACT: LEGAL AND REGULATORY ISSUES REMAIN, *supra* note 36, at 18.

and, as such, entailed delivery of the underlying commodity in normal commercial channels, but delivery was to occur at a latter date” while “futures were used primarily to shift or assume price risk without transferring the underlying commodity; thus actual delivery was not expected to occur.”<sup>162</sup> It is now difficult to distinguish forwards from futures because several unregulated forwards have developed to where delivery of the underlying commodity may not regularly take place, triggering a legal risk in the fear that forwards are unenforceable.<sup>163</sup>

The danger of the evolution of markets becomes more apparent in the new agricultural contracts that have been created in an effort to shift risk due to heightened price volatility and the globalization of agricultural markets.<sup>164</sup> The old contracts fail to provide the producers with enough flexibility because they require a delivery; therefore, variations in the forwards allow parties to “offset, cancel, or void delivery obligations rather than transfer the underlying commodity [that] may be viewed as futures contracts or trade options.”<sup>165</sup> If viewed as trade options with a non-agricultural underlying asset, the contracts are permitted by the CFTC; however, if the contracts are construed to be trade options with an agricultural underlying asset, then they are prohibited by the CFTC.<sup>166</sup> The question is where to draw the line.

*C. The Competition Between the CFTC and SEC*



In 1974, when the CFTC was originally created, the probability of disagreement between the CFTC and SEC was small because futures trading at that time mainly covered grains

162. See *id.* at 19.

163. See *id.* at 18.

164. See *id.* at 19.

165. See *id.* at 18.

166. See *id.* at 19-20.

and meats.<sup>167</sup> The incongruity became more apparent when more innovative financial futures instruments were introduced into the market resulting in disputes over their jurisdiction.<sup>168</sup>

One of the main reasons for the competition is that exchanges, like corporate firms, are driven by volume.<sup>169</sup> If one exchange (and thus one agency) obtains jurisdiction over a new type of contract, then they can increase their budgets and staffs, not to mention an augmentation in prestige.<sup>170</sup>

Exchanges act in the same manner as that of a firm in direct competition with another firm, even though exchanges are actually not for profit.<sup>171</sup> Although not a problem when the commodities under the purview of the CFTC only involved wheat and pork bellies, tension grew when futures were offered on securities and futures thus became close substitutes for options.<sup>172</sup>

The root of the conflict can be traced all the way back to the Commodity Exchange Act in 1974, which gave the CFTC exclusive jurisdiction over commodity futures because the definition for commodity – “all services rights, and interest in which contracts for future delivery are presently or in the future dealt in” – can be broadly interpreted to mean that any future would become a “commodity” and thus under the regulatory regime of the CFTC.<sup>173</sup> Congress must share some of the blame of this turf war because, when it obscurely created the CFTC in 1974, Congress seemingly preempted the field of commodity futures by providing restricted jurisdiction to the CFTC.<sup>174</sup> The 1974 amendments to the CEA were not intended to supersede SEC jurisdiction.<sup>175</sup> The vagueness evidences that, since the beginning of the CFTC, there never really were bright lines outlining the jurisdiction and authority of both the CFTC and the

167. B. Peter Pashigian, *The Political Economy of Futures Market Regulation*, 59 J. BUS. S63 (1986).

168. *Id.*

169. Daniel R. Fischel, *Regulatory Conflict and Entry Regulation of New Futures Contracts*, 50 J. BUS. S99 (1986). The profit is derived from transactional services sold by the exchange. See also Dennis W. Carlton, *Futures Markets: Their Purpose, Their History, Their Growth, Their Successes and Failures*, 4 J. FUTURES MKT. 237 (1991).

170. Fischel, *supra* note 170, at S99.

171. Carlton, *supra* note 170, at 237.

172. Fischel, *supra* note 170, at S100.

173. Securities and Exchange Commission, Jurisdiction, Pub. L. No. 97-626, 1982 U.S.C.A.N. (96 Stat. 1409) 2780, 2784.

174. See 7 U.S.C. §2(a)(1)(A)(2000); see also 120 CONG. REC. 30, 458-59 (1974) (remarks of Sen. Talmadge).

175. John C. Coffee, *Competition Versus Consolidation: The Significance of Organizational Structure in Financial and Securities Regulation*, 50 BUS. LAW. 447, 461 (1995).

SEC.

