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Derivative Law
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INTRODUCTION

Many attorneys practicing in the areas of securities, banking and financial services encounter from time to time an issue that invokes federal derivatives laws and their principal administrator, the Commodity Futures Trading Commission. Other attorneys work for or with companies that use the derivatives markets to manage their price risks. These contacts may be too infrequent to justify acquiring a full-fledged legal treatise on the subject but a handbook of basic information would be perfect. This publication has been prepared to meet that need.

The term "derivatives regulation" has effectively displaced today the older reference to "commodities regulation" mainly because of the rich variety of "things" that can be traded in the form of futures contracts, options and other financial instruments. In addition to tangible assets like grain, gold and oil, trading occurs in economic measurements of stock market performance, weather patterns, inflation rates, air quality, housing prices, natural catastrophes, and discrete events. While few of these phenomena would be considered "commodities" in any other context, they are treated as such for

regulatory purposes.¹ As a result, the first rule for counsel who encounters this regime is:
Make no assumptions.

This guide is organized to describe the general structures of the trading vehicles that must comply with federal derivatives regulation, the various "players" who receive special regulatory attention and vetting, and the types of conduct that can raise criminal as well as civil exposures. To assist in refining your inquiries, Chapter 1 introduces the reader to the regulator and to the regulated on a very general basis; more detail can be found in specialized chapters that follow.

To the extent that this guide identifies an issue that warrants deeper research than it provides, the reader is directed to two major, in-depth works: *CCH Commodity Futures Law Reporter* and *Johnson & Hazen: Derivatives Regulation* (Aspen Law & Business, 4th ed., 2004).

¹ The author contributed the statutory language that accomplishes this result by proposing successfully the inclusion within the definition of "commodity" in the 1974 amendments to the Commodity Exchange Act [7 U.S.C. §1 *et seq*] of the phrases "and all other goods and articles . . . and all services rights, and interests" that are or become subject to futures trading.

CHAPTER 1

OVERVIEW: WHAT IS REGULATED

The principal authorities for derivatives regulation are the *Commodity Exchange Act*, 7 U.S.C. §1 *et seq.* (hereinafter the "CEAct") and the regulations of the *Commodity Futures Trading Commission*, 17 C.F.R. §1 *et seq.* (hereinafter the "CFTC"). In the case of (i) options directly on securities, (ii) futures contracts on single securities or smaller stock indices, (iii) options on foreign currencies if listed on a national securities exchange, and (iv) the marketing of participations in collective investment vehicles using commodity futures or options, the federal securities laws can also apply but they are beyond the scope of this guide. There is no meaningful regulation of the derivatives markets at the state or local levels and the CFTC, with the exceptions noted above, acts as the sole and exclusive regulator of that activity at the federal level.²

What instruments are affected? For a transaction to be regulated under the CEAct by the CFTC, it must involve *both* a statutory "commodity" *and* either a "futures contract" or an "option." The latter two terms - referring to the structure of the trading instrument itself - are not defined in the CEAct or in the CFTC's regulations and, as a result, what is or is not a regulated trading instrument has been the subject of considerable litigation, with the courts acting as final arbiter.

"Commodity" Defined. With respect to the term "commodity," it includes a long list of specific farm products (the markets began almost exclusively as agricultural

² The author contributed the statutory language assigning "exclusive jurisdiction" to the CFTC in the 1974 amendments to the CEAct.

venues), but section 1a(4) of the CEAct also sweeps in "all other goods and articles . . . and all services, rights, and interests in which contracts for future delivery are presently or in the future dealt in."³ As a result, *almost anything can be a "commodity"* including mathematical calculations or measurements of phenomena, services and other intangibles or contingencies that would not fall within that term in any other real-life context.

Futures Contracts. The CEAct and CFTC regulations do not cover all forms of commodity transactions. Generally speaking, they do not apply to transactions involving the immediate transfer of title to an asset (often called "cash" or "spot" transactions) nor to transactions where transfer is simply deferred to a later date (known as "forward" contracts). Deferred transfers or forward contracts are most common among buyers and sellers that deal regularly in that commodity, such as grain merchants or government bond dealers.

