June 1996

The CFTC and Derivative Products: Purposeful Ambiguity and Jurisdictional Reach

Alton B. Harris

Follow this and additional works at: https://scholarship.kentlaw.iit.edu/cklawreview

Part of the Law Commons

Recommended Citation
Available at: https://scholarship.kentlaw.iit.edu/cklawreview/vol71/iss4/6

This Article is brought to you for free and open access by Scholarly Commons @ IIT Chicago-Kent College of Law. It has been accepted for inclusion in Chicago-Kent Law Review by an authorized editor of Scholarly Commons @ IIT Chicago-Kent College of Law. For more information, please contact dginsberg@kentlaw.iit.edu.
THE CFTC AND DERIVATIVE PRODUCTS: PURPOSEFUL AMBIGUITY AND JURISDICTIONAL REACH

Alton B. Harris*

I. INTRODUCTION: THE CFTC'S JURISDICTIONAL HOT SEAT

The Commodity Futures Trading Commission ("CFTC") has encountered more than the usual amount of public criticism for a federal regulatory agency in connection with its consent orders against BT Securities Corporation ("BT")1 and MG Refining and Marketing, Inc. ("MGRM").2 The CFTC has been accused of "egregious overreaching,"3 unjustified "micromanagement of business,"4 "legislating through enforcement actions,"5 and having "undone standing regulatory policy"6 in entering these orders.

I want to explore the bases and validity of these criticisms. Specifically, I plan to examine in depth both the BT Order and the MGRM Order—to provide, as it were, a more-than-you-wanted-to-know-and-never-thought-about-asking account of those Orders—and then to use that account as a basis for arguing that those orders, and other recent CFTC actions, can be fairly characterized as purposeful attempts by the CFTC to extend its jurisdictional reach by means of intentionally ambiguous jurisdictional claims.

In the following discussion, I am highly critical of the CFTC, particularly of its intellectual honesty. I am not, however, critical of its good intentions. The CFTC enjoys neither the strategically placed alumni and solid tradition of regulatory independence that the Securi-

* Partner, Ungaretti & Harris, Chicago, Illinois; Adjunct Professor at Northwestern University School of Law and Chicago-Kent College of Law. I am grateful to Jennifer Zordani for her assistance in the preparation of this article.


ties and Exchange Commission ("SEC") does, nor does it have the unchallengeable power of the Federal Reserve Board. It is a relatively new agency, tiny by federal standards, something of a legislative plaything, and more than a little beholden to those it regulates for its appropriations and jurisdictional mandate. More than that, it has been asked to administer our most poorly drafted federal regulatory statute and to use this statute to regulate our most dynamic financial markets—the over-the-counter ("OTC") derivatives markets. Perhaps it is the CFTC’s efforts, however modest, to give precise definition to its jurisdictional mandate that are extraordinary, and its (of late) more frequent resort to indirection, ambiguity, and silence as to its jurisdictional bases that should be expected.

That said, the first point that I hope will emerge from what follows is that, in the area of OTC derivative products, the CFTC has been unwilling or unable to define the scope of its own jurisdiction. The most common criticism has been that the CFTC has engaged in an "unjustified assertion" of jurisdiction. While undoubtedly correct in most circumstances, this criticism also misses the essential problem. The CFTC administers a statute that has such an open-ended reach that the agency could (seek to) rule the financial world if it were so minded. The problem is not that the CFTC aggressively uses the Commodity Exchange Act ("CEA") systematically to enlarge its turf, but that it appears to possess neither the intellectual nor institutional commitment to regulatory consistency to feel obligated to mark its own jurisdictional boundaries—whether aggressively or modestly drawn—with any clarity. The not surprising result is pervasive uncertainty in the financial markets as to the regulatory status of a wide variety of OTC products.

But there is a second point that I will try to make, and that is that the CFTC's difficulties in administering the CEA are in significant part the result of a fundamental conflict between what have been presumed to be the regulatory presuppositions of that statute and the economic realities of modern financial markets. Under what have been called the "classic" elements of futures contracts, any contract used to shift risk without also involving an intent to deliver or receive

7. See Morrison, supra note 4.
9. In re Stovall [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,941, at 23,775 (CFTC Dec. 6, 1979) (identifying the "classic elements" of futures contracts as being: (1) offered to the public; (2) secured by margin; (3) standardized as to terms; and (4) closed by offset). See discussion infra pp. 106-08.
commodities is a "futures" contract, period. This means that if the classic elements are the correct elements for identifying contracts subject to the jurisdiction of the CFTC, all risk shifting products\(^\text{10}\) can legally exist only within an exchange trading environment, absent an applicable exemption. Apart from the unlikelihood that this would be a sensible or desirable regulatory result, is it the correct legal result?

Some, most particularly the futures exchanges, argue "yes," pointing to the legislative history of the CEA and the judicial precedents confirming the classic elements.\(^\text{11}\) Others, most particularly the derivatives industry, argue "no," pointing to the need for the CEA's jurisdictional standards to evolve as new forms of commercial and institutional transactions are developed.\(^\text{12}\) In the midst of this debate, the CFTC often appears to be a mere mediator, seeking to reconcile the conflicting positions, but always careful to be sufficiently ambiguous in expressing its own views so as to not overly offend one side or the other.

In what follows, I first set out the statutory setting that gives rise to these fundamentally conflicting jurisdictional perspectives and provide some sense of how they have evolved. Then I examine the CFTC's BT Order and MGRM Order in an effort to illustrate both the CFTC's timidity in dealing with questions of the scope of its own jurisdiction and the costs of that timidity in terms of regulatory uncertainty. Finally, I offer a modest recommendation for ending the CFTC's current jurisdictional dilemma by suggesting that the traditional requirement for the identification of a forward contract—that the parties to it intend that it will be satisfied by delivery—is mistaken and needs to be replaced.

---

10. Options are a special case discussed infra note 135.


12. See Letter from the International Swaps and Derivatives Association to Jean Webb, Secretary of the CFTC (Dec. 13, 1994) (responding to the CFTC's request for comment regarding possible Amendment of CFTC Rule 35) (on file with author); see also Michael Ocrant, Industry Still Looking to Congress to Settle Questions Raised by Last Year's MG Settlement with CFTC, Sec. Wk., Jan. 29, 1996, at 5.
II. The Forward Contract Exclusion

A. Statutory Framework

The CEA grants the CFTC exclusive jurisdiction over "transactions involving contracts of sale of a commodity for future delivery." The CFTC is thus vested with exclusive regulatory jurisdiction over so-called "futures contracts." Until the passage of the Futures Trading Practices Act of 1992, which authorized the CFTC to exempt transactions from the CEA, the CEA required that all transactions in futures contracts occur only on, or subject to the rules of, boards of trades that have been designated by the CFTC as "contract markets," that is, "commodity exchanges."

The key exclusion from the CFTC's jurisdiction over future contracts is the so-called "forward contract exclusion." The CEA states, without further elaboration, that futures contracts do not include "any sale of any cash commodity for deferred shipment or delivery," that is, futures contracts do not include "forward contracts." Whether a contract that calls for delivery of a commodity in the future is a futures contract or a forward contract has great significance, for futures contracts established off of a commodity exchange are illegal in the absence of an otherwise available exemption.

The effort to draw a workable, if not precise, distinction between futures and forward contracts has engaged the CFTC and the courts for more than twenty years. The history of this effort is an often told tale, which I do not propose to retell. What I do propose to do, however, is to trace briefly the development of the concepts of "delivery" and "offset" as the key elements used to differentiate forward contracts from futures contracts; to make what should be the obvious

13. C.E.A. § 1a(3), 7 U.S.C. § 1a(3) (1994). This section of the CEA defines "commodities" to include enumerated physical commodities; other goods and articles; and all services, rights, and interests "in which contracts for future delivery are presently or in the future dealt in." Id. A transaction may be recognizable as a futures contract even though the underlying commodity is not presently being traded as a futures contract on a CFTC-designated contract market. See, H.R. REP. No. 93-975, at 76 (1974) (statement of the then-Assistant Secretary of Agriculture, Dr. Clayton Yeutter).


15. C.E.A. § 6(a), 7 U.S.C. § 6(a). The recent amendments to the CEA authorize the CFTC to "exempt any agreement, contract, or transaction (or class thereof) that is otherwise subject to subsection (a) of this section... either unconditionally or on stated terms or conditions or for stated periods and either retroactively or prospectively, or both, from... any other provision of this chapter (except section 2(a)(1)(B)). . . ." C.E.A. § 4c(1), 7 U.S.C. § 6c(1).

16. C.E.A. § 1a(11), 7 U.S.C. § 1a(11).

17. Off-exchange transactions in non-exempt futures contracts are prosecutable as felonies punishable by up to five years in prison and a fine of up to one million dollars. See C.E.A. § 9(a), 7 U.S.C. § 13(a).
point that if these elements are decisive in differentiating forwards from futures, the conflict between the CFTC's regulation of the futures markets and the growth and vitality of the OTC derivatives market is inevitable and unreconcilable; and finally to introduce the discussion of the BT and MGRM Orders with the observation that the CFTC's attempt to resolve this conflict by tinkering with the concepts of "delivery" and "offset" is the cause of its reliance on purposeful ambiguity.

B. Initial Attempts to Identify the Key Elements of Forward and Futures Contracts

In its earliest considerations of the elements that distinguish futures contracts from forward contracts, the CFTC, or at least its Office of General Counsel, developed two approaches, radically different and fundamentally inconsistent. The first was spelled out in a 1977 Interpretative Letter ("1977 Interpretation") written to a firm operating as a "blind broker"18 between primary dealers in Government National Mortgage Association (otherwise known as "GNMA") and Treasury securities.19

The Office of General Counsel sought to analyze whether the proposed transactions in GNMA's and Treasuries were "transactions involving contracts of sale of a commodity for future delivery within the meaning of the Act."20 Its starting point was that the "plain meaning [of the phrase 'contract of sale of a commodity for future delivery'] is clearly broad enough to encompass . . . contracts that are commonly described as forward contracts."21 The issue as the CFTC saw it, therefore, was to identify the basis on which the Congress intended futures contracts, which are to be fully regulated, to be distinguished from forward contracts.

The key distinction for the Office of General Counsel was that futures contracts "are defined not only by the element of deferred shipment [which is common to both futures and forwards contracts] but also by the nature of the marketplace in which a buyer and seller entered into the contract."22 Thus, the thrust of the forward contract

18. A "blind broker" protects the identity of the dealers which are party to the transaction by acting as the middleman between them.
20. Id. at 21,910.
21. Id. at 21,911.
22. Id.
exemption "is toward the marketplace in which the transaction occurs rather than the element of deferred shipment." 23 This means that the critical element in distinguishing futures from forwards is not whether delivery is intended or offset is available but whether the contracts under review "are traded by a group of persons whose activities [including general public participation in the transactions] bring them within the definition of a board of trade . . . [in the CEA]." 24 If the trading occurs on a board of trade, then the contracts are future contracts; if not, then not.

I will argue at the conclusion of this paper that the approach to the futures/forward distinction in the 1977 Interpretation is sensible and, at least in part, offers a way out of the regulatory dilemma in which the CFTC is currently entangled. For the time being, suffice it to note that the vitality of the 1977 Interpretation was short lived; for a little over a year later, the Office of the General Counsel, in a memorandum to the CFTC ("1978 Memorandum"), 25 which did not refer to the 1977 Interpretation or discuss looking to the "marketplace in which the transaction occurs" 26 as a way to identify futures contracts, concluded that all transactions involving contracts that call for future delivery are futures contracts except for cash sale contracts contemplating actual, although deferred, delivery. 27

Interestingly, the 1978 Memorandum starts at exactly the same point as did the 1977 Interpretation: "Its plain and literal meaning [of the phrase 'contract of sale of a commodity for future delivery'], however, encompasses any contract for the delivery of a specified commodity at a later date. Thus, the term may be read to include . . . 'forward' contracts that do not necessarily have all of the characteristics of futures traded on designated exchanges." 28 But in attempting to discern the Congressional intent as to how futures contracts were to be distinguished from forward contracts, the 1978 Memorandum came out at precisely the opposite place: the forward contract exclusion is available "solely for the benefit of persons involved in a commercial cash commodity business, which would allow them to effect cash sales of the commodity, contemplating actual delivery as a matter of course,

23. Id.
24. See id.
26. 1977 Interpretation, supra note 19, at 21,911.
27. See 1978 Memorandum, supra note 25.
28. Id. at 13,498.
but in which shipment or delivery of the commodity might be deferred for purposes of commercial convenience or necessity.\textsuperscript{29}

Thus, in the view of the Office of General Counsel, as reflected in the 1978 Memorandum, "all off-exchange offerings\textsuperscript{30} of commodities for future delivery . . . are generally unlawful."\textsuperscript{31} The only permissible off-exchange contracts calling for future delivery are in "the class of commercially motivated cash commodity sales, which contemplate actual delivery of the commodity, but in which delivery may be deferred for purposes of commercial convenience or necessity."\textsuperscript{32} Thus, was born in 1978, the notion that the elements that distinguish forward contracts from futures contracts are the "contemplation [of] [actual] delivery"\textsuperscript{33} and the fact of delivery "in virtually all cases."\textsuperscript{34} I will refer to these elements collectively as the "Delivery Requirement."

\section{C. The "Classic Elements" of a Futures Contract}

A year after the 1978 Memorandum, the CFTC decided its first administrative proceeding involving the question of when an off-exchange offering of contracts for the purchase or sale of commodities involves illegal off-exchange futures contracts.\textsuperscript{35} Without citing the 1978 Memorandum, in \textit{In re Stovall}, the CFTC held that the forward contract exclusion was intended to cover only contracts for sale which are entered into with the expectation that delivery of the actual commodity will eventually occur through performance on the contracts. . . . Although the desire to acquire or dispose of a physical commodity is the underlying motivation for entering such a contract, delivery may be deferred for purposes of convenience or necessity.\textsuperscript{36}

\textsuperscript{29} \textit{Id.} For a view of the legislative history of the forward contract exclusion contrary to that in the 1978 Memorandum and generally supportive of the 1977 Interpretation, see Letter and Appendix A thereto, from Robert E. Rubin, Partner, Goldman Sachs & Co., to the Office of the Secretariat, CFTC (May 10, 1988) (on file with author).

\textsuperscript{30} The notion of "offerings" in the 1978 Memorandum was derived from the concept of entities "existing to conduct a business in the offer of contracts of sale of a commodity for future delivery. . . ." which was illegal under then section 4h of the CEA. Undoubtedly, there is a presumption that the offering will involve the general public although that subtlety in the 1978 Memorandum has been generally lost in the CFTC and judicial rulings that have followed it.

\textsuperscript{31} 1978 Memorandum, \textit{supra} note 25, at 13,501.

\textsuperscript{32} \textit{Id.}

\textsuperscript{33} \textit{Id.}

\textsuperscript{34} \textit{Id.} at 13,499.