The question of which agency, the SEC or the CFTC, should regulate single stock and certain stock index futures has hinged on whether the securities are regulated under commodities laws or securities laws.<sup>176</sup> The test for determining jurisdiction is from *Chicago Mercantile Exchange v. SEC*, which first asks whether the instrument is a futures contract.<sup>177</sup> If the answer to this is “yes, then the CFTC’s jurisdiction is exclusive, unless it is also an option on a security, where the SEC’s jurisdiction is exclusive.”<sup>178</sup> As long as the instrument is a futures contract, but not an option, whether it is also a security is not important.<sup>179</sup>

The CFTC had argued that the separation of regulation of stocks and futures was the intent of Congress in the creation of the CFTC and that providing the SEC with jurisdiction over securities futures would undermine that approach because the gravamen of regulation of futures would be the underlying commodity rather than the product.<sup>180</sup> A former CFTC chairman worried about the “regulation of the futures based on the underlying commodity” because this “approach could create a fragmented regulatory environment.”<sup>181</sup> Since the CFTC does not regulate the underlying commodity of any futures traded contract, the National Futures Association stipulated that the SEC is not needed to regulate futures based on stocks.<sup>182</sup>

In a nutshell, the SEC and CFTC agreed that the three amendments to the CEA that caused the jurisdictional clash over securities-based futures are the following:

- 1) The act was amended to expand the definition of a commodity to include virtually anything – tangible or intangible. Consequently, a security fell within the definition of a commodity.
  
- 2) The act was amended to provide the CFTC with exclusive jurisdiction over all commodity futures

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176. GAO, ISSUES RELATED TO THE SHAD-JOHNSON JURISDICTIONAL ACCORD, *supra* note 3, at 28.

177. See *Chicago Mercantile Exch. v. SEC*, 883 F.2d 537, 544 (7th Cir. 1989) (citing *Chicago Board of Trade v. SEC*, 677 F.2d 1137 (7th Cir. 1982), *vacated as moot*, 459 U.S. 1026 (1982)).

178. See *id.*

179. See *id.*

180. GAO, ISSUES RELATED TO THE SHAD-JOHNSON JURISDICTIONAL ACCORD, *supra* note 3, at 29.

181. *Id.*

182. *Id.*

transactions, including options on futures.

3) The act was amended to preserve the SEC's preexisting authority over securities trading and the securities markets.<sup>183</sup>

#### D. *An Attempt to Reconcile – The Shad-Johnson Accord*

Over twenty years ago, before the House or the Senate had even considered the CFMA, matters came to head between the agencies.<sup>184</sup> The SEC claimed that options on securities should be regulated by the SEC, and the CFTC claimed that options on futures should be regulated as futures, which compelled both agencies to assert their jurisdiction in 1980.<sup>185</sup> Naturally the CFTC was displeased when the SEC permitted stock exchanges to start trading options, and the futures markets sought review in the Seventh Circuit Court of Appeals.<sup>186</sup> The Seventh Circuit eventually ruled in favor of the CFTC giving them exclusive jurisdiction basing their decision on options for GNMA's as both securities and futures.<sup>187</sup>

In anticipation of the pending case, both parties reached an agreement called the Shad-Johnson Accord.<sup>188</sup> The CFTC also retained exclusive jurisdiction over futures contracts on commodities under the Shad-Johnson accord, and it was given jurisdiction over option contracts on both commodities and currencies while the SEC maintained jurisdiction of options on securities.<sup>189</sup> The Accord stated that the question on who will take authority of the option depends upon the underlying thing

183. *Id.*

184. *See Chicago Mercantile Exch.*, 883 F.2d at 543.

185. *See id.* The SEC claimed that options written on securities are securities under § 3(a)(10) of the '34 Act, and the SEC maintained that because options are securities it should regulate all options. *Id.* at 543-44. The CFTC responded to this claim that "options on financial instruments are futures under § 4c(b) of the CEA, 7 U.S.C. § 6c(b), and added that because its jurisdiction is exclusive, it is the sole lawful regulator." *Id.* at 544.

186. *Id.* The Seventh Circuit did not assist in the decision of the agreement when it held in *Chicago Bd. of Trade v. SEC* (called *GNMA Options*) that the agencies were not permitted to modify their jurisdiction by mutual agreement. *Id.*

187. *See Chicago Mercantile Exch.*, 883 F.2d at 544.