However, the CEAct authorizes the CFTC to take enforcement action against any manipulation of the price of a commodity whatever the nature of the transaction by reason of sections 6(c)-(d) and 9(a) of the CEAct.⁴ Such misconduct may also constitute a criminal felony under federal law.

While a "futures contract" has not been defined by the CEAct or the CFTC, it is generally understood to include any instrument by which (i) the price for a transaction is established immediately, (ii) completion is set for a later date or time, and (iii) some mechanism exists and is commonly used to substitute a cash payment in lieu of the physical conveyance of the commodity between the parties. To make it easy to convert ("offset") the delivery mode into a cash settlement alternative, most futures

³ 7 U.S.C. §1a. See also footnote 1, *supra*.

⁴ 7 U.S.C. §§9 and 13b, and 13 respectively.

contracts (although not all) have standardized specifications and typically are available through a central market of some sort. However, a trading instrument allowing conversion into a cash-settled form may be a future contract even when offered by a single merchant if there is a mechanism, such as a standing offer by the merchant to "buy back" the contract either at any time or on some timed basis.

Unlike a genuine sale and transfer of an asset, a futures contract is simply an agreement to perform at a later date. Hence, neither party "owns" anything at the outset and, as a result, does not "owe" anything either. Gain or loss will occur solely on the basis of price movements in the futures market during the holding period. To illustrate, if the buyer (called a "long" in the trade) and the seller (a "short") of the futures contract agree to a purchase price of \$10, neither will gain nor lose money as long as the market value remains at that level. However, the buyer/long will gain if the value of the commodity increases above \$10 (because the commodity's true value has risen above what the buyer is obliged to pay) while the seller/short will gain if the value of the commodity falls below the agreed price (because the seller can acquire the commodity for less than the buyer has agreed to pay).

The economic behavior of a futures contract tends to be of the equal-and-opposite type, that is, one party's gain tends to be equal or comparable to the other party's loss. Because both parties take on similar market risk (albeit in opposite directions), there is seldom any fee or consideration paid between them upon entering the arrangement.⁵ Moreover, because possession of a futures contract does not convey any

⁵ While there is no fee charged *between* the parties at inception, use of a broker to arrange the transaction may result in payment of a commission to that broker.

ownership interest in the commodity (that to occur later absent cash settlement), there is no immediate payment between the parties based upon the commodity's starting value. As in the illustration above, if the commodity was worth \$10 at initiation of the futures transaction, neither party is entitled immediately to receive or obliged immediately to pay that \$10 and, therefore, no part of the purchase price is exchanged at inception.

However, both parties are at market risk and are responsible for *changes* in the value of the commodity during the life of the futures contract. To address this risk, most futures markets require the deposit by *both* parties of a specific sum of money to act as collateral for any daily losses they suffer. Called "margin," these deposits are compared each day with those gains and losses; where one party's holdings have gained in value, the deposit may be reduced proportionately and where a party's holdings have sustained losses, the deposit may be increased proportionately. In every case, the objective is to assure that the accounts always have *more money* on deposit than is owed at that time.⁶

Options. While futures contracts generally create equal but opposite obligations between the parties, exposing each to an equivalent level of market risk (albeit in different directions), an option imposes far greater burdens on the seller (a

⁶ The same term -"margin" - is used in the securities business as well but bears a far different meaning. Typically, securities margin is imposed following an outright purchase of stocks or bonds where the buyer wishes to borrow part of the cost, usually from a broker. Federal Reserve Board regulations and Securities and Exchange Commission rules dictate how much of the purchase price may be borrowed for this purpose - currently about 50% for shares and 20% for security options - and the partial payment actually made is referred to as margin.⁶ But, unlike the futures trader who acquires nothing upon entry into the transaction except a promise of later performance, the securities buyer takes title to the actual securities and may pledge them to the broker or other lender as collateral for the loan. Moreover, when securities are bought "on margin," only the buyer (the borrower) must post margin; the seller does not. With futures, both sides must meet margin requirements. Finally, a securities account on margin contains a *deficit* (the unpaid balance on the loan) while a futures account should always have an *excess* of funds above the amount of current obligations. To reduce confusion, some futures exchanges refer to margins as "performance bonds."