\textsuperscript{36} \textit{Id.} at 23,777-778.
Consequently, while both futures and forward contracts entail "the legal obligation to perform," the "major difference" between them is "the generally fulfilled expectation that the [forward] contract will lead to the exchange of commodities for money."37

In *In re Stovall*, the CFTC went on to identify four additional "classic elements"38 of futures contracts: they are (1) offered to the public; (2) secured by margin; (3) standardized as to terms; and (4) closed by offset.39 But the CFTC cautioned that "all of these elements" need not be present to identify a futures contract nor are these "classic elements" an "exhaustive catalogue" of relevant factors.40 Rather, "each operation" must be examined "in context."41 Nevertheless, the CFTC left no doubt that the "lack of delivery is the clearest indication that the contracts [are] not [forward contracts]."42

In 1982, the Ninth Circuit Court of Appeals decided *CFTC v. Co Petro*,43 which is unquestionably the leading case on the futures/forwards distinction. Relying heavily on *Stovall*, the Ninth Circuit held that so-called "Agency Agreements for Purchase and Sale of Motor Vehicle Fuel" marketed to the public by Co Petro were illegal off-exchange futures contracts.44 Although discussing other elements of futures contracts and acknowledging that "no bright-line definition or list of characterizing elements [of such contracts] is determinative,"45 the court squarely held that the forward contract exclusion is "narrow" and not available to contracts "sold merely for speculative purposes and which are not predicated upon the expectation that delivery of the actual commodity by the seller to the original contracting buyer will occur in the future."46 The court noted that the ability to avoid "delivery against the contracts" is accomplished through "offsetting or liquidating transactions" that are made possible by "[s]tandardized form contracts."47 Thus, "essential" to a futures contract is the ability to offset in order to avoid "the forced burden of delivery."48

37. Id. at 23,778.
38. Id. at 23,777.
39. Id.
40. Id. at 23,779.
41. Id.
42. Id.
43. CFTC v. Co Petro Mktg. Group, Inc., 680 F.2d 573 (9th Cir. 1982).
44. See id. at 582.
45. Id. at 581.
46. Id. at 579.
47. Id. at 580.
48. Id.
trast, "a cash forward contract is one in which the parties contemplate physical transfer of the actual commodity." 49

There is no point to be served by discussing the significant number of cases that have reiterated and elaborated on the Stovall and Co Petro decisions. 50 The point I want to emphasize is that beginning with the 1978 Memorandum, the CFTC, in identifying the forward contracts that are to be excluded from regulation under the CEA, almost always citing Co Petro, has focused ever more sharply on whether delivery is intended and regularly occurs. Thus in 1985, the CFTC's Office of the General Counsel identified illegal off-exchange futures contracts as those that are "standardized as to terms and conditions" and "undertaken primarily to assume or shift . . . risk . . . and . . . not generally entered into for purposes of obtaining delivery of the commodity, but rather are discharged through offsetting transactions. . . ." 51 Later that same year, the CFTC summarized its position by stating that “[i]n cash forward contracting the parties have the capacity to make or take delivery of the actual commodity, intend to do so, and delivery in fact routinely occurs.” 52 It certainly would not be an exaggeration to characterize the CFTC's view at this time as being that off-exchange transactions between parties that have as their primary purpose risk shifting and not product delivery are illegal futures contracts.

D. The CFTC's Apparent Abandonment of the Delivery Requirement

This pattern of CFTC interpretation of the forward contract exclusion continued unbroken until 1987. 53 In December of that year, the CFTC issued an Advance Notice of Proposed Rulemaking ("Advance Notice"), 54 which contained a number of far reaching and con-

49. Id. at 578.
51. The Regulation of Leverage Transactions and Other Off-Exchange Future Delivery Type Instruments—Statutory Interpretation, 50 Fed. Reg. 11,656, 11,657 (CFTC 1985). The other traditional elements of a futures contract were relegated to a footnote. See id. at 11,657 n.2.
troversial proposals. With respect to the futures/forwards distinction, the CFTC reiterated the traditional definition of a forward contract, but then acknowledged the regulatory need to address two "new" categories of transactions: the first, commercial "transactions [for example, in the Brent oil market] . . . that would constitute forward contracts but for the lack of delivery as the normal culmination of the transaction," 55 and, the second, commercial transactions, for example, in the swap market, that "substantially depart from the context in which the forward contract exclusion has historically operated." 56 In light of both types of transactions, the CFTC requested comments on a set of criteria to identify "categories of commercial commodity transactions [as to which CFTC] jurisdiction is unwarranted and . . . no-action relief is therefore appropriate." 57

What the CFTC was saying, or appeared to be saying, in the Advance Notice was really quite extraordinary. (1) "[T]he infrequency of delivery" in certain active and well established categories of commercial transactions, including at least the Brent oil market and the swap market, "tend to preclude their characterization as forward contracts within the [CEA's] jurisdictional exclusion. . . ." 58 (2) Nevertheless, the regulation of these transactions as futures contracts is "unwarranted." 59 (3) The CFTC was not, however, prepared to "modify or affect" the scope of the forward contract exclusion so as to clarify the legal status of these transactions. 60 But (4), the CFTC was prepared to consider no-action relief, which would in no way foreclose or even weaken private suits alleging the illegality of these contracts.

The CFTC received more than eighty comment letters, totaling over eight hundred pages, in response to the Advance Notice. The responses were overwhelmingly critical. The OTC dealers were outraged that the CFTC had cast doubt on the legal status of their markets. The commodity exchanges were outraged that the CFTC was moving to protect the OTC markets, rather than shut them down. And the other federal financial regulators were outraged that the CFTC appeared to be stepping on their turf. 61

55. Id. at 47,026-27.
56. Id. at 47,027.
57. Id. at 47,023.
58. Id. at 47,027.
59. See id. at 47,024.
60. See id. at 47,027 n.16.
61. The Department of Treasury told the CFTC the Advance Notice would "seriously inhibit the efficient operation of financial markets." Letter from George D. Gould, Under Secretary Finance, Dept. of Treasury, to Chairman Gramm, CFTC (Apr. 5, 1988) (on file with author). The Treasury also claimed that the CFTC's proposed scheme generated "uncertainty among
The CFTC had begun to reap the fruits of its reliance on the Delivery Requirement, for it had become apparent that if this requirement continued to be the touchstone of contracts excluded from the CEA, CFTC regulation and the OTC institutional financial market were on a clear collision course. The CFTC’s no-action proposal would be of no help in avoiding such a collision, and unless the CFTC was prepared to modify the Delivery Requirement, a major cataclysm appeared inevitable.\textsuperscript{62} Not surprisingly, therefore, the CFTC began to back away from the Delivery Requirement.

market participants with respect to a wide variety of transactions,” and could have “potentially deleterious effects on financial markets generally as the uncertainty increases.” \textit{Id.}

The Office of Comptroller of the Currency also disapproved. It saw the issue as a presumptuous assertion of CFTC jurisdiction “not only over new bank products, but also over traditional banking products.” Letter from J. Michael Sheperd, Comptroller of the Currency, to Chairman Gramm, CFTC (Apr. 11, 1988) (on file with author). The Comptroller informed the CFTC that its proposal “amounts to an unnecessary interference with banking activities and their regulation by the office of the Comptroller of the Currency.” \textit{Id.}

The SEC asserted that the Advance Notice had “an apparent chilling effect on new product development,” and that the adoption of the rules would “further retard capital market innovation exemplified by the development of hybrid instruments.” Letter from Jonathan G. Katz, Secretary, Securities and Exchange Commission, to Jean A. Webb, Secretary, CFTC (Aug. 19, 1988) (on file with author). The SEC also called the CFTC to task for an unjustified attempt to expand its jurisdiction. \textit{See id.} The CEA, according to the SEC, does not provide the CFTC with “the legal authority” or “the regulatory flexibility” to regulate the issuance and secondary-market trading of hybrid instruments issued in bona fide financing transactions. \textit{See id.} Appropriate regulation is provided by federal securities laws, which “provide a flexible regulatory scheme that . . . govern[s] effectively the evolving market for such instruments.” \textit{Id.}

62. Among the comments on the CFTC’s proposal were three full-scale analyses of Congress’s “intent” with respect to the CFTC’s regulation of off-exchange products. One analysis was by friends of the CFTC’s proposal, two were by critics. But each had a unique perspective, and each reached a different conclusion.

The friendly history consisted of an article written by two lawyers representing the Chicago Board of Trade. For them, the distinction between futures contracts and forward contracts is clear and unambiguous. Futures include all executory contracts requiring delivery some time after they are entered into. The sole exception is for forwards-future-settling contracts—entered into with an “intent to deliver” the commodity. This history concludes that the CEA prohibits trading future-settling contracts away from an exchange unless there is intent to deliver the subject of the contract. In this view, “Congress intended to excuse from the otherwise plenary reach of the exchange-trading requirement only a very narrow class of futures-settling contracts that contemplate the transfer of actual ownership of a commodity in a commercial, merchandising transaction.” Alton B. Harris et al., \textit{Hybrid Products: The Band Plays On,} \textit{INTERMARKET,} Nov. 1988.

An interpretation more in tune with financial realities was submitted by the New York Clearing House. It finds that from the beginning of federal regulation of the futures markets, “Congress has recognized the legitimacy of various forms of off-exchange transactions which may resemble exchange contracts in certain respects.” Letter from John F. Lee, Executive Vice President, New York Clearing House, to Office of the Secretariat, CFTC (Apr. 8, 1988) Appendix A (on file with author). Congress is determined to exempt such transactions from regulation, “rather than attempt to force them to be entered into on the exchange floors or impose other burdensome requirements.” \textit{Id.} Congress recognized that because of the expansive definition of “commodity” added to the CEA in 1974, “the possibility arose that the [CFTC’s] jurisdiction would be interpreted to apply to trading in foreign currencies and other financial instruments conducted off the organized commodity exchanges.” \textit{Id.} So Congress added the so-called “Treasury Amendment” to the CEA, which excluded from the statute’s coverage “transactions
The first step in this retreat was the CFTC's issuance of its Policy Statement Concerning Swap Transactions ("Swaps Policy Statement"). This statement reads in places as a CFTC no-action position, and in other places as a statutory interpretation. Whichever way the statement is read, however, it contains a significant new slant on the characteristics that distinguish forward contracts from futures contracts.

In the Swaps Policy Statement, the CFTC appears to acknowledge that, despite various distinctions between the trading of swaps and exchange-traded futures, "the economic reality of swaps nevertheless resembles that of futures contracts." The CFTC also argues, however, that swaps generally have characteristics "that may warrant in foreign currency [and six other specified instruments], unless such transactions involve the sale thereof for future delivery conducted on a board of trade." Harris et al., supra.

The Clearing House recognizes that because of market developments since 1974, "not all [off-exchange] financial products that have subsequently become widely offered may fit precisely within the explicit terms of the Treasury Amendment." Id. But if the products don't fit and aren't within the forward-contract exclusion because delivery is not intended, what exempts them from exchange trading requirements? The Clearing House argues "that had there been full awareness of such products . . . the Treasury Amendment or some other provision would have excluded such products explicitly." Id.

The most thoughtful analysis of legislative history came from Goldman, Sachs & Co. See Letter from Robert E. Rubin, Partner, Goldman, Sachs & Co., to the Office of the Secretariat, CFTC (May 10, 1988) (on file with author). "The critical distinction drawn in the statute," Goldman contends, is "not between exchange and off-exchange trading, but between 'legitimate' commercial trading and 'gambling'." Id. at A-1. As Goldman interprets the legislative history, the only off-exchange activity intended to be prohibited is the operation of bucket shops. See id. at A-17. This was accomplished through the exclusion of forward contracts, which "was intended . . . to encompass all permissible off-exchange trading." Id. at A-16. Contrary to other readings, Goldman does not think the availability of the exclusion turns on an "intent to deliver" but "on the nature of the parties at the time of contract." Id. Delivery is not critical because Congress understood that "settlement by offset, in a commercial context, is the legal equivalent of physical delivery." Id. at A-11. Goldman claims that Congress intended the forward-contract exclusion "to serve as a commercial exception covering a broad range of off-exchange transactions entered into for legitimate business purposes." Id. at A-26. As a result, it "did not limit its scope to those [transactions] resulting in delivery." Id.

Goldman's analysis has one major flaw. If the forward-contract exclusion was to be interpreted that broadly, why was the Treasury Amendment needed in 1974? Despite the use critics have made of the Treasury Amendment, its presence in the CEA is the strongest argument for the CFTC's position. Either Goldman is right and the Treasury Amendment is superfluous—a hard conclusion for the CFTC or a court to reach—or Goldman is wrong and the Treasury Amendment is necessary. If the latter is true, then products not specifically covered by the Amendment are subject to CFTC regulation. This is also a hard conclusion for a court and the CFTC to reach, given the major disruption it would cause.

64. "[T]he Commission has determined that a greater degree of clarity may be achieved through safe harbor guidelines establishing specific criteria for swap transactions to which the Commission's regulatory framework will not be applied." Id. at 30,696.
65. "[T]he Commission is issuing this policy statement to clarify its view of the regulatory status of certain swap transactions." Id. at 30,694.
66. Id. at 30,695.
distinguishing them from futures contracts."\textsuperscript{67} Therefore, the CFTC set out characteristics that constitute "safe harbor standards" by identifying "swaps for which regulation under the CEA . . . is unnecessary."\textsuperscript{68}

One of the CFTC's safe harbor standards is the "absence of exchange-style offset."\textsuperscript{69} By exchange-style offset, the CFTC means the ability to terminate or liquidate a contract by taking "an equal and opposite position" without the "[p]rior consent of the . . . counterparty."\textsuperscript{70} In contrast to "exchange-style offset" is the ability to terminate a contractual obligation "only with counterparty consent" that is "privately negotiated" either before or after the "outset of the agreement."\textsuperscript{71} In the CFTC's view, swaps that do not have exchange-style offset may be excluded from regulation under the CEA "consistent with policies reflected in the CEA's jurisdictional exclusion for forward contracts . . . ."\textsuperscript{72}

Two points are noteworthy about the CFTC's reliance on the absence of exchange-style offset as a distinguishing feature of forward contracts. First, in characterizing the nature of forward contracts as they "generally have been recognized,"\textsuperscript{73} the CFTC does not mention the Delivery Requirement, that is, the parties' intent to effect delivery and delivery, in fact, routinely occurring.\textsuperscript{74} Of course, swaps do not generally call for delivery under any circumstances, but by acknowledging that nondelivery contracts can be forward contracts and by shifting the emphasis as to the distinguishing elements of forward contracts away from intent\textsuperscript{75} and actual performance, the CFTC set the stage for further retreat from the Delivery Requirement. Second, the

\begin{itemize}
  \item \textsuperscript{67} Id. Why "may" warrant? This is a trivial example of the CFTC's studied ambiguity.
  \item \textsuperscript{68} Id. According to the Swaps Policy Statement, exempted swaps must have individually-tailored terms, lack the ability to terminate by exchange-style offset, be based upon individualized credit determinations, be undertaken in conjunction with a line of business, and not be marketed to the public. Id. at 30,696-697.
  \item \textsuperscript{69} Id. at 30,696.
  \item \textsuperscript{70} "In the context of exchange-traded futures, offset refers to the liquidation of a futures position through the acquisition of an opposite position. The availability of such offset, resulting in the liquidation of the position, typically is established by exchange rules governing exchange members' relationships with the clearing house." Id.
  \item \textsuperscript{71} Id.
  \item \textsuperscript{72} Id. at 30,695.
  \item \textsuperscript{73} Id.
  \item \textsuperscript{74} "Sales of cash commodities for deferred delivery, or forward contracts, generally have been recognized to be commercial . . . counterparties who have the capacity to make or take delivery of the underlying commodity but in which delivery 'may be deferred for purposes of convenience or necessity.'" Id. (citing In re Stovall, [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) § 20,941, at 23,777-78 (CFTC Dec. 6, 1979)).
  \item \textsuperscript{75} The CFTC does limit the availability of this safe harbor characteristic to "instruments . . . that are entered into with the expectation of performance." Id. at 30,696. But without any
notion that forward contracts are characterized by the absence of "exchange-style offset" is a puzzling notion since neither Stovall nor Co Petro were characterized by a right of offset in this sense. In these cases, and in almost all other cases finding illegal off-exchange futures contracts, offset was accomplished by the accommodation or tacit understanding of the counterparty, not by there being any sort of right to offset without the "consent" of the counterparty.