188. *Id.* Shad was the SEC's chairman and Johnson was the CFTC chairman at the time. *Id.* For a more detailed report of the agreement, *see generally* Richard L. Hudson, *SEC and CFTC End Regulatory Dispute, Clearing Subindex Stock Futures Trading*, WALL ST. J., Jan. 19, 1984.

189. Coffee, *supra* note 176, at 462. Under the agreement, the CFTC could approve a "stock index futures contract for trading if CFTC found that the contract was (1) settled in cash; (2) not readily susceptible to manipulation; and (3) based on an index . . . widely published . . . and reflected the market as a whole . . ." GAO, ISSUES RELATED TO THE SHAD-JOHNSON JURISDICTIONAL ACCORD, *supra* note 3, at 6.

for which the option is *written*.<sup>190</sup> The most important piece to come out of this legislation was that neither futures nor options on futures for single corporate or municipal securities were permitted.<sup>191</sup> On the other hand, the CFTC was permitted to sanction futures on securities indexes and options on futures indexes.<sup>192</sup>

This agreement faced few problems until the stock market crashed in 1987 when both the SEC and New York Stock Exchange complained to Congress that trading through futures on indexes interrupted the stock markets and made them unstable.<sup>193</sup> A year later the SEC authorized the Chicago Board of Exchange (CBOE) to trade index participation contracts and, naturally, the futures exchanges (both the CBOT and CME) sued the SEC and won again.<sup>194</sup>

Before the next lawsuit over single stock index futures went to court, both parties came to another agreement and published a joint interpretive release with four criteria that stock index futures must meet before they can be designated for trading.<sup>195</sup> Another proposal suggested to alleviate the tension gave the SEC oversight responsibility with regard to the CFTC's financial and stock index jurisdiction.<sup>196</sup> Clearly, Congress has been reviewing this since the 1982 accord, and, for many years it seemed unlikely that the adjustments to the jurisdiction of the SEC and

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190. *Chicago Mercantile Exch.*, 883 F.2d at 544.

191. GAO, ISSUES RELATED TO THE SHAD-JOHNSON JURISDICTIONAL ACCORD, *supra* note 3, at 6.

192. *See* Coffee, *supra* note 176, at 462. Professor Coffee notes that basically each agency "obtained jurisdiction over a close substitute relating to security indexes: the SEC could authorize options on stock indexes and the CFTC could permit futures on securities indexes (and also options on future indexes)." *Id.*

193. *Id.* The Brady Commission believed that the regulatory structure of two separate markets exacerbated problems during the crash. Allan Kleidon and Robert Whaley, *One Market? Stocks, Futures, and Options During October 1987*, XLVII J. FIN. 851, 852 (1992).

194. *See* Coffee, *supra* note 176, at 463.

195. Those criteria include the following:

- (1) Minimum number of securities (at least 25 domestic issuers);
- (2) Index capitalization (the aggregate capitalization of the component securities must be at least \$75 billion);
- (3) Percentage Weight Afforded Larger Stocks (no single security could represent more than 25 % of the index's aggregate capitalization); and
- (4) Percentage Weight Permitted Three Largest Stocks (no three stocks could account for more than 45% of the index).

*See* Designation Criteria for Futures Contracts and Options on Futures Contract Involving Non-Diversified Stock Indexes of Domestic Issuers, 49 Fed. Reg. 2884 (Jan. 24, 1984).

196. *See* Report of the Presidential Task Force on Market Practices (Jan. 8, 1988).

CFTC would be reached until 1999, when the two agencies nearly came to an agreement that included changes such as the repeal of the prohibition on futures on individual securities. This legislation forms what is now known as the Commodity Futures Modernization Act of 2000, which allows the trading of futures on individual securities and also permits that jurisdiction over securities-based swap agreements remains mainly with the CFTC.<sup>197</sup>

#### E. CFMA - the Great Compromise?

Congress' intent, when passing the CFMA, was to ensure confidence, clarity, and to reform derivative regulation while simultaneously protecting the investor and public interest.<sup>198</sup> The CFTC generated legal uncertainty when it issued a concept release regarding OTC derivatives because many people believed that this was the CFTC stepping in to regulate these derivatives as futures.<sup>199</sup>