"writer" in the trade) than on the buyer (the "holder"). The option seller/writer must stand ready and willing to complete the transaction during the entire life of the option,⁷ whereas the buyer/holder can simply abandon the transaction if it would not be profitable to complete it (to "exercise" the option). Unremarkably, the writer demands compensation for the added risk, in an amount that is negotiated with the buyer and acts as a sort of stand-by commitment fee (called a "premium").

Options can be acquired that profit from rising value (a "call" option) or from declining value (a "put" option). A call option behaves like a "long" futures contract in that it rewards the holder in rising markets (though it does not carry a corresponding downside risk), while a put option rewards the holder in falling markets (but, again, does not bear a corresponding upside risk).

Whether an option becomes profitable depends not only on changes in its value but the cost of the premium as well. To illustrate, if a writer makes a commitment to complete the transaction at \$10 on or before a certain date if the holder so requests, the holder may exercise the option if it achieves a profit greater than \$10 plus the cost of the premium already paid to the writer (*e.g.*, in the case of a "call" option, a price increase to \$13, minus \$2 premium = \$1 profit). The writer remains exposed to this market risk no matter how high the price goes (*e.g.*, \$100), while the holder may simply walk away if exercise would not be profitable.

Like futures contracts, options are versatile in that they can offer profit when prices are falling as well as rising. In the illustration above, a call option was used.

⁷ Some options may be exercised by the holder at any time during their life ("American-style" options) while others can be exercised only on a set date ("European-style" options). Because American-style options offer the holder more flexibility and a greater chance for gain they are usually considered to be more valuable than European-style options.

In a put option, the holder has the right to sell the commodity to the writer for a certain sum (*e.g.*, \$10) even if the value of the commodity has fallen below that level. The writer, as before, must stand ready to pay the agreed amount (and to incur a loss) upon the holder's demand no matter how low the price declines. That commitment also carries a premium which the holder negotiates with the writer, and the economics are the same (in reverse) as described above.

While holders of options normally have unlimited potential profit with relatively limited loss (the premium), options can be designed to replicate the two-way behavior of a futures contract. A party that has acquired a right to buy something at \$10 (the holder of a call option) but has written an option to sell that same thing at \$10 (the writer of a put option) will experience the same effects as if it possessed a "long" futures contract in that gains will occur if prices rise and equivalent losses will occur if prices fall. To replicate a "short" futures contract the party would acquire a put option and write a call option.

The CEAct and CFTC regulations do *not* apply to options directly on any security or directly on a foreign currency but, in the latter case, only if it is listed for trading on a market that has been registered with the Securities and Exchange Commission as a national securities exchange.

Other Derivatives. There are two other principal forms of derivatives that, as a rule, are not offered by a CFTC-regulated exchange: *swaps* and *hybrid instruments*.

Swaps have essentially the same economic attributes as futures contracts, generating gain for one party and loss for the other party in generally corresponding amounts depending on price movements. Like futures, they are typically settled through

cash payments between the parties. Swaps originated in the banking community where lenders with large portfolios of fixed rate loans but wishing to have more adjustable rate loan exposure on their books would "swap" hypothetically some of their fixed rate loans with another financial institution in exchange for some of the latter's variable rate loans. The loans themselves were not transferred but each operated as if that had occurred and, at intervals, each would calculate whether its adapted portfolio had made or lost money as compared with the other lender's experience, and the net difference would be paid by the loser.

Swaps have now spread into nearly all industries; crude oil swaps, for example, proliferate during periods of energy price volatility. To illustrate, a crude oil swap would see one party agreeing to pay at stated intervals a fixed amount per barrel (*e.g.*, \$50) while the counterparty agrees to pay the actual market value of a barrel of oil on the reconciliation date. The first party receives a net amount if the price has risen above the fixed level, while the counterparty gets a net payment if the fixed price exceeds current market levels.

Swaps tend to arise from private transactions rather than exchange trading and, while the CFTC considered at one time whether to regulate them as futures contracts, the law now allows a wide spectrum of entities to employ swaps without fear of CFTC repercussions.