After the Swaps Policy Statement, the CFTC's final step in its apparent retreat from the Delivery Requirement appears, in hindsight, to have been inevitable. In the Advance Notice, the CFTC noted that one court had "preliminarily expressed the view that [15-day] Brent oil transactions are predominantly futures transactions."76 In early 1990, that federal district court definitively ruled in Transnor (Bermuda) Ltd. v. BP North American Petroleum that "15-day Brent transactions constitute futures contracts."77 In the view of that court, 15-day Brent contracts are "a novel type of transaction, which appears to be a hybrid of a futures contract and a forward contract."78 In particular, "[b]ecause the contracts do not provide for offset without the consent of the parties and because the seller cannot predict in advance whether a particular buyer will insist on physical delivery, the market remains one based on physical trading."79 Yet, the "three major motivations in Brent market activity [are] hedging, speculation and tax spinning, ..."80 And over ninety-five percent of 15-day Brent contracts are "routinely settled by means other than delivery, most typically through clearing techniques of offset and bookout."81

Under these circumstances, the court concluded "the 15-day Brent market does not remotely resemble the commercial trading

requirement that swaps, in fact, will generally be "held to maturity," it is hard to understand what this "expectation" means.

78. Id. at 1489. 15-day Brent contracts are negotiated in the Brent market. The Brent market is comprised of the chain of producers and commercial entities and others who use oil from the North Sea fields. The participants contract to buy and sell cargoes of Brent oil. (A cargo of Brent system crude oil is approximately 500,000 barrels, and depending on the market price, a single contract has a value in the millions of dollars.) Title to the cargo passes to each participant in the chain and each participant is responsible for its performance, although the participants may also terminate their contracts through individually negotiated cancellation agreements.
79. Id. at 1490 (citing The Legal Aspects of the 15-Day Brent Market (Part I), 5 J. ENERGY NAT. RESOURCES & ENVTL. L. 109, 116 (1987)).
80. Id.
81. Id. at 1491.
originally excepted from the [CEA],”82 for the “high levels of speculation and performance without delivery . . . distinguish the 15-day Brent transactions from the forward contracts contemplated by the drafters of the [CEA].”83 The court, therefore, held that the transactions in 15-day Brent contracts were illegal off-exchange futures contracts despite the fact that the contracts did not provide for offset without the consent of the parties.84 In the court’s view, “even where there is no ‘right’ of offset, the ‘opportunity’ to offset and a tacit expectation and common practice of offsetting suffices to deem the transaction a futures contract.”85

The Transnor decision squarely posed for the CFTC an acute regulatory dilemma. It could either accept the decision and its implications—namely, to regulate or prohibit the entire Brent market—or reject the Delivery Requirement and permit the Brent market to continue to operate. Not surprisingly, the CFTC chose the latter course. Five months after the Transnor decision was handed down, the CFTC issued its Statutory Interpretation Concerning Forward Transactions86 ("1990 Interpretation"), effectively stating that the Transnor court had misunderstood the legal characteristics of forward contracts.

The 1990 Interpretation appears to eliminate entirely the traditional, critical focus on (1) the intent of the parties to make and take delivery and (2) the actual occurrence of delivery on a regular basis. Instead, the CFTC stated that the forward contract exclusion would be satisfied if transactions entered into between commercial participants in connection with their businesses created specific delivery obligations that impose on the participants substantial economic risks of a commercial nature.87 Directly contradicting the Transnor court, the CFTC effectively held that it is the contractual right to offset the transaction or, more accurately, the absence of such a contractual right “by the terms of the contracts as initially entered into,” that is controlling.88 As long as the parties must negotiate separate agreements relieving them of their delivery obligations and thus “cannot discharge [their] obligations through exchange-style offset,”89 that is,

82. Id. at 1492 (alteration in original).
83. Id.
84. See id. at 1492.
85. Id.
87. See id. at 39,191.
88. Id. at 39,192.
89. Id. at 39,191.
they have no "right of offset," it is no longer relevant that the parties enter such transactions for the purpose of hedging, speculating, and tax spinning, and with the "tacit expectation" that delivery will not occur.

The CFTC explained the change in its previous position by stating that the "concept of what constitutes delivery" in the context of the forward contract exclusion must be reinterpreted to reflect the realities of "today's commercial environment." The CFTC effectively conceded that notwithstanding the long history of CFTC and judicial interpretations of the forward contract exclusion, "a diverse variety of transactions" between commercial counterparties evolved that was beyond the established definition of forward contracts. These transactions "serve the same commercial functions" as the forward contracts that were originally subject to the forward contract exclusion, but differ in that the transactions "may ultimately result in performance through the payment of cash as an alternative to actual physical transfer or delivery of the commodity."

The CFTC carefully avoided saying it was reversing its position on the necessity of meeting the Delivery Requirement in order for a contract to come within the forward contract exclusion. Nonetheless, the upshot of the CFTC's 1990 Interpretation appeared to be that it would no longer assess the "underlying purpose" of the parties to a purported forward contract, particularly with respect to whether delivery of the underlying commodity is in fact intended by the parties, as long as the formal contractual indicia of a forward contract can be satisfied. The CFTC's rejection of the Delivery Requirement as the critical element in identifying forward contracts appeared to be confirmed in 1992 by the then Chairman of the CFTC. In a letter to the Chairman of the House subcommittee with oversight responsibility for the CFTC, Wendy Gramm stated: "In the Commission's experience, commercial reality dictates that the legality of a forward contract be based upon the objective standard of a legally enforceable obligation between commercial entities to make or take delivery, coupled with the commercial capacity to do so."

90. Id.
91. See id.
92. Id. at 39,191.
93. Letter from Wendy Gramm (then CFTC Chairperson) to Glenn English, Chairman of the House of Representatives Subcomm. on Conservation, Credit and Rural Dev. (May 4, 1992).
E. The CFTC’s Ambivalence and the A-Mark Decision

Despite the CFTC’s apparent moves away from the Delivery Requirement as the touchstone for identification of a forward contract, the CFTC’s inherent ambivalence on the issue became apparent almost immediately in its response to the district court’s opinion in Krommenhoek v. A-Mark Precious Metals Inc.94 A-Mark Precious Metals Incorporated (“A-Mark”), a wholesale precious metals dealer, had been doing a cash-and-carry business in gold and silver with Keith D. Bybee, Sr. (“Bybee”), a retail precious metals dealer. Beginning in 1982, Bybee purchased gold and silver from A-Mark by means of so-called “Deferred Delivery (margin) Sales” contracts. Pursuant to these Deferred Delivery contracts, Bybee made a down payment of ten or twenty percent; the metals were to be delivered upon payment of the balance (purportedly within two years), and A-Mark held a lien on the metal until it received full payment. By the terms of the Deferred Delivery contracts, Bybee had no right to terminate the contracts other than by full payment and acceptance of delivery, and he certainly had no right to discharge his obligations through exchange-style offset. Nevertheless, over ninety-five percent of Bybee’s margin purchases were closed or offset without delivery. Furthermore, A-Mark did not enforce the provision of these contracts that required Bybee to take delivery within two years.

Bybee was not playing the metals markets with his own money. He sold silver to his retail customers, obtained full payment from them up front, and told them they could store their metal at A-Mark for up to two years at no cost. Bybee then used the customer payments to enter into Deferred Delivery contracts rather than purchase silver for immediate delivery as he had been instructed. In other words, Bybee used his customers’ money “to gamble on the price of silver with no intention of taking delivery.”95 The customers were unaware of Bybee’s scheme and believed their silver was stored at A-Mark and available for delivery free of any liens. Inevitably, the price of silver declined, A-Mark demanded additional margin, Bybee defaulted, A-Mark sold the silver, Bybee speculated with the minimal proceeds he received and lost everything, and Bybee filed for bankruptcy protection. The trustee-in-bankruptcy, Krommenhoek, sued A-Mark on the ground, among others, that the Deferred Delivery

95. Id. at 37,485.
contracts were illegal off-exchange futures contracts. Both the bankruptcy court and the district court held that these contracts were forward contracts.96

It should be noted that the District Court ruled before the CFTC issued its 1990 Interpretation. Notwithstanding the unavailability of that precedent, the district court ruled that the Deferred Delivery contracts between A-Mark and Bybee were not futures contracts because Bybee was "a commercial precious metals dealer," the "public was not involved" in the contracts, and "Congress has determined that such activities [i.e., those involving "savvy commercial entities, well-versed in the commodities they trade"]97 should flow freely without the dragging anchor of regulation."98 Interestingly, the court did not cite the CFTC's 1977 Interpretation, but it was strongly influenced by a 1986 Report of the Committee on Commodities Regulation of the Association of the Bar of the City of New York.99 This lengthy and thoughtful Report concludes that as a "general rule" commercial off-exchange "principal to principal" transactions that involve only "commercial, financial, and other institutional parties" and not "the general public" are within the "parameters enumerated" by "congressional policy and the legislative history underlying the [CEA for inclusion within] . . . the forward contract exclusion."100

Unfortunately, in restating the Report's conclusion, the district court stated baldly that the Deferred Delivery contracts "have all the indications of futures contracts save one: the public was not involved . . . . The congressional intent behind the Commodity Exchange Act was not to regulate transactions between commercial entities."101 On its face this statement is simply wrong. For example, a transaction on the Chicago Board of Trade is not transformed from a futures contract to a forward contract merely because the parties are commercials. With more sensitivity to the nuances of the Report's conclusion, but no less instinct for the right result, the district court could have reached the same result by holding that a bilateral off-exchange contract between commercial counterparties that does not, by its terms, allow a right of exchange-style offset is an exempt forward contract.

96. See id. at 37,486.
97. Id.
98. Id.
100. Id. at 871, 899.
Indeed, a sympathetic reading of the district court opinion suggests that this is what it intended.

The district court's careless statement that transactions that do not involve the public are not futures transactions caused the CFTC and the major futures exchanges sufficient concern that they filed amicus curiae briefs in the appeal to the Ninth Circuit. Given that the CFTC issued its 1990 Interpretation shortly after the district court's opinion was handed down and shortly before it filed its amicus brief, one would have expected the CFTC to use this occasion to amplify its 1990 Interpretation and illustrate the application of the new right-of-offset standard outside the context of the Brent oil market. Without explanation, however, the CFTC did not even refer to its 1990 Interpretation in its brief.

Furthermore, Bybee's transactions with A-Mark raised a host of issues relevant to the futures/forwards distinction. For example, was Bybee truly a "commercial" counterparty, as the district court held? If he was such generally, was he a commercial counterparty with respect to those transactions involving unauthorized speculation with his clients' money? Should the fact that his activities were unauthorized be relevant to the classification of the contracts as futures or forwards so long as A-Mark believed in good faith that Bybee was a commercial counterparty? Did Bybee have the capacity to take delivery, that is, to bear the risks of such transactions? How should this factor be weighed against A-Mark's knowledge of and belief about Bybee's capacity? What should be made of Bybee's intent? Obviously his transactions were speculative and not entered into for a commercial purpose related to his business as a retail metals dealer. But the major motivations in Brent market activity are hedging, speculation, and tax spinning and many transactions are unrelated to any business of the participants involving the production, processing, or distribution of oil. And what about the absence of an intent to take delivery? It is clear that the Deferred Delivery contracts, just as the 15-day Brent contracts, did not contain a right of exchange-style offset. In both situations, however, actual delivery occurred very infrequently. Is there, nevertheless, a distinction to be drawn between the two situations

102. The district court's opinion was issued on July 9, 1990, the effective date of the 1990 Interpretation was September 25, 1990, and the CFTC filed its brief in In re Bybee on December 17, 1990.

103. See Amicus Curiae Brief of the Commodity Futures Trading Commission, In re Bybee, 945 F.2d 309 (No. 90-35604) (on file with author) [hereinafter Bybee Brief].

104. See Bybee, 945 F.2d at 314, 315.
such that the Deferred Delivery contracts Bybee used fell outside of the 1990 Interpretation?

The CFTC chose to address none of these questions. Indeed, it did not even take a position on whether the Deferred Delivery contracts were futures or forward contracts. The only issue the CFTC did address was "whether public involvement is a critical definitional element of a 'contract of sale of a commodity for future delivery' within the meaning of section 2(a)(i)(A) of the CEA." As pointed out above, the answer to this question is clearly "no," but this question is hardly the most important jurisdictional issue the court faced. Yet the CFTC's seventeen-page brief never once addressed any other issue.

Worse, however, than the CFTC's failure to provide the issue explanation expected of the federal agency to whom the appellate court was prepared to give "great deference," was the CFTC's disingenuous discussion of the one issue it did address: public involvement. Keep in mind, as the circuit court did not do, that all contracts for future or deferred delivery of commodities are either futures contracts or forward contracts and there is no undivided middle. As the 1978 Memorandum points out, "[i]ts plain and literal meaning, however, [of the phrase "contract of sale of a commodity for future delivery"] encompasses any contract for the delivery of a specified commodity at a later date." Thus, standing alone, this phrase would encompass—and bring within the CFTC's exclusive jurisdiction—all executory contracts for commodities. But, of course, the concept of a "futures contract" does not stand alone; it is set in opposition to and draws its meaning from the forward contract exclusion.

It makes no sense, therefore, to talk about the characteristics of future contracts without contrasting them with the characteristics of forward contracts. In its decision in Co Petro, the Ninth Circuit analyzed the contracts at issue as though two questions needed to be answered: (1) were those agreements within the exclusion for cash forward contracts, and (2) if not, were they futures contracts. But there is really only one question: Is an executory contract for the future delivery of a commodity to be classified as a futures contract or as a forward contract? By the plain and literal language of the statute, such a contract cannot be both, and it cannot be neither.

105. Bybee Brief, supra note 103.
107. 1978 Memorandum, supra note 27, at 13,498.
It its brief in Bybee, the CFTC repeatedly argues that "public involvement has never been recognized as an essential element in the definition of a futures contract."\textsuperscript{109} That is correct as far as it goes, but what the CFTC fails to point out to the court is that public involvement frequently has been recognized as foreclosing the availability of the forward contract exclusion.\textsuperscript{110} The absence of public participation does not mean that contracts are not futures contracts. According to substantial precedent, however, the presence of public participation does mean that contracts that do not routinely settle by delivery are most certainly not forward contracts. Furthermore, the CFTC's own insistence that the availability of the forward contract exclusion depends upon the presence of commercial counterparties transacting in connection with their businesses\textsuperscript{111} is simply the opposite side of the "public participation" coin.