The CFMA set up the structure for joint regulation by the SEC and CFTC of trading U.S. futures on single securities as well as on narrow-based security indexes, and the term for these instruments is security futures products (SFP's).<sup>200</sup> The CFMA removed the ban on the single stock and narrow based stock index futures, which had been illegal to trade in the U.S. before the act.<sup>201</sup> Previously, the CFMA futures contracts were only permitted on indexes that had a list of securities and not on a

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197. See Commodity Futures Modernization Act of 2000, Pub. L. No. 106-554, 114 Stat. 2763A-365, app. E (codified as amended in scattered sections of 7 U.S.C., 12 U.S.C., and 15 U.S.C.) (2000). See also THOMAS L. HAZEN, *THE LAW OF SECURITIES REGULATION*, § 1.5[5], at 36 (4th ed. 2002).

198. 146 CONG. REC. S11,896 (daily ed. Dec. 15, 2000) (statement of Senator Harkin speaking). Another incentive driving Congress was to ensure that our financial markets stay up to date with those of other countries. 146 CONG. REC. S11,868 (daily ed. Dec. 15, 2000) (statement of Senator Gramm). "[T]he work of this Congress will be seen as a watershed, where we turned away from the outmoded, Depression-era approach to financial regulation and adopted a framework that will position our financial services industries to be world leaders into the new century." *Id.*

199. 146 CONG. REC. S11,925 (daily ed. Dec. 15, 2000) (statement of Senator Lugar). Congress feared that the uncertainty may cause the participants to abandon the U.S. market for OTC derivatives and leave for London, thus resulting in an increase American unemployment. *Id.*

200. See Futures on Securities: Definitions and Overview of the Regulatory Landscape (Dec. 12, 2002), available at <http://www.cftc.gov/opa/backgrounder/opapart30.htm>. At the most basic level, a security future is just a futures contract on a common stock or a futures contract on a narrow-based index of securities. *Id.* at Page 3.

201. *Id.* See U.S. Securities and Exchange Commission, Division of Market Regulation: Staff Legal Bulletin No. 15 (Sept. 5, 2001), available at <http://www.sec.gov/interps/legal/mrslb15.htm>.

single security.<sup>202</sup> The CFTC will have exclusive jurisdiction over the broad-based security indexes that do not fall under the definition of SFP's, while the SEC and CFTC will retain joint jurisdiction over security futures products.<sup>203</sup>

The definitions set forth by Congress are still a little convoluted, as the definition for security future is slightly different from that of an SFP.<sup>204</sup> The definition of SFP is "a security future or any put, call straddle, option, or privilege on any security future".<sup>205</sup> Nevertheless, the CEA still mandates that "securities underlying security futures products must be common stock or other equity securities that the CFTC and SEC jointly deem appropriate."<sup>206</sup>

According to the CFTC, a narrow-based index is classified as a narrow-based security index when it meets certain requirements.<sup>207</sup> Thus, anything that is not narrow-based, is, by corollary a broad based security index, even though the term narrow-based index is not a defined term in the law.<sup>208</sup> Recall that the broad based indexes, unlike the SFP's that fall under joint regulation by the SEC and CFTC, are governed exclusively by the CFTC.<sup>209</sup>

In sum, the newly enacted CFMA allows securities futures to be traded on either the securities exchange the futures exchange, or both.<sup>210</sup> The purpose of the CFMA was to make available a

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202. Futures on Securities: Definitions and Overview of the Regulatory Landscape, *supra* note 201.

203. *Id.*

204. A security future is defined under the statute as:

[A] contract of sale for future delivery of a single security or of a narrow-based security index . . . except an exempted security . . . of the Security Exchange Act of 1934 . . . . The term 'security future' does not include any agreement, contract, or transaction excluded from this Act (as in effect on the date of the enactment of the Commodity Futures Modernization Act of 2000) or title IV of the Commodity Futures Modernization Act of 2000.

Commodity Futures Modernization Act of 2000, Pub. L. No. 106-554, sec. 101, 114 Stat. 2763A-365, 374-75 (codified as amended at 7 U.S.C. § 1a(31)).

205. *Id.* at § 1a(32).