Hybrid instruments are equity or debt securities whose value is affected by some external factor. To illustrate, there exist a wide array of "exchange traded funds" where the pay-out to investors may be affected by changes in the value of a portfolio of securities, the price of a commodity, or the severity of a natural disaster. Because these

instruments may be said to contain an "imbedded" futures contract or option, the CFTC took an interest in their early years (at the time, over-the-counter futures trading was illegal) and agreed not to challenge them only if the impact of indexation did not predominate over other influences on the price. More recent congressional action, however, has allowed hybrid securities without CFTC regulation even if they are 100% commodity-impacted. And unlike the swaps exclusion from CFTC jurisdiction which pertains only within a select group of participants, hybrid instruments may be offered to the general public.

Profile of the Regulator: In 1922 the Congress enacted legislation to regulate the nation's grain futures markets and assigned primary responsibility to the U.S. Department of Agriculture (hereinafter the "USDA"). In the ensuing years, other farm products were listed for trading on the exchanges and the USDA supervisory role was expanded to reach that activity as well. By the 1970s, however, the futures exchanges had moved beyond the agricultural sector to offer futures contracts on various foreign currencies, precious metals and energy sources. Developmental work was also underway to trade futures contracts on debt instruments that were designed to track changes in interest rates.⁸

Recognizing that the USDA's expertise did not extend to these new products, the Congress enacted legislation in 1974 creating the CFTC as an independent agency of the United States with five commissioners (one to serve also as chairman) by presidential appointment and Senate confirmation.⁹ As noted previously, its jurisdiction

⁸ The author was principal legal advisor in the creation of the world's first interest-rate futures contracts, a genre which now accounts for roughly 53% of international futures volume.

extends far beyond the farm sector to include nearly anything - tangible or intangible - that can be offered in the form of a futures contract or of a commodity option. And, with the exception of certain securities-related derivatives,¹⁰ the CFTC's authority preempts all other federal, state and local regulators, allowing for a unified and cost-efficient regime.

While the regulation of the futures and commodity option markets has been placed in the hands of an agency having no affiliation with the USDA, the CFTC retains a particular interest in farm products because it is overseen in the Congress principally by the House and Senate committees responsible for agricultural policy and which display a special concern for the integrity and efficiency of the farm futures markets. At the same time, however, the CFTC has close relations with other branches of the Government - the Securities and Exchange Commission, the Department of the Treasury, the Federal Reserve Board etc. - to consult on futures matters affecting their interests.

The CFTC's headquarters is in Washington, D.C. and it has major offices in New York City and Chicago. Smaller offices exist in Kansas City, Missouri and Minneapolis. Policy is set by the members of the CFTC and all rules, regulations and orders (other than in initial adjudicatory proceedings) issue from the same group. Its principal operating units are the Division of Market Oversight (hereinafter "DMO"), the Division of Clearing and Intermediary Oversight (hereinafter "DCIO"), and the Division of Enforcement (hereinafter the "DOE"). DMO oversees the exchanges' compliance with duties imposed by the CEAct and CFTC regulations, while the DCIO supervises the

⁹ The author served as the CFTC's chairman and commissioner from 1981 to 1983.

¹⁰ The Securities and Exchange Commission regulates options directly on securities and options on foreign currencies if the currency options are listed on a national securities exchange, and co-regulates with the CFTC futures contracts on single stocks and narrow-based stock indexes.

operations of clearinghouses and conformity by various registered intermediaries with their legal duties. The DOE conducts investigations and brings proceedings with respect to violations of the CEAct or CFTC regulations. At this writing the CFTC's annual budget is roughly \$127 million.

In addition, the CFTC administers an unusual "reparations" program allowing futures and options customers to make claims to the CFTC for damages against registrants. Hearings are conducted before officers or judges on the CFTC's staff and, if any violations are found, an award for actual damages may be made in favor of the claimant.

The Regulated Markets: For many years, all lawful futures trading was confined by the CEAct to federally-regulated central exchanges known as "contract markets" which were authorized to offer any form of futures contract (until recently, however, only with agency vetting and approval) and to the general public as well as to professional investors and commercial users. Copious regulations evolved to mandate the behavior of these contract markets and, while many of the prescriptive rules have been replaced by broader "core principles," the obligations remain for these exchanges to operate in a fair and orderly manner and to police their participants against trading abuses, market manipulations and other forms of misconduct.