Given the paucity of guidance provided by the CFTC, its failure to cite, much less discuss, its 1990 Interpretation, and its repetitious insistence that public participation is not a necessary characteristic of futures contracts, it is hardly surprising that the court of appeals made a muddle of the law in deciding the case. On the one hand, relying on Stovall and Co Petro, the court held that the Deferred Delivery contracts between A-Mark and Bybee were futures contracts.\textsuperscript{112} In doing so, the court emphasized that even contracts that are not wholly standardized as to their terms can be futures contracts if the seller, as did A-Mark, "implicitly guarantees that it will provide for offset."\textsuperscript{113} On the other hand, relying on the 1990 Interpretation, the court held that the Deferred Delivery contracts were forward contracts.\textsuperscript{114} Acknowledging that the "concept of delivery is the determining factor"\textsuperscript{115} for distinguishing futures contracts from forward contracts, the court characterized the 1990 Interpretation as a "real innovation" in the appropriate understanding of the delivery requirement.\textsuperscript{116} Finding that "A-Mark and Bybee had the legal obligation to make or take delivery

\begin{itemize}
  \item \textsuperscript{109} Bybee Brief, supra note 103.
  \item \textsuperscript{111} See 1990 Interpretation, supra note 86, at 39,191; The Regulation of Leverage Transactions and Other Off-Exchange Future Delivery Type Instruments—Statutory Interpretation, 50 Fed. Reg. 11,656-67 (CFTC 1985).
  \item \textsuperscript{112} See Bybee, 945 F.2d at 313.
  \item \textsuperscript{113} Id.
  \item \textsuperscript{114} See id. at 315.
  \item \textsuperscript{115} Id. at 313.
  \item \textsuperscript{116} See id. at 313-14.
\end{itemize}
upon the demand of the other," the court held that their transactions fit squarely within the CFTC's 1990 Interpretation.\textsuperscript{117}

Of course, the Ninth Circuit was wrong in holding that the Deferred Delivery contracts were both futures contracts and forward contracts—although as a practical matter, only the forward contract holding had effect, because the contracts were not invalidated. And, of course, the CFTC was unhappy with the decision.\textsuperscript{118} But what is most important about \textit{Bybee} is that it points out the unresolved conflict between the so-called "classic" analysis of the forward contract exclusion found in \textit{Stovall, Co Petro}, and their progeny, and the "real innovation" in the analysis of that exclusion found in the Swaps Policy Statement and the 1990 Interpretation. Because of this unresolved conflict and because of the unsatisfactory nature of both the Delivery Requirement and the new right-of-offset standard in the 1990 Interpretation, the CFTC has increasingly relied on purposeful ambiguity to carry out its regulatory role. The following analyses of the BT and MGRM Orders may help to explain why the conflict between these analyses remains unresolved and why neither of these analyses of the forward contract exclusion is satisfactory.

\section*{III. Analysis of BT Order}

The BT order arose out of particularly egregious conduct by BT Securities Corporation ("BT Securities") in its sales of derivative products to Gibson Greetings, Inc. ("Gibson"). BT Securities is an affiliate of Bankers Trust Company ("Bankers Trust") and acts as Bankers Trust's representative in negotiating interest rate swaps and other derivative transactions in which Bankers Trust participates.\textsuperscript{119}

\textsuperscript{117} The court stated:

The underlying postulate of the exclusion is that the Act's regulatory scheme for futures trading simply should not apply to private commercial merchandising transactions \textit{which create enforceable obligations to deliver} but in which delivery is deferred for reasons of commercial convenience and necessity [citation omitted].

Here, both A-Mark and Bybee had the legal obligation to make or take delivery upon demand of the other. Accordingly, consistent with the Statutory Interpretation, we conclude section 2(a)(1) of the CEA precludes application of the exchange trading requirement to these transactions.\textsuperscript{118}

\textit{Id.} 945 F.2d at 315 (quoting 1990 Interpretation, \textit{supra} note 86, at 39,190).

\textsuperscript{118} The CFTC expressed its concern with "the court's unprecedented expansion of the forward contract exclusion to cover agreements where delivery of the commodity apparently was not contemplated, that it would provide for offsetting contracts without the need for delivery." \textit{Commodities Futures Trading Commission, OTC Derivative Markets and Their Regulation} 145 (Oct. 1993). It would appear that it is the CFTC and not the court that is responsible for the "unprecedented expansion" of the forward contracts exclusion.

Bankers Trust was the counterparty to each of the derivative products BT Securities sold to Gibson.

Gibson had issued fifty million dollars of fixed rate notes in May 1991. Shortly thereafter rates declined and Gibson sought to reduce its net borrowing cost through the use of interest rate swaps. Bankers Trust was Gibson's "lead bank." As Gibson sought proposals from various dealers as to how it might reduce its interest costs over the life of the notes, Bankers Trust introduced BT Securities to Gibson. In November of 1991, representatives of BT Securities proposed and Gibson entered into a two-year fixed-for-floating interest rate swap, followed for the next three years by a floating-for-fixed interest rate swap. This swap was terminated in July 1992, at a gain to Gibson.

From that time until March 1994, representatives of BT Securities proposed and Gibson entered into eleven distinct derivatives transactions, many of which were amended several times and terminated in whole or in part. "Over time, the derivatives sold to Gibson by BT Securities became increasingly complex, risky and intertwined." More problematic was that the valuation of these derivatives depended on sophisticated computer models that Bankers Trust had and Gibson did not. Gibson, therefore, relied upon BT Securities for the valuations of these derivatives used in Gibson's financial statements. But BT Securities lied to Gibson in providing it with these valuations and, as a result, the values reflected in Gibson's financial statements "significantly understated the magnitude of Gibson's losses."

A. Regulatory Actions Against BT Securities

It appears clear from the available information that BT Securities made material misrepresentations and omissions in the offer and sale of derivatives to Gibson. From a regulatory perspective, however, the issue is what, if any, violations of law BT Securities had thereby committed. The Federal Reserve Bank of New York ("FRBNY") was

120. See Complaint & Jury Demand ¶ 7, Gibson Greetings, No. C-1-94-620.
121. See id. Based on the allegations in the Gibson Complaint, it appears that BT Securities had no prior relationship with Gibson and provided no advice to Gibson other than with respect to derivative products the counterparty to which was Bankers Trust.
122. See id. ¶ 15.
123. See id. ¶ 17.
124. BT Order, supra note 1, ¶ 7.
125. Id. ¶ 11.
126. But see, Hanley & Moser, supra note 6, at 25, wherein Hanley and Moser provide possible explanations for differences between quoted prices, market prices, and book value after noting that in the settlement orders with the CFTC and the SEC, Bankers Trust did not contest the allegations of fraud.
the first to act in the matter, entering into a "Written Agreement" with Bankers Trust and BT Securities on December 4, 1994.127 While not explicitly finding any violations of law and, indeed, pointedly avoiding any discussion of the facts surrounding this matter, the Written Agreement does note that it is being entered into "to ensure compliance with applicable federal and state laws, rules and regulations"128 and then proceeds to impose a series of quite severe and unique restrictions on the activities of Bankers Trust and BT Securities with respect to so-called leveraged derivative transactions.129

Approximately two weeks later, the SEC and the CFTC simultaneously announced the institution and settlement of separate administrative proceedings against BT Securities.130 The SEC action was straightforward. It characterized two of the derivatives transactions BT Securities sold to Gibson as securities,131 found that BT Securities had made "material misrepresentations and omissions in the offer and sale" of these securities, held that those misrepresentations and omissions constituted violations of § 17(a) of the Securities Act of 1933 and § 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder, and ordered that BT Securities be subject to various sanctions.132 Certainly, the wisdom of the SEC's action can be questioned133 and the basis for its characterization of these derivatives


128. Id.


131. The SEC found the Treasury-Linked Swap, the Knock-Out Call Option, and the amendments to those derivatives were securities under the federal securities laws. According to the SEC, the Treasury-Linked Swap was "a cash-settled put option" based on a group of United States government securities and the Knock-Out Call Option also was an option on a security. The SEC repeated this assertion in other settlement releases arising from the Gibson Greetings matter, but apparently has yet to claim jurisdiction over swap agreements other than the Treasury-Linked Swap and the Knock-Out Call Option. See, e.g., In re Mitchell A. Vazquez, 1996 WL 86528, at *4 n.4 (S.E.C. Feb. 29, 1996).

132. See BT Order, supra note 1, ¶ 11.

133. See, e.g., Coffee, supra note 129; Hanley & Moser, supra note 6.
transactions as securities can be challenged.\textsuperscript{134} However, the SEC cannot be criticized for being unclear or ambiguous as to the basis for its claim to jurisdiction in this case. The SEC put its credibility where its sanctions were. It articulated its basis for characterizing specifically identified derivatives transactions as securities, and it laid out the reasons for there having been fraud in connection with their offer or sale. So far as assertions of its own jurisdictional reach go, little more can be expected from a federal agency.

In contrast to the SEC, the CFTC chose to proceed against BT Securities based on what appears to be a purposefully ambiguous basis. The CFTC made virtually the same findings as the SEC did with respect to BT Securities' misrepresentations and omissions. The CFTC did not, however, then identify or even explicitly claim that any of the derivative transactions recommended by BT Securities to Gibson were future contracts or commodity options.\textsuperscript{135} The CFTC did list and describe each of the twelve distinct derivatives that Gibson entered into with Bankers Trust, but it did not find or even suggest that any of these transactions were futures contracts or commodity options.\textsuperscript{136} What the CFTC found, instead, was that BT Securities had "entered into an advisory relationship with Gibson which . . . is sufficient to cause BT Securities to have become a commodity trading advisor with respect to its derivatives transactions with Gibson"\textsuperscript{137} and that BT Securities violated the antifraud provision in the CEA applicable to a commodity trading advisor.\textsuperscript{138}

\textsuperscript{134} See, e.g., Coffee, supra note 129. In \textit{Procter & Gamble Co. v. Bankers Trust Co.}, 925 F. Supp. 1270, 1274 (S.D. Ohio 1996), Judge John Feiken found that the swap agreements at issue were not securities. The key swap, referred to as the 5s/30s Swap, was similar to, but certainly not identical to the Treasury-Linked Swap the SEC found to be a security in its BT Order. See \textit{id.} While it is possible (to attempt) to reconcile the SEC's BT Order and its reaffirmation of its conclusion with Judge Feiken's decision, e.g., Becker et al., \textit{What is a Security after Proctor & Gamble v. Bankers Trust?} (July 1996) (on file with author), the two appear in serious conflict. The Judge Feiken opinion is flawed in so many respects, however, that any ultimate reconciliation of the SEC's view as to when a swap is a security with judicial precedent will have to await a more careful and knowledgeable opinion.

\textsuperscript{135} By reason of section 4c(b) of the CEA, 7 U.S.C. § 6c(b) (1994), it is illegal to enter into transactions involving an option on a commodity in contravention of the Rules of the CFTC. Under 17 C.F.R. § 32.11 (1996), OTC commodity option transactions are unlawful absent compliance with § 32.4(a), the so-called "trade option" provisions or other CFTC created exemptions. In any event, commodity option transactions are subject to section 32.9, a broad antifraud provision comparable to the SEC's Rule 10b-5.

\textsuperscript{136} See \textit{BT Order}, supra note 1.

\textsuperscript{137} \textit{Id.} \S 7.

\textsuperscript{138} \textit{Id.} \S II. This conclusion is based on the following finding: "BT Securities' managing director for the Gibson account told his supervisor in February 1994 that, 'from the very beginning, [Gibson] just, you know, really put themselves in our hands like 96% . . . And we have known that from day one.' The managing director also told the Bankers Trust relationship officer responsible for the Gibson account that 'these guys [Gibson] have done some pretty wild
Under the CEA, a person that falls within the definition of a "commodity trading adviser"\(^\text{139}\) ("CTA") is required to register with the CFTC,\(^\text{140}\) comply with various regulatory requirements, primarily with respect to specified disclosures,\(^\text{141}\) and observe the prohibitions in section 4(o) against engaging in fraudulent activity of any sort with respect to any client.\(^\text{142}\) Having summarily found that BT Securities was

stuff. And you know, they probably do not understand it quite as well as they should. I think that they have a pretty good understanding of it, but not perfect. And that's like perfect for us."

*Id.* In *P & G*, Judge Feiken found that, while BT "came close to giving advice," because P & G representatives used "their own independent knowledge of market conditions in forming their own expectation as to what the market would do in [these swaps]." BT was not a CTA. *Procter & Gamble Co.*, 925 F. Supp at 1287. Whatever the differences between the Gibson and P & G situation that could have lead to different results with respect to the status of BT as a CTA, Judge Feiken's analysis is certainly wrong.

\(^\text{139}\) C.E.A. § 1a(5), 7 U.S.C. § 1a(5) (1996), defines, in relevant part, a commodity trading advisor as follows:

(A) In general. Except as otherwise provided in this paragraph, the term "commodity trading advisor" means any person who—

(i) for compensation or profit, engages in the business of advising others, either directly or through publications, writings, or electronic media, as to the value of or the advisability of trading in—

(I) any contract of sale of a commodity for future delivery made or to be made on or subject to the rules of a contract market;

(II) any commodity option authorized under section 4c [7 U.S.C.S. § 6c]; or

(III) any leverage transaction authorized under section 19 [7 U.S.C.S. § 23]; or

(ii) for compensation or profit, and as part of a regular business, issues or promulgates analyses or reports concerning any of the activities referred to in clause (i).

(B) Exclusions. Subject to subparagraph (C), the term “commodity trading advisor” does not include—

(i) any bank or trust company or any person acting as an employee thereof;

(ii) any news reporter, news columnist, or news editor of the print or electronic media, or any lawyer, accountant, or teacher;

(iii) any floor broker or futures commission merchant;

(iv) the publisher or producer of any print or electronic data of general and regular dissemination, including its employees;

(v) the fiduciary of any defined benefit plan that is subject to the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1001 et seq.);

(vi) any contract market; and

(vii) such other persons not within the intent of this paragraph as the Commission may specify by rule, regulation or order.

(C) Incidental services. Subparagraph (B) shall apply only if the furnishing of such services by persons referred to in subparagraph (B) is solely incidental to the conduct of their business or profession.

\(^\text{140}\) See C.E.A. § 4m, 7 U.S.C. § 6n (1996). See also 17 C.F.R. § 4.14 (1996); C.F.R. § 35.2 (1996) (exempting “any person . . . offering, entering into, rendering advice, or rendering other services with respect to” exempted swap agreements from all provisions of the CEA with certain exceptions, including sections 2(a)(1)(B), 4b and 4o).


\(^\text{142}\) See C.E.A. § 40(1), 7 U.S.C. § 6o(1) (1996), provides, in part:

It shall be unlawful for a commodity trading advisor, associated person of a commodity trading advisor . . . by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly—

(A) to employ any device, scheme, or artifice to defraud any client or participant or prospective client or participant; or
a CTA, the CFTC then took the unsurprising and quite appropriate step—assuming its characterization of BT Securities as a CTA was correct—of holding that BT Securities had "employed devices, schemes, and artifices to defraud Gibson in violation of section 4(o)(1)(A) ...". The CFTC did not find that BT Securities had violated the CEA by failing to register as a CTA (it had not so registered), nor did it find that BT Securities was otherwise delinquent under any other requirement of the CEA applicable to CTAs.

B. *The CFTC's "Deft Side-Stepping" of the Jurisdictional Issues*

In order to find that BT Securities had violated Rule 10b-5, the SEC was required to demonstrate that the fraud had occurred "in connection with" the purchase or sale of securities. By finding that BT Securities was a CTA and charging it with violating section 4(o)(1)(A), the CFTC had no comparable burden. This is so because section 4(o) broadly prohibits a CTA from using "any device, scheme or artifice to defraud any client . . . or prospective client . . .". That is, if BT Securities is a CTA, then whether its "scheme to defraud" Gibson occurred in connection with a transaction in a futures contract or commodity option was not an issue, for if BT Securities defrauded a "client" then the nature of the product or scheme involved in the fraud is irrelevant.

To some commentators, the CFTC's decision to proceed against BT Securities under section 4(o) was laudatory because it avoided any explicit or even implicit characterization of the derivatives transac-

---

143. *BT Order, supra* note 1, at 30.
144. Securities Exchange Act Rule 10b-5 states:

> (B) to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or participant or prospective client or participant.