206. Futures on Securities: Definitions and Overview of the Regulatory Landscape, *supra* note 201.

207. *Id.*

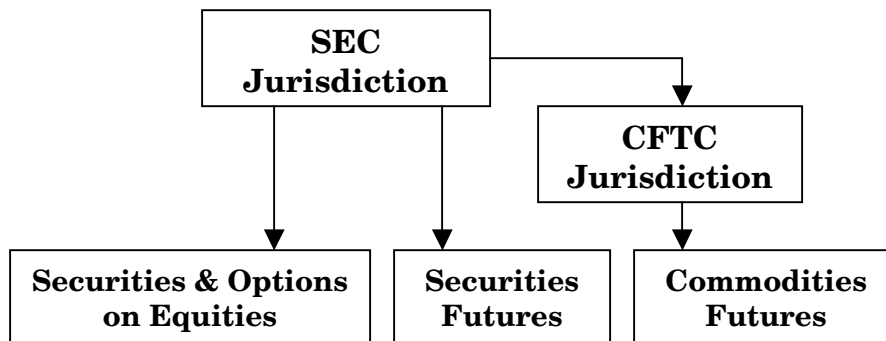
208. *Id.*

209. *Id.*

210. William Brodsky, Chairman and Chief Executive Officer, Chicago Board Options Exchange, *New Legislation Permitting Stock Futures: The Long and Winding Road*, 21 NW. J. INT'L L. & BUS. 573, 578 (2001). The eligibility to trade stock futures hinges on a futures exchange having the designation of contract market or registered derivative transaction execution facility. Commodity Futures Modernization Act of 2000, Pub. L. No. 106-554, sec. 251, 114 Stat. 2763A-365, 2763A-437 (codified as amended 7

regulatory structure that is integrated as well as one that provides some reprieve from duplicative SEC and CFTC regulation in the form of notice.<sup>211</sup>

#### IV. POLICY – A SINGLE REGULATORY AGENCY WITH EXCLUSIVE JURISDICTION OVER THE DERIVATIVES MARKET IS THE BEST CHOICE



The easiest solution would be for the CFTC to merge into the SEC, and give final unification over stocks, stock options, and stock futures.<sup>212</sup> The split between jurisdiction over securities and securities futures markets in the U.S. is anomalous because normally only one regulatory agency takes the responsibility for all equity markets.<sup>213</sup> Regardless of whether the agencies actually merge, attorneys with expertise in futures and securities laws will still be required.<sup>214</sup>

Several interesting proposals have been brought before Congress. The Chicago Mercantile Exchange set forth a well-known proposal that sought to consolidate the CFTC, the SEC, and various other agencies.<sup>215</sup> In this proposal, nine

U.S.C. § 2a). Brodsky notes “in other words, an exempt board of trade that is not subject to CFTC regulation cannot trade stock futures.” Brodsky, *supra* note 211, at 578 n. 15.

211. Brodsky, *supra* note 211, at 578 n.15.

212. *Id.* at 587. Nearly all other countries have only one regulatory agency governing their equity markets. *Id.* at 586.

213. *Id.* at 587. Representative Leach made the same statement at a hearing to merge the SEC and CFTC: “The U.S. is the only advanced county in the world that splits its regulation of futures and securities trading into separate agencies.” Jeff Taylor, *Rep. Leach Pushes his Plan to Merge the SEC and CFTC*, WALL ST. J., Mar. 31, 1995, at A7.

214. GAO, CFTC/SEC ENFORCEMENT PROGRAMS, STATUS AND POTENTIAL IMPACT OF A MERGER (GAO/T-GGD-96-36, Oct. 1995), at 1.

215. CHICAGO MERCANTILE EXCH., MODEL FOR FEDERAL FINANCIAL REGULATION 3 (1993). Some of the other offices include the, the Federal Deposit Insurance Corporation (FDIC) the Office of Thrift Supervision (OTS), Office of the Comptroller of the Currency (OCC), some of the Department of Labor and the Federal Reserve Board the Securities

commissioners (each appointed by the President and confirmed by the Senate) would run the Federal Financial Regulatory Service (FFRS) and the chair would sit on the President's cabinet.<sup>216</sup> The FFRS would be like a financial cabinet where a group of autonomous agency heads would make financial policy rather than one sole agency.<sup>217</sup> The proposal also suggested that, *inter alia*, the SEC would lose its jurisdiction over options.<sup>218</sup>