Today, it is possible to trade futures contracts outside the facility of *any* organized exchange if it occurs between certain limited classes of defined participants dealing directly with each other. In addition, it is now possible to operate an exchange where trades can be matched randomly without contract market status if trading is limited to certain futures contracts and participation is confined as well to only specific groups of

users. One such alternative is a "derivatives transaction execution facility" or "DTEF" which must restrict its futures offerings to commodities having very little risk of being manipulated and which must confine participation to defined institutions and wealthy individuals or other traders utilizing very highly capitalized brokers. Another alternative style of exchange, where participation is even more restricted but the product qualifications are roughly the same as for DTEFs, is an "exempt board of trade." Finally, an exchange can exist to trade commodities that are more vulnerable to price manipulation if it operates through an electronic trading facility and is open to participation only by persons that are commercially involved with the underlying commodity, and known as an "exempt commercial market."

The Clearinghouses: Since the 1930s, every regulated futures market has employed the services of a "clearinghouse" to process daily transactions and, more important, to financially guarantee them once the matching process has been completed and verified. For many years these clearinghouses were either operating units within, or controlled affiliates of, the exchanges they served. The CFTC, which had no formal role in relation to the clearinghouses, nevertheless oversaw the clearinghouses as a part of its supervision of the affiliated exchanges themselves.

More recently, however, it has become permissible to create and to operate clearinghouses independent of control by any particular exchange. To accommodate the unaffiliated clearinghouses, Congress created a new registration system for them to qualify as "derivatives clearing organizations" or "DCOs."

To understand the primary function of a clearinghouse, which is substantially different from the services provided by "clearing agencies" in the securities

markets, it is important to visualize the structure of credit protection in the futures markets. As noted earlier, buyers and sellers of futures contracts must deposit with their brokers margin funds to support their market positions and this serves as the first line of credit support for the process. Their brokers, which may be full members of the clearinghouse or may be standing between the customer and such "clearing members," have an obligation to provide funds if the customer defaults on its margin obligation. The same guarantee proceeds to the clearing member if the intermediating broker fails to pay and, in the unlikely failure of the clearing member, the coffers of the clearinghouse itself constitute the final recourse. To fund its role as last-resort obligor, the clearinghouse will often maintain reserves consisting of substantial cash, with assessment rights against all clearing members and possibly a layer of insurance coverage. As a result, transactions are supported successively by greater and greater capital resources, and every default to date has been satisfied in full through this mechanism.

Clearinghouses do not generally regulate the markets in the way that is expected of a CFTC-approved exchange. They tend to be operated as a financial services organization and leave to the futures markets the task of devising and enforcing trading and ethical standards. Most clearinghouse rules deal with the credit guarantee function, including recourse in the event of defaults which is often swift and decisive.

Other "Private" Regulators: For many years, all "self-regulation" within the futures community was centralized within the exchanges which generally allocated responsibility among themselves based on which firms belonged to what exchanges, and the oversight included both members' on-exchange activity and their other business dealings such as the operation of brokerage or advisory firms. Today, however,

substantially all of the policing of activity of industry professionals away from the exchanges is conducted by the National Futures Association or "NFA," for which membership is mandatory. The NFA was organized under a special provision of the CEAct and, in addition to surveilling its members against off-exchange misconduct, the NFA administers the CFTC's registration ("licensing") programs for various categories of its members.

The Registrants The principal focus of the CFTC's registration program is on the point of contact between customers and various intermediaries offering them brokerage services, advice or an opportunity to participate in certain collective investment vehicles using commodities.

Futures commission merchants: Registration is required of any natural or legal person that solicits or accepts orders from customers for futures activity and that, *in addition*, receives cash, securities, property or other value to margin or guarantee the contemplated transactions. These "FCMs" perform what is broadly viewed as full brokerage services and must have and maintain substantial net capital, must follow rigid recordkeeping duties, adhere to reporting requirements in relation to their customer accounts (including specific risk warnings), and are subject to audit by both the NFA and the CFTC. In addition, each FCM must maintain its customers' funds in accounts separate ("segregated") from its own and must generally use such funds solely for the customers' benefit.