145. By contrast, the general fraud provision in section 4b of the CEA prohibits "any person ... in connection with ... any contract of sale of any commodity for future delivery ... to cheat or defraud ... [any] person ...". There is no mention of section 4b in the BT Order.

146. A similar structure exists on the securities side. Under § 206 of the Investment Advisers Act of 1940, 15 U.S.C. § 80b-6(1) (1996), an investment adviser (whether registered or not) is prohibited from employing "any device, scheme, or, artifice to defraud any client or prospective client." There is no discussion in the SEC's order of BT Securities status as an investment adviser or the applicability of § 206 to its conduct.
tions between Bankers Trust and Gibson as futures contracts or commodity options. For example, John Coffee praised the CFTC's "restraint" in avoiding any legal characterization of these transactions.\(^\text{147}\) In his view, the CFTC's "deft side-stepping" of the "problematic issue" of whether derivative contracts are appropriately classified as futures contracts or commodities options, resulted in the CFTC acting "far less intrusively" than the SEC.\(^\text{148}\) By refusing to take "the definitional issue on frontally"\(^\text{149}\) and asserting only "relatively narrow jurisdictional grounds"\(^\text{150}\) for its actions, the CFTC "sought only to remedy the over-reaching that was clearly detected"\(^\text{151}\) and thereby "avoided the unnecessary issue of which agency [the CFTC or SEC] had the stronger claim to jurisdiction over the OTC derivatives market."\(^\text{152}\)

Coffee's praise of the CFTC's chosen means of proceeding is hard to understand. The CFTC was able to accomplish its "deft side-stepping"\(^\text{153}\) of the jurisdictional issues only because it declared, without further discussion, that BT Securities was a CTA. Coffee appears to support this classification.\(^\text{154}\) Indeed, he comments that "[b]ecause most brokers and dealers handle some commodities transactions, they can fall under the CEA's definition of 'commodity trading advisor,' even if the particular transaction in which the fraud occurs does not involve a futures contract or commodity option."\(^\text{155}\) But this is misleading. First, broker-dealers that merely handle some commodity transactions are not CTA's; they fall within the definition only if they engage "in the business of advising others ... as to ... the advisability of trading in [commodity interests]."\(^\text{156}\) Second, while a violation of section 4(o) does not require a finding that the CTA committed fraud in connection with a futures contract or commodity option, section 4(o) does require a finding that the CTA sought to defraud a "client ... or prospective client ..."\(^\text{157}\) In other words, to support a finding of a violation of section 4(o), the CFTC must establish not just a CTA's scheme to defraud, but a CTA's scheme to defraud a client,

\(^{147}\) See Coffee, supra note 129, at 6.  
\(^{148}\) See id.  
\(^{149}\) Id.  
\(^{150}\) Id. at 5.  
\(^{151}\) Id.  
\(^{152}\) Id. at 36.  
\(^{153}\) Id. at 6.  
\(^{154}\) See id.  
\(^{155}\) Id. at 5.  
that is, someone with respect to whom the CTA provides advice of the sort that gives rise to its being a CTA.\footnote{See id.}

In the case of BT Securities, the CFTC’s finding of a violation of section 4(o) depends on the assertion that the firm “entered into an advisory relationship with Gibson.”\footnote{\textit{BT Order}, supra note 1, at 8.} We know from Gibson’s own action against BT Securities that Gibson had no prior relationship with BT Securities. Also we know from the CFTC’s BT Order that all of the derivative products that BT Securities sold to Gibson are described in Appendix A to that order (the “Appendix A transactions”).\footnote{See id. at 3.} Therefore, if there was, in fact, an “advisory relationship” between BT Securities and Gibson, then BT Securities must have advised Gibson with respect to “the advisability of trading in:” (1) futures contracts “made on or subject to the rules of a contract market,” (2) permissible commodity options, or (3) authorized leverage transactions.\footnote{See \textit{C.E.A. § 1a(5)}, 7 U.S.C. § 1a(5) (1994). See \textit{supra} note 142.} Further, since the only transactions about which BT Securities advised Gibson are those described in Appendix A to the BT order, the CFTC must necessarily be claiming that one or more of the Appendix A transactions are futures, commodity options, or leverage contracts.

Professor Coffee’s view that the CFTC “deftly side-stepped” jurisdictional classification of the challenged instruments is, thus, quite wide of the mark. Rather than showing what Coffee has characterized as “restraint in not explicitly characterizing the instruments as futures or commodities options,”\footnote{Coffee, \textit{supra} note 129, at 6.} in the BT Order, the CFTC called into question the legal status of all of the Appendix A transactions. The SEC, by taking “the definitional issue on frontally,”\footnote{Id.} had laid its jurisdictional cards on the table, made its argument for classification of two of the Appendix A transactions as securities, and offered its opponents a clearly articulated position with which to argue.

In contrast, the CFTC cast a legal shadow over all of the other Appendix A transactions. The CFTC necessarily, although implicitly, found that one or more of these transactions is a futures contract or commodity option, but it did not identify which one or ones and why. The CFTC did not “deftly side-step” the jurisdictional issue, but rather claimed jurisdiction based on purposefully ambiguous grounds.

\begin{itemize}
\item \footnote{158. \textit{See id.}}
\item \footnote{159. \textit{BT Order}, supra note 1, at 8.}
\item \footnote{160. \textit{See id.} at 3.}
\item \footnote{161. \textit{See \textit{C.E.A. § 1a(5)}, 7 U.S.C. § 1a(5) (1994). See \textit{supra} note 142.}}
\item \footnote{162. Coffee, \textit{supra} note 129, at 6.}
\item \footnote{163. \textit{Id.}}
\end{itemize}
This is not the hallmark of an agency motivated by jurisdictional "restraint" but rather one concerned more about its jurisdictional reach than precedential guidance, consistent policy making, or intellectual integrity. This is not a pretty picture.

C. The Muddled Legal Status of Swaps

If we assume, as we must, that the legal classification of certain Appendix A transactions provided the CFTC with its sole basis for action against BT Securities, then it is important to determine as much as we can about the nature of those transactions. What do we know? First, we know that BT Securities' status as a CTA depends on one or more of these transactions being futures contracts made on or subject to the rules of a contract market, permissible commodity options, or authorized leverage contracts. However, none of these transactions involved a futures transaction made on a contract market or a leverage transaction. Therefore, it appears that the CFTC must view one or more of the Appendix A transactions as commodity options subject to its jurisdiction. Yet if this is so, why did the CFTC not charge BT

164. Leverage transactions involve the delivery of a commodity pursuant to a standardized contract known in the trade as a margin account, margin contract, leverage account, or leverage contract or any arrangement serving the same function. See C.E.A. § 19, 7 U.S.C. § 23(a) (1994). The Appendix A transactions were customized (presumably for Gibson) and therefore could not be considered standardized contracts falling within the definition of a leverage transaction.

165. This is entirely consistent with an analysis of the Appendix A transactions. See BT Order, supra note 1, at A-1. Apart from the initial fixed-for-floating and floating-for-fixed swaps and the two transactions which the SEC asserted were options on securities (which if correct, would be subject to the SEC's jurisdiction without any residual CFTC authority), all but two of the remaining transactions had embedded in them various options on the London Inter-Bank Offered Rate ("LIBOR"). See id. at A-1 to A-8. If LIBOR is a commodity, which it clearly appears to be given that futures contracts are traded on it, e.g. futures on One-Month LIBOR, then options on LIBOR are certainly commodity options. CEA section 1a(3) defines a commodity to include "all services, rights, and interests in which contracts for future delivery are presently or in the future dealt in." C.E.A. § 1a(3), 7 U.S.C. §1a(3) (1994). CEA section 4c(b) and CFTC Rule 1.3 define commodity option transactions as any transaction or agreement in interstate commerce involving a commodity "which is or is held out to be of the character of, or is commonly known to the trade as, an 'option,' 'privilege,' indemnity,' 'bid,' 'offer,' 'call,' 'put,' 'advance guaranty,' or 'decline guaranty.'" Certain of the transactions appear to have been pure options, e.g., the Periodic Floor ("Bankers Trust would pay Gibson a floating payment of 6-month LIBOR plus .28% times $30 million while Gibson would pay Bankers Trust the six-month LIBOR rate as long as the six-month LIBOR rate was not more than .15% points lower than the LIBOR rate on the immediately preceding swap coupon calculation date), while others were more complex transactions with a collection of embedded options, e.g., Spread Lock 1 (Bankers Trust would pay Gibson a fixed payment equal to $30 million times the sum of the "Mid-Market Swap Spread" and the "On-The-Run Treasury Rate" while Gibson would pay Bankers Trust a fixed payment of $30 million times the sum of the "Spread Lock," set at 38 basis points, and the "Off-The-Run Treasury Rate.") See BT Order, supra note 1, at A-2.

In the P & G decision, Judge Feiken held that the swaps at issue there "may not" be commodity options because they are "exempt from CFTC rules" rather than "authorized under section 6c." Procter & Gamble Co. v. Bankers Trust Co., 925 F. Supp 1270, 1287 (S.D. Ohio 1996).
Securities with a violation of section 32.9, the provision in the CFTC’s Regulations prohibiting fraud in connection with commodity option transactions? One can only conclude that the CFTC chose not to do so to avoid an explicit statement as to the basis for its jurisdictional claims.

Second, no conclusion can be drawn one way or the other as to whether the CFTC viewed any of the Appendix A transactions as futures contracts. It is readily apparent from an analysis of these transactions that none were futures contracts made on or subject to the rules of a commodity exchange, and thus none of them could have been the basis for the CFTC’s finding that BT Securities was a CTA. Nevertheless, some or all of these transactions might still be viewed by the CFTC as off-exchange futures contracts. The CFTC does not say that they are or that they are not; it simply does not say anything about the issue.166

Third, in its press release announcing the entry of the BT Order, the CFTC stated that “all” of the Appendix A transactions were “swaps” and that the action against BT Securities was “brought under the antifraud authority [the CFTC] retained in the Commission’s swaps exemption . . . .”167 The definition of “swaps” in the Swaps Exemption is certainly broad enough to encompass the plain vanilla, ratio, and time swaps described in Appendix A as well as the remaining essentially option-like transactions into which Gibson entered.168 Thus, there is no question that the swap contracts between Banker’s

Given that the Swap Exemption specifically references section 6c among its authorizing provisions, it is difficult to understand the significance of the distinction the Judge believed he was making.

166. Indeed, Chairperson Schapiro stated that “by bringing this action, the Commission did not intend to change the existing legal environment for trading these instruments. Nor did it signal an intent to regulate these transactions.” Chairperson Mary L. Schapiro, Remarks to the National Capital Chapter of the National Association of Business Economists (Feb. 15, 1995) (transcript on file with author).

167. CFTC Rule 35 does not exempt persons from the provisions of sections 2(a)(1)(B), 4b, and 4o of the CEA; Rule 32.9; nor from the provisions of sections 6(c) and 9(a)(2) of the CEA to the extent “these provisions prohibit manipulation of the market price of any commodity in interstate commerce or for future delivery on or subject to the rules of a contract market.” 17 C.F.R. § 35.2 (1996).

168. CFTC Rule 35.1(b)(1) defines a swap agreement as:

(i) 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, any other similar agreement (including any option to enter into any of the foregoing);
(ii) any combination of the foregoing; or
(iii) a master agreement for any of the foregoing together with all supplements thereto.

17 C.F.R. § 35.1(b)(1).
Trust and Gibson fell within the swaps exemption. However, just because a contract falls within the swaps exemption does not mean that that contract is, therefore, a futures contract or commodity option subject to the CFTC’s jurisdiction. And that is the rub.

Look first at precisely what the CFTC did in adopting the swaps exemption. It exempted “swap agreements” from most provisions of the CEA except the antifraud provisions, and in doing so it explicitly stated that it was not making any determination that swaps generally or in specific circumstances are futures contracts or commodity options. In other words, the swaps exemption was premised on the proposition that whether swaps are or are not futures or commodity options need not be decided. The concept was that the swap market is important and if it operates within the minimal constraints of the exemption it is not in need of regulation. Therefore, if a swap falls within the terms of the exemption, it may be freely sold without the need for a determination of whether it is or is not otherwise subject to the CFTC’s jurisdiction.

The action against BT Securities ended the CFTC’s agnosticism with respect to the legal status of swaps. In order to find that BT Securities was a CTA, the CFTC had to find that at least one of the “swaps” in Appendix A was a commodity option subject to its jurisdiction. But if at least one of the option-like swaps is, indeed, subject to the CFTC’s jurisdiction, what about the futures-like swaps? The former Chairman of the CFTC stated in early 1996 that “the Commission has not taken a position on whether swap agreements are futures contracts.” This may be correct as far as it goes, but with the entry of the BT Order, the CFTC has taken the position that certain

169. The CFTC said that “[t]he issuance of this rule [the swaps exemption] should not be construed as reflecting any determination that the swap agreements covered by the terms hereof are subject to the Act, as the Commission has not made and is not obligated to make any such determination.” Final Rule on Exemption for Certain Swap Agreements, 58 Fed. Reg. 5587, 5588 (CFTC 1993).

170. Responding to accusations that the BT Order was power grabbing, Mary Schapiro stated: “We did not say that swaps are futures . . . or use a statutory provision that says swaps are futures.” Tim W. Ferguson, Commodities Boss Forswears Future in Swaps, WALL ST. J., Jan. 3, 1995, at 9.

171. The Plain Vanilla Swaps provided that “Gibson would pay Bankers Trust a fixed payment of 5.91% times $30 million while Bankers Trust would pay Gibson the 6 month [LIBOR rate] times $30 million.” BT Order, supra note 1, at A-1. The Ratio Swap provided that “Bankers Trust would pay Gibson a fixed payment of 5.5% times $30,000,000 while Gibson would pay Bankers Trust the 6-month LIBOR rate squared divided by 6% times $30,000,000.” Id.

"swaps" are commodity options, and the fact that it has not clarified the status of futures-like swap agreements should hardly be a source of pride for the agency.

Shortly before she resigned from the CFTC, former Chairman Mary L. Schapiro was quoted as stating that the CFTC's current legal regime is a "patchwork quilt of interpretations, policy statements, and . . . exemptions." She went on to state that "[t]he market needs certainty, and quite frankly, so do the regulators." It is hard to argue with either statement, but it is also hard not to assign primary responsibility for the existing legal uncertainty as to the regulatory status of swaps to the CFTC itself. The BT Order did not provide certainty but rather created uncertainty: uncertainty as to when swaps that are essentially option-like instruments, such as caps, floors, and collars, are commodity options; uncertainty as to when swaps with embedded option-like features, such as transactions similar to the Spread Lock transactions Gibson entered into with Bankers Trust, are commodity options; and uncertainty as to when, if ever, traditional futures-like swaps, such as transactions similar to the Plain Vanilla and Ratio Swaps Gibson entered into with Bankers Trust, are futures contracts. The markets do, indeed, need certainty, but the CFTC's ambiguous jurisdictional claim in the BT Order is not the way they are going to obtain it.