The CME proposal also suggested that a new division called the Division of Risk-Shifting Markets would resemble the current CFTC and would be "responsible for all trading in standardized offset instruments (whether overlying financial assets or obligations, foreign exchange, or agricultural or mineral commodities), for the futures and options exchanges, for the National Futures Association (NFA), and for the professional entities . . . registered in those markets."<sup>219</sup> The downside to a merger of multiple agencies this size is that the panel, which would not be an independent staffed agency, would be concerned with broader agency concerns rather than the issue at hand.<sup>220</sup>

### A. Arguments for Consolidation

#### 1. More Efficient

A firm that can double the output for less than twice the cost has taken advantage of what economists call "economies of scale."<sup>221</sup> A merger between the two agencies will do just that, even though initially it would "entail a substantial commitment of time, money, and resources, both for Congress and the two agencies."<sup>222</sup> Probably the most important advantage would be the

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Investor, and the Protection Corporation (SIPC). *Id.* The plan was for all of these agencies to be one massive regulator. *Id.*

216. Coffee, *supra* note 176, at 452.

217. *Id.*

218. *Id.*

219. *Id.*

220. U.S. Congress, Office of Technology Assessment, *supra* note 1, at 176.

221. Economies of scale and scope are often, mistakenly, used interchangeably. The difference between the two is relatively simple. Economies of scope are present when the joint output of a single firm (or administration) is greater than the output that could be achieved by two different administrations each regulating a single body by themselves. Economies of scale occur when a firm (or administration) can double output for less than twice the cost. See Pindyck & Rubinfeld, *supra* note 94, at 223-227.

222. Testimony of Richard R. Lindsey, Director, Division and Market Regulation of the SEC before the House Committee on Banking and Financing Services, Concerning the Regulation of the Over-the-Counter Derivatives Market and Hybrid Instruments (July 24, 1998), available at <http://www.sec.gov/news/testimony/testarchive/1998/tsty0898.htm>. The

transfer of functions between the CFTC and the SEC, and a more streamlined regulatory oversight as well as reduced administrative costs.<sup>223</sup> Rather than the current system of joint resolutions for poorly defined securities, a system that provides a uniform manner to settle and clear securities and options would be used once the agencies were consolidated.<sup>224</sup>

The laws creating the SEC and the CFTC were forty years apart and seventy years ago Congress could not have possibly foreseen the different types of derivative products on the market today.<sup>225</sup> Although the idea of merger is not novel, the issue is still relevant because the securities laws have major financial, economic, and social consequences.<sup>226</sup>

## 2. No More Problems with Statutory Ambiguities

Comparing the enforcement programs of the CFTC and SEC has proven to be difficult due to differences in the regulations and markets that the two agencies enforce.<sup>227</sup> However, if both agencies were consolidated, problems arising from statutory ambiguities would be reduced—at least as far as those definitions causing the agencies to argue over jurisdiction.

## 3. Markets are Linked

Especially due to the various types of financial instruments available today, the markets are essentially interconnected,<sup>228</sup> and Wall Street firms would rather account to just one regulator

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director also noted that the SEC was wary of the costs of the merger at the time, and that those costs made be limited because the agency would have to retain divisions that would watch over each of the regulatory areas within its jurisdiction. *Id.*

223. *Id.*

224. Coffee, *supra* note 176, at 479.

225. U.S. Congress, Office of Technology Assessment, *supra* note 1, at 167.

226. *Id.*

227. GAO, CFTC/SEC ENFORCEMENT PROGRAMS: STATUS AND POTENTIAL IMPACT OF A MERGER, *supra* note 215, at 1.

228. If there is any question as to the derivative instruments being connected, recall the analogy to Legos discussed earlier in this paper. In sum, the off-balance-sheet instruments are linked the following ways:

- (1) futures can be built by ‘snapping together’ a package of forwards;
- (2) swaps can also be built by putting together a package of forwards;
- (3) synthetic options can be constructed by combining a forward with a riskless security; and
- (4) options can be combined to produce forward contracts – or conversely, forwards can be pulled apart to replicate a package of options.