Commodity trading advisor: Registration is required for any natural or legal person that provides trading advice regarding futures on a CFTC-regulated exchange or involving commodity options to clients for profit or gain unless the advice is

solely incidental to some other services being provided such as banking, brokerage, publishing or news reporting. Registration is not required if the advice is given without regard for the client's particular circumstances, such as a general market view conveyed to multiple clients without linking it to those clients' specific strategies or positions. In the event that a "CTA" is given power of attorney to make unilateral trading decisions for a client, however, the regulatory demands are considerable. For example, the CTA is generally required to provide the client with very extensive information regarding its background, prior trading performance and other matters.

Commodity Pool Operator. Registration is required for any natural or legal person engaged in the business of operating a collective investment vehicle and receives funds or other value from prospective participants for the purpose of trading futures contracts on a CFTC-regulated exchange. Note that it is the *operator* of the commodity pool, not the pool itself (each of which is generally required to be organized separate from the "CPO"), that must register and, having once done so, it can operate as many commodity pools as it desires. There are a number of exemptions and exceptions to be identified later in the guide. Generally, the CPO must provide prospective participants with a disclosure document similar to a prospectus, make periodic reports on the commodity pool's performance, and maintain substantial records regarding its activities. Units of participation in a commodity pool may also be treated as "securities" subject to registration and reporting requirements under the federal securities laws.

Floor Participants. Registration is also required of natural persons acting as *floor brokers* who execute customer orders on the trading floor of a CFTC-regulated exchange or as *floor traders* who engage on the trading floor solely in transactions for

their own accounts. Floor brokers and floor traders have traditionally been either owners or lessees of exchange memberships granting them access to the trading arena; as physical floor trading recedes as a business model and exchanges convert from membership organizations to open stock corporations, these categories may be effectively eliminated. Where floor brokers form partnerships or other collaborations, usually in order to share or allocate brokerage fees or operating costs among themselves, registration is required of the *broker association* as well although the relevant exchange, and not the CFTC, performs the registration function.

Other. Finally, registration as *agricultural trade option merchants* or "ATOMs" is required for natural or legal persons marketing options on farm products to commercial users and, while none are believed to exist today, merchants offering bulk precious metals on a leveraged basis must register as *leverage transaction merchants* or "LTMs."

Introducing brokers: Registration is required of any natural or legal person *not an employee* of an FCM that directs ("introduces") customers to an FCM in exchange for compensation or some other form of gain, but does not receive customer funds. This person must either meet minimum capital requirements (modest compared with FCM capital rules) or must be guaranteed financially by an FCM. Since these "IBs" do not actually service customer accounts, their recordkeeping and reporting duties are less stringent than for FCMs.

Registration as an IB is also required for any person not employed by a commodity trading advisor or a commodity pool operator to solicit advisory clients or pool participants.

Associated persons: Registration is required for any natural person that *is employed by* an FCM or an IB for the purpose of soliciting or accepting customer orders. There are no minimum capital requirements and most recordkeeping and reporting duties are imposed on the employing FCM or IB. However, these "APs" can be prosecuted for fraud and other misbehavior in their dealings with customers.

Registration as an AP is also required for any person that is employed by a CTA or CPO for the purpose of soliciting advisory clients or pool participants, as well as solicitors for an ATOM or an LTM.

In addition to fitness standards, APs are generally required to successfully complete a proficiency examination demonstrating their knowledge of the markets.

Serious Offenses and their Consequences. Every violation of the CEAct or of CFTC regulations can be prosecuted as a felony with fines of \$1 million or more and 5 years of imprisonment. These penalties are raised from time to time and need to be reviewed periodically.

Most offenses do not rise to the level warranting criminal proceedings but the civil consequences can be severe as well. The CFTC, using an administrative proceeding or by application to a federal court, may exact a ban on use of the markets by a violator, civil penalties of \$130,000 per "violation" (raised from time to time) may be assessed or in the alternative an amount equal to treble the violator's gain, conduct may be enjoined, and restitution to injured victims may be ordered.

Although not disciplinary in nature, the CFTC's *reparations* tribunal offers victims of CEAct violations an opportunity to recover actual damages from liable registrants.

Finally, the NFA and each of the regulated exchanges have codes of conduct applicable to their members and members' employees which, if violated, can result in expulsion (including forfeiture of a valuable membership), suspension for a period of time, large fines, and corrective steps.