IV. ANALYSIS OF MGRM ORDER

In the MGRM Order, the CFTC found that from at least December 1991, until at least December 1993, MGRM "marketed, offered and sold" futures contracts in transactions not conducted on or subject to the rules of a contract market and, thus, in violation of section 4(a) of the CEA. These contracts, so-called "45-Day Agreements," were one of several types of off-exchange contracts for

174. Id.
175. See supra note 165 (describing the Spread Lock transaction).
176. See supra note 171 (describing the Plain Vanilla and Ratios Swaps transaction).
177. MGRM Order, supra note 2.
178. MGRM, a Delaware corporation, is a subsidiary of MG Corporation, which is a subsidiary of Metallgesellschaft, AG, a company "organized under the laws of the Federal Republic of Germany." Id. at 2.
179. Id.
180. See id. at 6-7. The CFTC also found that MG Futures Inc., another subsidiary of MG Corp. and a registered futures commission merchant (FCM), failed to notify the CFTC of material inadequacies in its internal controls and failed to file with the CFTC certified financial reports. See id. at 2-3. These violations are not discussed in this article.
the future delivery of gasoline, heating oil, and diesel fuel that MGRM had entered into during this period with commercial counterparties, such as independent gasoline stations and heating oil distributors.\footnote{181}

To understand why the CFTC found that the 45-Day Agreements were futures contracts and thus illegal, and MGRM’s other energy supply contracts presumably were neither, it would be useful to have the contracts themselves to review. Unfortunately, the CFTC chose not to append the contracts to its order, and, to date, neither it nor MGRM has made them publicly available. Second best would be to have a detailed description of the various supply contracts used by MGRM. Unfortunately, again, the CFTC chose not to include such a description in the MGRM Order. Third best, as it were, is what we have: a sketchy and incomplete account in the MGRM Order of the 45-Day Agreements and essentially no account at all of the other supply contracts. The sections that follow discuss (1) what the CFTC does say about the 45-Day Agreements and what more is known about them and the other supply contracts, (2) the CFTC’s legal analysis of why the 45-Day Agreements are illegal futures contracts, (3) the nature of the CFTC’s defense of its order and its critics attack on it, and (4) an analysis of the fundamental problems with the MGRM Order.

A. Nature of the Supply Contracts MGRM Had with Its Customers

1. The Contracts Themselves

In its order, the CFTC has the following to say about the 45-Day Agreements: These Agreements were “among the contracts” MGRM marketed, offered, and sold that “purportedly requ[ir]ed the delivery in the future of gasoline, heating oil, and diesel fuel to commercial counterparties . . . .”\footnote{182} The price the purchasers were to pay upon the future delivery of the petroleum product “was established by the parties at initiation.”\footnote{183} At initiation, no money exchanged hands.\footnote{184}

To obtain delivery, a purchaser tendered forty-five days advance notice to MGRM.\footnote{185} A purchaser was not, however, required to take “any ratable, monthly deliveries of petroleum product.”\footnote{186}

\footnote{181. See id. at 3.}
\footnote{182. Id.}
\footnote{183. Id.}
\footnote{184. See id. at 5.}
\footnote{185. See id. at 3.}
\footnote{186. Id.}
Delivery of "any, or all, product . . . could be deferred [for the term of the contract, which was] five or ten years." In the event that prior to the end of the term of the 45-Day Agreement "the price of the underlying product [based upon price levels of energy futures contracts traded on the NYMEX] reached a preestablished exit level," a purchaser could "terminate the contract and obtain a cash payment from MGR&M" by exercising a so-called 'blow-out' provision in the contract.

The Order contains no other information about the terms of the 45-Day Agreement. Based on various studies, reports and conversations, the following additional information about the 45-Day Agreements, which are also referred to as "fixed-flexible contracts" or "flexies," appears basically correct. The "blow-out" provision, or what has been referred to as the cash-out or early liquidation option, could be exercised for all or any part of the product deliverable under contract whenever near-term NYMEX futures prices exceeded the contract price. Apparently because of the potential size of MGRM's contingent liability as the result of this short option position, MGRM agreed to fully hedge its supply obligations at all times. In the event the purchaser exercised the "blow-out" option, MGRM was obligated to pay the purchaser any profits above the contract price realized on liquidation of the hedge of the contract or part contract. Thus, one hundred percent of the hedging profits were to be paid to the purchaser, but the purchaser also bore the entire liquidation risk on the hedge. The 45-Day Agreements also provided MGRM with an option to put product to the purchaser at the end of the contract term to the extent not previously delivered.

Apparently because of the risk of default on (or forced renegotiation of) these long-term fixed-price supply contracts, MGRM limited the annual volume that could be supplied to a purchaser to no more than twenty percent of the purchaser's needs. Nevertheless, if the blow-out option was out of the money and a purchaser had deferred delivery until the end of the, say, five year contract, that purchaser would be obligated to take delivery—and pay for—an entire year's supply in one shot.

As for the other types of supply contracts that MGRM used, one was a Firm Fixed-Price Agreement for the Sale of Petroleum Product ("Firm Fixed Agreement"). The Firm Fixed Agreements either had a

187. Id.
188. Id.
"blow-out" provision similar to that in the 45-Day Agreements or an exit letter that caused the contract to be automatically canceled if the NYMEX price exceeded a set price. In both cases, hedging profits above the contract price were to be equally shared between MGRM and the purchaser. The Firm Fixed Agreements required ratable, monthly deliveries of a specified petroleum product. Although the CFTC does not discuss or even mention the Firm Fixed Agreements in the factual and legal findings sections of its Order, the sanctions section of the Order contains an undertaking by MGRM that it “shall not market, offer or sell Firm Fixed Price Agreements for the Sale of Petroleum Product as sold between December 1991 and December 1993.” The CFTC makes no finding that these Firm Fixed Agreements are in any way illegal nor does it explain why, or on what basis, it required MGRM to stop using them.

There remain a number of things that we do not know about the 45-Day Agreements. For example, were all of these agreements identical, or had purchasers individually negotiated various provisions? Were all of these agreements for standardized commodity units, or was the quantity of deliverable product tailored to the needs of each purchaser? Were margin or mark-to-market payments required or requireable under the agreements? Were the agreements transferable by the purchasers without MGRM's consent? How was the contract price set, and to what extent was it subject to negotiation? Were the terms of the "blow-out" option ever varied or individually negotiated? What were the terms of MGRM's put option, and had they ever been varied?

2. The Marketing of the 45-Day Agreements

According to the CFTC's Order, between approximately December 1991 and December 1993, MGRM "marketed, offered and sold" 45-Day Agreements "to more than one hundred independent gasoline stations and heating oil distributors throughout the United States." The CFTC does not tell us with how many purchasers MGRM had open 45 Day Agreements at the end of this period.

According to the CFTC, in early September 1993, MGRM decided "to massively increase the size of its 'book' of petroleum prod-

---

189. *Id.*
190. *Id.*
191. Based on other information, it appears that as of September 30, 1993, MGRM had 100 open 45-Day Agreements. Between that date and March 31, 1994, MGRM had negotiated the cancellation of approximately 70 of these agreements.
uct contracts to customers. 

During the second half of September 1993, MGRM sold enough contracts "to increase the size of its business by nearly one-third. This increase was accomplished by adding sales of 45-Day Agreements to many of its existing customers." By the end of September 1993, MGRM had "sold" energy supply contracts of varying sorts, including 45-Day Agreements, "representing the equivalent of approximately 160 million barrels of products to at least several hundred customers." We do not know how many of these 160 million barrels were accounted for by the 45-Day Agreements, or what proportion of the late September "sales" were 45-Day Agreements.

From the CFTC's Order, we do know, however, that "virtually all purchasers" of the 45-Day Agreements did so with the "intent of invoking the 'blow-out' provision for the purpose of speculating on the price of the underlying product." Furthermore, "[t]his speculative intent was encouraged by MGR&M sales presentations," which emphasized (1) "the likelihood that prices would reach the exit level well before the expiration of the contract term," and (2) that if prices did not reach the exit level, "alternative arrangements could be made to offset the contracts without delivery." The CFTC provides no further information about MGRM's sales presentations or what was meant or intended by the alternative arrangements. The CFTC does emphasize that "no deliveries of product were made pursuant to the 45-Day Agreements," although it does not provide any information as to either the length of time remaining on the outstanding 45-Day Agreements or how or whether MGRM had negotiated the termination of any of these agreements.

B. CFTC's Legal Analysis

The CFTC's legal analysis of the 45-Day agreements is a model of conciseness, if not jurisdictional justification. The CFTC's entire legal discussion is contained in the following sentence:

These contracts, therefore, contain all the essential elements of a futures contract: they call for the making or taking of delivery of a commodity in the future at a price or pricing formula established at

192. MGRM Order, supra note 2, at 5.
193. Id.
194. Id.
195. Id.
196. Id.
197. Id. at 4.
198. See id.
initiation; they may be satisfied either by delivery of the commodity or by engaging in an offsetting transaction without delivery; the purpose of the transaction is primarily to speculate or hedge the risk price change in the commodity without actually acquiring the underlying commodity. 199

The CFTC provides no discussion of precedent, no comparison of the 45-Day Agreements with other legal or illegal OTC contracts, no analysis of why the 45-Day Agreements do not fit within any of the available exemptions, and no explanation of whether the 45-Day Agreements might have avoided their regulatory fate if they had been differently marketed—for example, if the contracts themselves had remained the same but MGRM had made clear that "alternative arrangements" for offset would not be available in the event commodity prices never reached the exit level.

C. Defense and Criticism of the MGRM Order

1. CFTC: "Not a Policymaking Decision"

In responding to the criticisms and questions that have followed the issuance of the MGRM Order, the CFTC, for the most part, has expressed surprise, given that the Order was entered by consent and was fact-specific to the MGRM situation. As then-CFTC Chairperson Mary L. Schapiro stated, the MGRM Order is "a settled action that applies only to these parties . . . ." 200 One Commission spokesperson went so far as to state that the action "did not carry the weight of a policymaking decision." 201

It is hard to know what to make of the CFTC's position. On the one hand, if the CFTC's point is simply a jurisprudential one, that as a matter of law, a consent order has no precedential force, 202 then the agency is unquestionably correct but pointlessly so, for no one to my knowledge has suggested, much less argued, the contrary.

On the other hand, if the CFTC's position is that the MGRM Order—or any other consent order—ought not appropriately be read as a reflection of the CFTC's interpretation of the statute it administers and thus as an indication of CFTC policy, then the CFTC is most certainly wrong. Consent orders, despite their contractual characteris-

199. Id.
tics, draw their legitimacy solely from the CFTC’s authority to proceed against a person\(^\text{203}\) who “is violating or has violated any of the provisions of the [CEA] or of the rules, regulations, or orders of the Commission thereunder . . . .”\(^\text{204}\) Unless the CFTC has appropriately found that there has been such a violation, the agency is not authorized to enter into a cease and desist order even by consent—notwithstanding its desire to do so; its belief that such an order would serve the public interest; and the respondent’s willingness, for whatever reason, to voluntarily enter the stock.

Therefore, whenever the CFTC enters a consent order, there necessarily has been a policymaking decision. The CFTC should expect and view as entirely appropriate the public scrutiny of that order in an effort to define the CFTC’s current legal perspective and priorities. To the extent a consent order provides reasoned and convincing accounts of the CFTC’s legal analyses and conclusions, the public is afforded useful guidance in holding economic and commercial rivers within the banks of understood legal norms. To the extent a consent order provides only abbreviated, incomplete, and unexplicated analyses and conclusions—as is the case in the MGRM Order—appropriate commercial activity is constricted because of uncertainty, proposed economic ventures are aborted because of legal apprehensions, and far too many law review articles, such as this one, are written in an effort to tease out of the CFTC’s cryptic pronouncements the semblance of a coherent regulatory policy.

With considerable understatement, Douglas E. Harris, Senior Deputy Comptroller, Office of the Comptroller of the Currency, said that the MGRM Order had “‘injected an element of uncertainty’ into some derivatives contracts.”\(^\text{205}\) Such a comment from a fellow regulator indicates just how far off the mark is the CFTC’s characterization of the MGRM Order as not a policymaking decision.

2. Miller and Culp: “Egregious Overreaching”

In what is now a well-known and much discussed editorial-page article in the *Wall Street Journal*, Merton H. Miller and Christopher L. Culp, two University of Chicago economists already deeply embroiled in the debate over the wisdom and appropriateness of the strategy

---

203. This discussion is framed in terms of persons other than contract markets or other registrants. The points made, however, are equally applicable with respect to other types of persons. See C.E.A. § 6b-c, 7 U.S.C. § 8b-c (1994).


employed to "hedge" MGRM’s energy supply contracts,206 strode boldly into the regulatory debate under the headline: *Rein In The CFTC.*207

Miller and Culp’s argument appears to proceed basically as follows. Futures contracts have “no specific economic attributes of their own other than exchange trading to distinguish them from ordinary forward contracts or swaps. . . .”208 Any attempt, therefore, to establish an “objective definition” of futures contracts “not already exchange-traded is doomed from the start.”209 In the MGRM Order, the CFTC sought to advance such a definition and chose for the purpose an “extremely broad definition” of off-exchange futures. This “broad definition” has “call[ed] into question the legality of numerous financial transactions,” and the use of this “broad definition” “far exceed[es] [the CFTC’s] public mandate. . . .” and represents “egregious overreaching” by an agency “seemingly more concerned with establishing turf than with the damage it may be doing to the markets.”210

As an initial matter, I confess to a good deal of sympathy with Miller and Culp’s “doomed from the start” claim about any attempt to consistently and sensibly distinguish futures, which must be exchange traded, from forwards, which need not be. This is a deeply radical claim, however, directly at odds with a fundamental presupposition of many years of rulemaking and enforcement actions under the CEA and deserves to be dealt with on its terms. I address it below in Section VI. At this point, I want to focus only on Miller and Culp’s critique of the MGRM Order, and I have a great deal more trouble with their argument as a whole than I do with their major premise.

Miller and Culp acknowledge that the CEA draws a distinction between “futures” and “ordinary commercial forward contracts.” (They puzzlingly, unhistorically, and incorrectly attribute this distinction to a Congressional attempt to “limit[ ] the jurisdiction of the


207. See Miller & Culp, supra note 3, at A10.

208. Id.

209. Id.

210. Id.
They also acknowledge that the term "futures contract" is not explicitly defined in the CEA, and, while they do not make the point directly, they would presumably also acknowledge that no explicit definition of "ordinary commercial forward contracts" is provided in the CEA either. As a result of this statutory, but undefined, distinction between futures and forwards, Miller and Culp assert that "[t]o lawyers, the seeming oxymoron of 'off-exchange futures' has legal meaning . . . ." But, why only "to lawyers"? If Miller and Culp's argument is that the CEA should be interpreted by reading "futures contract" to mean "contract traded on an exchange," they are just plain wrong. Section 4(a) of the statute, the section at issue in the MGRM Order, makes it illegal to effect "any transaction in" a futures contract otherwise than on an exchange. If "futures contract" meant "exchange traded contract," section 4(a), and a number of other sections of the CEA, would simply make no sense.

Yet if everyone, and not just the lawyers, must accept that there can be such things as "off-exchange futures," then surely there must be some way to identify them, or at least a responsible regulatory agency charged with enforcing a statute that makes them illegal should attempt to do so. This appears to be the crux of the Miller and Culp argument. Because futures contracts lack "specific economic attributes of their own," an "overzealous regulator fishing for 'illegal off-exchange futures' . . . confronts a virtually unlimited supply of possibilities [for accomplishing the identification]." In its overzealousness, the CFTC chose an "extremely broad definition" to identify "off-exchange futures." It did this not in response to its "public mandate" but in an effort to "establish[ ] turf," thereby rendering "uncertain the enforceability of an important class of commercial derivatives transactions."

The problem with this argument is that it could be used against virtually all of the classic, traditional definitions of "off-exchange futures," for it is difficult to draw from any of these formulations of the

211. The Futures Trading Act of 1921, 42 Stat. 187, distinguished "futures" and "ordinary commercial forward contracts" in order to exclude private commercial transactions from the taxing provisions of the Act. See 1977 Interpretation, supra note 19, at 21,911. However, although the distinction has been included in all statutes regulating futures trading since the enactment of the FTA, the CFTC was not created until the passage of the Commodity Futures Trading Commission Act of 1974. 88 Stat. 1389 (1974).