SMITH, SMITHSON & WILFORD, *supra* note 47, at 357.

rather than both the CFTC and SEC.<sup>229</sup> Of course, William Brodsky, the President of the Chicago Mercantile Exchange in 1995, cautioned that if the CFTC were subsumed into the SEC, the CFTC's more narrow issues would be lost in the sea of SEC issues over mutual funds and municipal bonds.<sup>230</sup>

#### 4. SEC Disclosure Requirements Have Been Traditionally More Tightly Regulated

One of the main criticisms of the CFTC in the 1980's was that it was unable to police its markets effectively because its disclosure requirements were less than that of the more stringent SEC requirements.<sup>231</sup> In fact, as of 2000, the CEA did not expressly prohibit insider trading.<sup>232</sup> The argument is that two regulatory agencies, the CFTC with less rigorous standards than SEC, would thwart SEC attempts to monitor and control insider trading because insiders could flee to the futures markets.<sup>233</sup> The SEC has often pointed out that it was created for the protection of the investor.<sup>234</sup> The SEC has stated that, without a suitability rule imposed on brokers requiring them to recommend only those securities suitable to their customers, the customer may be subject to unlimited loss as a result of a future contract adverse price change.<sup>235</sup>

#### 5. Better Training

A merger would provide CFTC enforcement staff with better training under the guidance of the SEC.<sup>236</sup> In an internal review conducted by the CFTC chairman in 1994, serious problems of the CFTC were exposed such as a lack of skills and training in the enforcement staff, no clear goals, and an environment that

229. Jeffrey Taylor, *Support Grows for SEC, CFTC Merger*, WALL ST. J., Feb. 6, 1995, at C1.

230. *Id.*

231. B. Peter Pashigian, *The Political Economy of Futures Market Regulation*, 50 J. Bus., at S56, S63-64 (1986).

232. GAO, ISSUES RELATED TO THE SHAD-JOHNSON JURISDICTIONAL ACCORD, *supra* note 3, at 20.

233. *Id.*

234. See RICHARD A. POSNER, *The Regulation of Securities Markets*, ECONOMIC ANALYSIS OF THE LAW, 331 (2nd ed. 1978). Posner notes that the regulations promulgated by the SEC are based on "the premise that, without such regulation, the securities markets would not function satisfactorily." *Id.*

235. GAO, ISSUES RELATED TO THE SHAD-JOHNSON JURISDICTIONAL ACCORD, *supra* note 3, at 21.

236. GAO, CFTC/SEC ENFORCEMENT PROGRAMS: STATUS AND POTENTIAL IMPACT OF A MERGER, *supra* note 215, at 12.

did not encourage communication among the staff.<sup>237</sup> If the agencies were combined, synergies in training may even result such as improving enforcement procedures for taking depositions and developing testimony.<sup>238</sup>

### B. Arguments Against the Merger

#### 1. Farmers' Interests May Be Secondary

The opposition to a merger has expressed that the issues pertaining to farmers and ranchers, who often use the futures exchanges in order to hedge their risk, will become second under a merged agency to those of Wall Street.<sup>239</sup> The fear is that this interest group will not receive adequate consideration in an "agency dominated by the securities folks."<sup>240</sup>

#### 2. Joint Regulation May Be Succeeding

Despite some early growing pains, some CFTC members appear to be optimistic in the mutual framework created by both agencies.<sup>241</sup> James Newsome, the CFTC Chairman, stated that it is possible for two agencies to write rules conjointly with respect to their shared jurisdictions<sup>242</sup> as evidenced by the CFTC and SEC's cooperation over the last three years.

## V. CONCLUSION

Regardless of any recent indication that the joint proposal is succeeding, the merging of the SEC and CFTC would result in speedier proposals and regulations. Twenty years passed before the two agencies could agree on allowing single stock securities futures, and almost three more years elapsed before the two agencies could iron out the details. The fact that the agencies are currently working together is commendable. However, one single agency, with directions coming top-down from the SEC, could

237. *Id.*

238. *Id.*

239. Jeffrey Taylor, *Rep. Leach Pushes His Plan to Merge the SEC and CFTC*, WALL ST. J., Mar. 31, 1995, at A7.

240. *Id.* This statement was made by Republican Pat Roberts of Kansas. *Id.*

241. SEC/CFTC SECURITIES FUTURES PLANNING ON TRACK, SEC. WEEK, July 14, 2003. Mr. Lukken was countering a comment that the SEC was not following parts of the agreement entered into by the commissions. *Id.*

242. Melissa Allison, *CFTC OK's Trading of New Stock Instrument; Single-stock Rules Need SEC Action*, CHI. TRIB., July 3, 2002, at 3.

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expedite the writing of technicalities because negotiation and approval from one agency to the other would no longer be necessary. And, there is no guarantee that a future falling out between agencies is not on the horizon.

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