The three principal missions of the CFTC are:

- Prevention and detection of fraud against market users
- Prevention and detection of market manipulations
- Maintenance of competitive and transparent markets

Intermediaries continue to play a vital role in the interface between market users and the markets themselves, and the CFTC seeks to assure their honest treatment of users through disclosure of risks, accurate performance data, and safeguarding of users' funds. And, because the futures and commodity option markets are often relied on for the pricing and hedging of commercial transactions, the CFTC endeavors to assure that their prices are determined by the economic forces of supply and demand and not by the aberrant efforts of one or a few large traders. To perform these services, the markets must have high visibility ("transparency") and the CFTC seeks to assure that prices are readily available to the trading and hedging communities.

Speculating or Hedging: The Policy Implications. To the extent that the futures and commodity option markets are employed to speculate on (to predict) the future price of goods, services or other forms of "commodity," they resemble the dynamic of other investment markets where the principal aim is to anticipate the direction of prices and to profit from favorable changes. It is generally the national policy that, within any investment group assuming the same market risks, no special advantages or

handicaps should be allowed to exist. In the securities industry, for instance, investors are not permitted to use nonpublic information that is material to market decisions until it has been made available to the rest of the investor community. But the futures and commodity option markets also serve as a form of privately-funded insurance system where parties having an exposure in their ordinary business dealings to a particular risk may "hedge" against that danger by acquiring futures or options positions that will gain in value from the same events that will inflict commercial losses on their regular business. This form of protection would not be possible if every hedger were required, in advance of acquiring the hedge, to announce to the world why it has become necessary to do so. The market would react immediately by driving prices away from the hedger's needs.

Similarly, in the securities industry there are traditional restrictions on the right to "short" a stock, that is, to sell a stock prior to acquiring it. One concern has been that this practice would tend to put downward pressure on security prices while nearly all investors aspire to enjoy rising prices; another concern is the risk of default if the security cannot be or is not acquired by the agreed delivery date. But the futures and commodity option markets exist to serve, in equal measure, those who worry about falling prices as surely as those favoring rising prices and, to provide a hedge for the former, short selling must be freely available.

The differences in "margin" between securities and futures/options activity were discussed earlier. To summarize, securities margin generally applies *after* the sale is complete and delineates how much of the purchase price may be borrowed by the buyer under federal regulations designed to control the amount of credit extended in these circumstances. But margin in the futures/options context is a deposit made *before* the

transaction is carried out and constitutes a form of performance bond to be applied against any intervening changes in market price; in other words, this margin is *excess funds* in the trader's account.

Role of Other Government Authorities. As a general matter, the CFTC enjoys truly exclusive jurisdiction to set and to enforce regulatory standards for the exchanges offering futures contracts or commodity options as well as for individuals and entities providing services related to those markets as brokers, advisors, portfolio managers and the like. The only major exception exists in the case of futures contracts based upon single corporate securities or upon smaller indices of corporate securities, where the SEC acts as co-regulator with the CFTC and all rules or policies require their joint concurrence.

A less formal relationship exists between the CFTC and USDA with respect to futures and options on farm products and between the CFTC and the Department of the Treasury when government security futures or options are involved. In addition, the rules of a futures market establishing the level of margins for stock index futures contracts may be rejected or changed by the Federal Reserve Board.

For all intents and purposes, there is no material involvement by the States in the regulation of futures or options activity occurring on the CFTC-regulated exchanges. In the case of transactions conducted directly between parties which are eligible to trade futures contracts or options outside the regulated markets, however, States may set standards but may not invoke local gaming or bucket shop laws to invalidate the transactions, although at this writing no State has become an active regulator of this activity.

Role of Other Laws. As a general matter, the Commodity Exchange Act and CFTC rules preempt other legislation at the federal and state levels that might relate to the same or similar activity. With respect to federal statutes, however, actions may be brought under the federal antitrust laws when the conduct involves anticompetitive behavior, such as the manipulation of commodity prices on an exchange or in the commercial realm. Similarly, violations of the Racketeer Influenced and Corrupt Practices Act ("RICO") can be asserted in appropriate cases. And actions may also be brought under state antifraud laws of general applicability (*i.e.*, not specifically related to the futures business). Finally, the CFTC is accorded an active role in the winding up of futures entities under the Bankruptcy Act.