213. Id.

214. Id.
futures/forwards distinction\textsuperscript{215} an objective, closed-ended definition of a futures contract that would not "call[ ] into question the legality of numerous financial transactions."\textsuperscript{216} Miller and Culp are simply wrong when they assert that the broad definition of futures contract in the MGRM Order was put forward by the CFTC "[i]n almost total disregard of its previous rulings and statements."\textsuperscript{217} On this point, Chairman Schapiro has the better argument when she states: "Despite the expressed fears of some market observers, language in the [MGRM] order shorthanding ‘all the essential elements’ of a futures contract is not a departure from traditional legal/economic analysis or case law."\textsuperscript{218} Indeed, the CFTC appears to have consciously modeled its MGRM definition of "all the essential elements of a futures contract" directly on a discussion in the Swaps Policy Statement of the "common" and "necessary" elements of futures contracts.\textsuperscript{219}

The problem with the CFTC's "essential elements" is not their pedigree or that they are in conflict with the CFTC's previous rulings and statements. The problem is the ambiguity of the phrase itself and the implication the phrase carries that the CFTC is seeking to freeze the definition of a "futures contract" to establish a clear, objective, immutable standard, without regard for the concept's historical and needed future evolution as the commercial OTC market evolves.


\textsuperscript{216} Miller & Culp, supra note 3, at A10.

\textsuperscript{217} Id.

\textsuperscript{218} Chairperson Mary L. Schapiro, Remarks at National Grain Trade Council Fall Meeting (Sept. 15, 1995) (transcript available from the Commodities Futures Trading Comm'n Office of Pub. Affairs).

\textsuperscript{219} The MGRM Order states:

[The 45-Day Agreements] contain all the essential elements of a futures contract: they call for the making or taking of delivery of a commodity in the future at a price or pricing formula established at initiation; they may be satisfied either by delivery of the commodity or by engaging in an offsetting transaction without delivery; the purpose of the transaction is primarily to speculate or hedge the risk of price change in the commodity without actually acquiring the underlying commodity.

\textit{MGRM Order, supra} note 2. Compare this to the Swaps Policy Statement, which states:

Although there is no definitive list of the elements of futures contracts, the CFTC and the courts recognize certain elements as common to such contracts. Futures contracts are contracts for the purchase or sale of a commodity for delivery in the future at a price that is established when the contract is initiated, with both parties to the transaction obligated to fulfill the contract at the specified price. In addition, futures contracts are undertaken principally to assume or shift price risk without transferring the underlying commodity. As a result, futures contracts providing for delivery may be satisfied either by delivery or offset.

D. The Problems with the MGRM Order

Certain of the problems with the MGRM Order—for example, the inadequate description of the 45-Day Contract and the absence of meaningful legal analysis of the reasons for the CFTC's findings—have been previously discussed. In addition, the uncertainty the Order has created about the continuing validity of various legal precedents has been referred to on several occasions. This Section specifically addresses how the MGRM Order creates that uncertainty and highlights those areas that are of the greatest concern.

1. Are the 45-Day Agreements Futures Contracts by their Own Terms?

The CFTC states that the 45-Day Agreements "contain all of the essential elements of a futures contract." This wording suggests that these agreements, by their own terms, are futures contracts. But the MGRM Order states that one of the "essential elements" of a futures contract is that it may be satisfied by "an offsetting transaction without delivery." The problem is that the 45-Day Agreements, by their terms, may be satisfied by offset without the consent of the counterparty only in limited and unpredictable circumstances, that is, when near-term futures prices are above the contract price. By classifying the 45-Day Agreements as futures contracts, is the CFTC suggesting that, if a contract has a right of offset under any circumstances, it contains the essential element of offset and cannot be a forward contract? If this were so, it would turn the futures/forwards distinction topsy-turvy. This is the case because when a counterparty enters into a contract, such as a 45-Day Agreement, for which the ability to exercise a right of offset is uncertain, that counterparty (by the terms of the contract) must necessarily "contemplate[] physical transfer of the actual commodity." That is, in such a circumstance, the intent, capacity, and resources of the counterparty must be that of the counterparty to a classic forward contract. Yet, the CFTC says nothing that would shed any light on whether or how it analyzed this issue, the status of contracts with partial or "sometimes" offset rights, or the presence in the 45-Day Agreements of other contract provisions that would expand the offset possibilities.

220. MGRM Order, supra note 2, at 4.
221. Id.
222. CFTC v. Co Petro Mktg. Group, Inc., 680 F.2d 573, 578 (9th Cir. 1982).
Further, because of the clear possibility (by the terms of the contract) that a purchaser may be forced to take delivery, the absence of any discussion by the CFTC of the applicability of the 1990 Interpretation is, at minimum, surprising. The CFTC's finding of a need for exchange-style offset in commercial contexts to invoke "futures contract" jurisdiction would appear to precisely cover the 45-Day Agreements (by their terms).

Of course, one can surmise that, despite the contractual provisions of the 45-Day Agreements, the CFTC concluded that the 1990 Interpretation was not applicable because of the apparent availability, at the inception of the contract and without "private negotiations," of "alternative arrangements . . . to offset . . . without delivery." On the other hand, one can surmise that the CFTC was taking MGRM's misfortune as an opportunity to back away from the 1990 Interpretation or, at least, to limit its classification of commercial transactions without exchange-style offset as forward contracts to the Brent market. This latter view of the MGRM Order is strengthened by a recent statement of the CFTC's general counsel that "the delivery feature is the primary factor that distinguishes a forward from a futures contract." In the General Counsel's view, the MGRM situation involved the sale of futures contracts because "delivery was never contemplated in the first instance." But, of course, for most 15-Day Brent contracts delivery was never contemplated in the first instance either. Without a discussion by the CFTC of the distinctions between the 45-Day Agreements and the 15-Day Brent Contracts, it is difficult to know what to conclude about why it found the 45-Day Agreements to be futures contracts and whether the 1990 Interpretation has any continuing vitality apart from the Brent market.

2. Possible Exemptions from CFTC Jurisdiction

Prior to the 1990 Interpretation, a mantra in evaluating whether a transaction constitutes a futures contract was that the transaction must be assessed "as a whole with a critical eye toward its underlying purpose." Such an assessment entails a review of the 'overall effect' of the transaction as well as a determination as to 'what the parties in-

223. MGRM Order, supra note 2, at 4.


225. Id. at 1820.
Based on the information in the MGRM Order, it appears that MGRM marketed the 45-Day Agreements as purely speculative transactions, with no risk that the purchaser would ever have to take delivery. In other words, as the CFTC characterizes the transactions, it appears that the only substance to the 45-Day Agreements was the blow-out option and a tacit understanding that the contracts could be offset if the option was not exercised. Based on this characterization, the 45-Day Agreements appear to fit easily within the long series of cases holding that commodity investment vehicles in which the parties never anticipate delivery are futures contracts. Assuming this was the basis on which the CFTC found the 45-Day Agreements to be futures contracts, there remain a number of unanswered questions about why these contracts did not fall within one or another of the safe harbors or exemptions from CFTC jurisdiction.

Given the "blow-out" option and the fact that much of the economic substance of the transactions came from these options, an obvious question is why the 45-Day Agreements were not viewed as commodity options exempted from CFTC regulation by the Trade Option Exemption. A convincing characterization of the 45-Day Agreements as commodity options would require information about the economics of these agreements, but the CFTC tells us virtually nothing about those economics. For example, in the event the blow-out option could not be exercised, what would be the terms of the "alternative arrangements" for offset? If MGRM would have permitted purchasers to offset with no or little economic cost, then the 45-Day Agreements would certainly look like commodity options. If the purchasers fully bore downside risk, then these agreements, despite their option elements, would look like ordinary forward contracts. More facts and some CFTC discussion of the issue are needed.


228. One serious difficulty with viewing the 45-Day Agreements as investment vehicles is their pricing. Why would MGRM "sell" what amounted to five or ten year American-style call options for zero premium? Without more information about MGRM's economic motivation for entering into the 45-Day Agreements, it is hard to be entirely comfortable with this characterization.

As for the availability of the Trade Option Exemption—assuming the economics of the 45-Day Agreements would support the contracts' characterization as options—the critical issue appears to be the manner in which the 45-Day Agreements were marketed. The Trade Option Exemption is available for a commodity option offered by a person that reasonably believes that he or she is offering the option “to a producer, processor, or commercial user of, or a merchant handling” the commodity underlying the option.230 MGRM appears to have satisfied this aspect of the exemption. However, the exemption also depends upon the commercial offeree entering into the option transaction “solely for purposes of its business as such.”231 The apparent purpose of this requirement is to exclude the sale of options to otherwise qualified persons that are interested in speculating in the commodity rather than in its “business use.” The obvious question, of course, is whether the manner in which the 45-Day Agreements were marketed caused the transactions to fail the “business use” requirement.

Also not discussed in the MGRM Order, but possibly applicable to the 45-Day Agreements, are the Swaps Policy Statement232 and the Swaps Exemption.233 With some massaging, these agreements appear to be capable of fitting into the swap category, either as commodity swaps—an agreement to exchange payments “calculated by reference to the price of a specified commodity, such as oil”234—or as commodity options with a “similar structure” to other option-like products.235 Indeed, the 45-Day Agreements appear to be viewed by a number of major swaps dealers as sufficiently swap-like to raise questions as to whether the CFTC was backing away from its view that “most swap transactions . . . are not appropriately regulated as [futures contracts.]”236 Reacting to the MGRM Order, The Wall Street Journal ran a lead editorial criticizing the order under the headline: Swaps in Danger.237

But even if the 45-Day Agreements are or could be viewed as swaps, there are serious questions as to whether they could be brought under either the Policy Statement or the Swaps Exemption. For ex-

230. Id.
231. Id.
ample, were the 45-Day Agreements susceptible to individual negotiation or were they standardized as to their material economic terms? Did MGRM make individualized credit determinations with respect to each purchaser? Did the purchasers' speculative intent conflict with their undertaking the transactions in a manner consistent with the "line of business" requirement? And were the purchasers eligible swap participants?

The MGRM Order provides answers to none of these questions although the Chairman of the CFTC has subsequently commented that MGRM "did not analyze whether the gas station operators to whom it sold its contract[s] were 'appropriate' participants in the swaps markets. Nor did it seek to apply other applicable [swaps] criteria."238 The Chairman has also stated that the MGRM Order "has nothing to do with . . . swaps or the swaps exemption."239 And the CFTC's General Counsel has stated that the company "‘did not claim the swaps exemption.’"240 Obviously, therefore, the swap safe harbors were not available to the 45-Day Agreements. It would be, however, very useful for understanding the CFTC's jurisdictional perspective if we knew why.

At least one other exemption worthy of CFTC comment is the Energy Contract Exemption.241 This exemption is available to commercial participants that have the capacity to make or take delivery of specified energy products and that are also "appropriate persons," as determined by an asset or net worth test.242 From the MGRM Order, we do not know whether any of the purchasers of the 45-Day Agreements were in fact appropriate persons. The more interesting issue under the Energy Contract Exemption is that it is not available if either party has a "right . . . to effect a cash settlement of [its] obligations without the consent of the other party."243 Certainly, the "alternative arrangements" for offset, as described by the CFTC, appear to constitute such a right; but apart from this marketing representation did the blow-out option, by its own terms, constitute such a right? That is just one more of the legion of unanswered questions posed by the MGRM Order.

238. Schapiro, supra note 200, at A9.
239. Schapiro, supra note 218.
242. See id. at 21,287.
243. Id. at 21,294.
3. The Ambiguity of the Phrase "All the Essential Elements of a Futures Contract"

The CFTC’s list of “all of the essential elements of a futures contract” is itself a source of considerable confusion and uncertainty.244 What does this phrase mean? Does it mean that the three elements the CFTC lists are: (1) “necessary conditions” for a contract to be a futures contract, (2) “sufficient conditions” for a contract to be a futures contract, or (3) “necessary and sufficient conditions” for a contract to be a futures contract?245

It is difficult to answer that question for a number of reasons, not the least of which is the ambiguity of the “elements” themselves. Take the “offset” element, as an example. The MGRM Order states, without any further explanation, that contracts contain this “essential element” if “they may be satisfied . . . by engaging in an offsetting transaction without delivery.”246 Does this mean that a contract contains the “offset element” if, but only if, as the CFTC stated in the 1990 Interpretation, there is a right of offset provided for “by the terms of the contracts as initially entered into. . . .”?247 Or does it mean something broader, such as the traditional Offset Requirement, that is, the availability of an “‘opportunity’ to offset and a tacit expectation and common practice of offsetting”?248 Which of these interpretations—the new “Right of Offset” or the old Offset Requirement—characterizes the CFTC’s views of the offset “element” in the MGRM Order?

Let us assume that this offset “element” is a Right of Offset. This assumption appears reasonable given the terms and currency of the 1990 Interpretation and the CFTC Chairman’s recent statement that the MGRM Order does not “signal a new Commission view toward any of [its] other exemptions, exclusions and interpretations.”249 But the consequences of this assumption are very problematic, for it would appear to mean the “essential elements” set out in the MGRM Order

244. See MGRM Order, supra note 2, at 4.
245. "If p is a necessary condition of q, then q cannot be true unless p is true. If p is a sufficient condition of q, then given that p is true, q is so as well. Thus steering well is a necessary condition of driving well, but it is not sufficient, for one can steer well but drive badly for other reasons." SIMON BLACKBURN, THE OXFORD DICTIONARY OF PHILOSOPHY 73 (1994).
246. MGRM Order, supra note 2, at 4 (emphasis added).
249. Schapiro, Remarks at Fall Meeting, supra note 218.
are neither necessary nor sufficient conditions for a contract to be a futures contract.

For example, assume the CFTC were confronted with an off-exchange market in energy contracts that was identical in all respects but one to the Brent 15-day market—that is, this market had active trading in contracts requiring the delivery of a product in the future at a price established at the initiation of the contract; there was no "right" of offset but contracts were "routinely settled" by means other than delivery; and the primary purpose of trading was hedging, speculating, and tax trading. The sole difference from the real Brent market was that this market was not limited to commercial counterparties, but regularly involved trading by and marketing to the general public. Can there be any doubt that the CFTC would view this market—despite lacking a Right of Offset—as an illegal off-exchange futures market?

If so, then interpreting the offset "element" in the MGRM Order as a Right of Offset means that there are obvious circumstances in which the CFTC's catalogue of "all essential elements of a futures contract" does not contain the sufficient conditions for identifying contracts that are futures contracts. Moreover, accepting the Right of Offset interpretation means that the CFTC's "essential elements" are not even necessary conditions for identifying all futures contracts, since the assumed public Brent market does not have a Right of Offset, but it would still be an illegal off-exchange futures market.

The sensible response to these difficulties with interpreting the offset "element" as a Right of Offset would be to reject the notion of a Right of Offset as one of the "essential elements" of a futures contract, view the MGRM Order as a clear backing away from the 1990 Interpretation, and accept the more traditional opportunity to offset notion expressed in Co Petro and Transnor as the proper interpretation of the offset element in the CFTC's catalogue of "essential elements." But this shift does not solve the problem, for the CFTC's "essential elements" are still not sufficient conditions for identifying a futures contract. If they were, the real Brent oil market would be an illegal off-exchange futures market, but the CFTC has told us—and reemphasized the point in September of 1995—that this is not the case. Furthermore, even if we use the opportunity to offset interpretation, the CFTC's "essential elements" are not necessary condi-

250. MGRM Order, supra note 2, at 4.
251. See Schapiro, Remarks at Fall Meeting, supra note 218.
tions for a contract to be a futures contract, for if there were an opportunity to offset in a public off-exchange market, the intent of the participants is likely to be irrelevant for a finding that that market involved illegal off-exchange futures.

This discussion began with an inquiry into the meaning of the CFTC's catalogue of "all the essential elements of a futures contract." The conclusion—after an analysis of necessary and sufficient conditions and the Right of Offset and Delivery Requirement—is that we simply do not know the meaning of the phrase "all the essential elements." And we do not know because the CFTC has interpreted the offset "element" in such contradictory ways that the phrase can have no certain meaning. Indeed, the very notion of a definite and unambiguous catalogue of "all the essential elements of a futures contract" seems an impossible and undesirable objective.

V. The Reasons for the CFTC's Resort to Ambiguity

Three conclusions can be drawn from the preceding discussions of the BT Order and the MGRM Order. First, the CFTC is purposefully avoiding an articulation of its current view as to why or why not particular OTC risk shifting products are futures contracts or commodity options. Second, the CFTC's effort to avoid specifying the scope of its own jurisdiction is motivated by an institutional commitment to definitions of a futures contract and a commodity option that are flexible, open-ended, and fundamentally ambiguous. Third, the CFTC, in preserving that ambiguity, is willing to be both disingenuous and intellectually dishonest because it needs the ambiguity to accomplish three, often conflicting, objectives: (1) the maintenance of its ability to proceed against malefactors as it sees them; (2) the reassurance of the OTC dealer community and its congressional supporters that it will not disrupt the institutional off-exchange derivatives markets; and (3) the reassurance of the exchange community and its congressional supporters that it is and will remain true to the classic standards for distinguishing futures from forward contracts.

On the one hand, these are not particularly flattering conclusions to reach about one of our principal market regulators. On the other hand, given the judicial and administrative precedents concerning the Delivery Requirement with which the CFTC must work, these conclusions may be a good deal better than they might otherwise have been

252. MGRM Order, supra note 2, at 4.
had the CFTC not been willing to commit itself to studied regulatory ambiguity.

In a fascinating speech in February of 1995, Mary L. Schapiro, Chairperson of the CFTC, stated that "[t]he creation of new classes of OTC derivatives presented the CFTC with a regulatory dilemma."253 One horn of the dilemma was that new OTC products "resembled futures, both in design and in the economic functions they performed."254 The other horn was that these products "fulfilled a legitimate economic need for legitimate market users."255 The CFTC was thus forced to "struggle[] to apply [the] inflexible [exchange trading] requirement to innovative OTC financial products that the law's drafters . . . clearly never envisioned."256 It chose, according to Chairperson Schapiro, a "pragmatic approach" that was designed "to allow OTC products to trade within the existing regulatory framework."257 Yet "court rulings . . . conspired to keep OTC derivatives under a cloud of legal uncertainty," and the CFTC, in order "to avoid disrupting the new OTC derivatives markets," was forced to issue "ever more tortured interpretations of the [CEA] . . . ."258 Not until granted plenary exemptive authority in 1992 was the CFTC able to solve this "regulatory dilemma[]."259

It is not often that one hears regulators describe their interpretations of the statutes they administer as "tortured," although in this case that description appears to be particularly apt. The only two points of disagreement I have with Chairperson Schapiro are first, her failure to acknowledge that the CFTC's own creation and promotion of the Delivery Requirement are largely responsible for the very existence of the agency's regulatory dilemma and second, her unjustified assumption that the grant of exemptive authority to the CFTC has solved this regulatory dilemma. As the BT and MGRM Orders illustrate, the CFTC is still caught on the horns of the same dilemma.

254. Id.
255. Id.
256. Id.
257. Id.
258. Id. (emphasis added).
259. Id.
VI. A MODEST PROPOSAL TO END THE CFTC'S RESORT TO JURISDICTIONAL AMBIGUITY

The CEA's requirement that futures contracts must trade on exchanges and the obvious, legitimate and valuable economic contributions made by the OTC derivatives markets pose a clear regulatory dilemma for the CFTC. On the one hand, if the CFTC continues to utilize notions such as "delivery," "offset," and "standardization" to distinguish forward contracts from futures contracts, it calls into question the legality of the products that trade in these markets. On the other hand, if it relies, as it did in the 1990 Interpretation, on notions such as "exchange-style offset" to mark that distinction, it risks leaving unregulated public speculative markets, such as those in A-Mark, which raise the possibility for serious public abuse. In the preceding sections, I have argued that the CFTC has purposefully resorted to ambiguity to extend its jurisdictional reach to avoid confronting, much less resolving, this regulatory dilemma. It is as though, in both the BT Order and the MGRM Order, the CFTC refused to explicitly assert, much less to justify, its jurisdictional claims for fear of landing on one horn or the other of this dilemma. But I have also tried to suggest that the dilemma itself is in large part of the CFTC's own creation. In what follows, I propose the outline of how the CFTC might go about resolving, or better yet, making the dilemma, disappear entirely.

The starting point in this project is the Delivery Requirement. Stovall, Co Petro, the 1978 Memorandum, and other "classic" cases involve what may simply be a logical mistake. They start from the obvious and clearly correct proposition that if the parties to a contract for the sale of a commodity contemplate delivery, and delivery, in fact, routinely occurs, then that contract is a forward contract, period. But they appear to conclude from that proposition that if the parties to such a contract do not contemplate delivery, then the contract is not a forward contract and, therefore, is a futures contract. But the conclusion does not follow from the premise. My first proposal, therefore, is to urge the CFTC to make clear by means of yet another statutory interpretation that the Delivery Requirement does indeed identify an important class of forward contracts, but that a con-

260. See 1990 Interpretation, supra note 86.
261. See, e.g., Co Petro, 680 F.2d at 577.
262. See, e.g., id.
263. If X then Y, does not entail if not X then not Y. For example, if A is pregnant, A is a female does not entail if A is not pregnant, then A is not a female.
tract’s failure to satisfy the Delivery Requirement does not bear on whether that contract is a futures contract. That is, the first part of my proposal recommends that the CFTC reaffirm that a bona fide intent to deliver conclusively establishes a contract as a forward contract but that the absence of such a delivery intent neither conclusively establishes nor creates a presumption that the contract is a futures contract. In the recent Division of Economic Analysis Statement of Policy in Connection With the Unwinding of Certain Existing Contracts for the Delivery of Grain and Statement of Guidance Regarding Certain Contracting Practices (hereinafter the “Policy Statement Regarding Contracts for the Delivery of Grain”), the Division states that “the failure to deliver on an individual contract alone would not require the Division to conclude that the contract did not qualify for the forward contract exclusion.” But this statement is decidedly unhelpful since no one, to my knowledge, would argue the contrary. The issue is intent, not what in fact occurs.

The second part of my proposal addresses that set of contracts for the sale of a commodity that are made by counterparties that do not generally intend or expect to satisfy the contract by delivery, although delivery may nevertheless occur based on the determination of one or both parities. I will refer to such contracts as “Non-Delivery Contracts.” Certain Non-Delivery Contracts in some contexts, such as plain vanilla swaps, are appropriately classified as forward contracts or a series of forward contracts; other Non-Delivery Contracts in other circumstances, such as those traded on futures exchanges, are appropriately classified as futures contracts. The issue is the bases on which the two types of Non-Delivery Contracts are to be distinguished.

With due respect to the CFTC and the courts that have wrestled with the futures/forwards distinction, I want to suggest that it is not only unhelpful but, indeed, highly counterproductive to regulatory certainty to make that distinction based on an assessment of the transaction “as a whole with a critical eye toward its underlying purpose. Such an assessment entails a review of the ‘overall effect’ of the transaction as well as a determination of ‘what the parties intended.’”

There may be some cases at the margin that require such an assessment, but surely the OTC derivatives market is not at the margin of the CFTC's jurisdictional concerns. Quite simply, it misses the point to inquire into the "underlying purpose" of a Non-Delivery Contract—so what if it is to hedge or speculate as in the Brent Market?—or into its overall effect? We already know its objective is to shift risk rather than to deliver product. Given our present jurisdictional concerns, "underlying purpose" and "overall effect" are just not useful standards.

Thus, the second part of my proposal is to recommend that the CFTC reject those aspects of prior futures/forwards jurisprudence that call for a "critical assessment of the transaction as a whole," and refocus its attention on the obvious and defensible public policy objectives underlying the futures/forwards distinction. Specifically, I propose that the CFTC distinguish Non-Delivery Contracts based on whether: (1) they are (a) executed on a "board of trade" or (b) marketed or sold to the general public, or (2) they are not so executed or marketed. Those that fall within the first category are to be classified as futures contracts; those within the second category are to be classified as forward contracts. Some of the wisest and most knowledgeable members of the commodities bar reject even the possibility of establishing fixed categories, such as those I am proposing, that would function as a "Platonic model of a futures contract." Nevertheless, unless there are relatively mechanical tests for futures and forwards contracts that can be applied in the main, as are the definitions of securities, without policy debate or ambiguity, it will be impossible for the derivatives market to develop its full potential.

Let us examine the two tests I am proposing for the identification of Non-Delivery Contracts that should be classified as forward contracts. The first of these tests is that the contracts not be executed on a "board of trade." In making this proposal I am following the 1977 Interpretation, which looked to the nature of the market and its participants to identify when Non-Delivery Contracts become futures contracts. The 1977 Interpretation suggested that "when so-called forward contracts are traded by a group of persons whose activities bring them within the definition of a board of trade, the contracts may, as a consequence, lose their essentially private nature and come within the category of contracts for future delivery with which the [CEA] is pri-

The question, of course, is how to determine when a "group of persons" selling contracts for the future delivery of a commodity come within the definition of a board of trade.

The CEA defines a "board of trade" as "any exchange or association, whether incorporated or unincorporated, of persons who are engaged in the business of buying or selling any commodity..."). And if a board of trade is engaged in the business of buying or selling contracts for the sale of commodities "for future delivery"—futures contracts—it must register with the CFTC as a contract market.

As an initial matter, the identification of a board of trade would appear to be straightforward. For example, the Ninth Circuit held that the definition of a "board of trade" is "clear on its face" and was "broad enough to encompass Co Petro's activities [of extensively marketing to the general public gasoline contracts at a fixed price with a deposit based on a fixed percentage of the purchase price]." Likewise, there appears to be no question but that the term "includes both formally organized exchanges and informal associations of persons engaged in the business of buying and selling commodities."

Nevertheless, there are many commentators that undoubtedly would argue that the identification of a "board of trade" is anything but a straightforward matter and that my proposal to shift the focus for differentiating forward contracts and futures contracts from the Delivery Requirement to the identification of a board of trade is to jump from the frying pan into the fire. There are, at least, two bases for such an argument and I shall respond briefly to each.

First, the meaning of the term "board of trade" has become hopelessly tangled in the controversy over the meaning of the so-called Treasury Amendment. This provision of the CEA, added at the re-

---

268. 1977 Interpretation, supra note 19, at 21,911.
269. C.E.A. § 1a(1), U.S.C. § 1a(1).
271. CFTC v. Co Petro Mtg. Group, 680 F.2d 573, 581 (9th Cir. 1982).
Nothing in this Act shall be deemed to govern or in any way be applicable to transactions in foreign currency, security warrants, security rights, resales of installment loan contracts, repurchase options, government securities, or mortgages and mortgage purchase commitments, unless such transaction involve the sale thereof for future delivery conducted on a board of trade.

quest of the Department of the Treasury in 1974, exempts from the statute "transactions in" certain specified instruments "unless such transactions involve the sale thereof for future delivery conducted on a board of trade." 274 A broad reading of "board of trade" in this context—that is, one that would encompass trading of the nature that occurred in Co Petro—would render the Treasury Amendment purposeless, for virtually no transaction would escape CFTC jurisdiction. 275 Thus, if the Treasury Amendment is to be given legislative purpose, a narrow interpretation of the phrase "board of trade" is required, perhaps one that limits the concept to organized exchanges. But this result also may be undesirable, for it would permit virtually unlimited and unregulated public speculation in those commodities subject to the Treasury Amendment, e.g., foreign exchange and government securities.

This is not the place for a full blown discussion of the Treasury Amendment, much less to propose a resolution of its conflicting interpretations. Suffice it to say, I believe there is a resolution and that resolution is precisely along the lines of the 1977 Interpretation. Thus, the Fourth Circuit Court of Appeals appears to me to be very close to the mark when it read the "unless" clause of the Treasury Amendment such that all "off-exchange transactions" in "foreign currency" are exempted from the CEA except where the enterprise is used "as a base for marketing off-exchange futures contracts to the general public" 276 or for transactions other than "individually-negotiated . . . transactions between sophisticated, large-scale . . . traders." 277

The second reason that some commentators might argue for rejecting the approach of the 1977 Interpretation is that there are no statutory standards for identifying those market activities that would bring an association of persons within the definition of a "board of trade." In particular, the CEA does not differentiate between institutional and noninstitutional transactions or between the general public and sophisticated counterparties. The best response to that argument is to point out that there is nothing in the statute, either, about a differentiation between commercial and noncommercial transactions or

274. Id.
275. CFTC v. Frankwell Bullion Ltd., 904 F. Supp. 1072, 1075 (N.D. Ca. 1995) ("If the CFTC's broad interpretation of 'board of trade' were to prevail, i.e., that any organization engaged in selling foreign currency futures was a 'board of trade,' this would render the Amendment meaningless: Every organization would fall outside the scope of Amendment."). aff'd, 99 F.3d 299 (1996).
276. Saloman Forex, 8 F.3d at 978; see also American Bd. of Trade, 803 F.2d at 1249.
277. Saloman Forex, 8 F.3d at 978.
anything that speaks in terms of an "intent to deliver." The entire futures/forwards distinction has been built on one enormous gloss placed upon the CEA by the CFTC in the 1978 Memorandum. The approach was wrong in 1978 and is positively perverse now. The CFTC is in large part responsible for the continued vitality of this approach; it can, however, put an end to this approach if it wants to, as its half-hearted attempt to do so in the 1990 Interpretation makes clear.

Everyone starts at the same place: The CEA is a terribly drafted statute. The objective is to make the best of it. Further, it appears far more fruitful to start the analysis of the futures/forwards distinction with the notion that the "national public interest" is affected by "[t]ransactions in [futures contracts] commonly conducted on boards of trade"\textsuperscript{278} than with the notion that regulation is required of all contracts for futures delivery that do not satisfy the Delivery Requirement.

How then should a "board of trade" be defined for purposes of the two-part definition of forward contracts I am proposing? Much work may need to be done here, but the basic concept is that so long as transactions, in the Fourth Circuit's language, are "individually negotiated," there is no "board of trade." But what does "individually negotiated" mean, given that transactions on all of the principal commodity exchanges are individually negotiated as to price? At a minimum, it means that all material economic terms of the transactions must, in fact, be open for negotiation—that is, there can be no dictated terms or contract provisions that are "requirements" of the market.\textsuperscript{279} In addition, the transactions cannot have been executed on any "physical or electronic facility in which...participants...simultaneously have the ability to execute transactions and bind both parties by accepting offers which are made by one [participant] and open to all [participants in] the facility."\textsuperscript{280} In other words, a contract should be deemed not to have been effected on a "board of trade" so

\textsuperscript{279} Compare this with the condition in the Swaps exemption which states the swap agreement must not be part of a "fungible class of agreements that are standardized as to their material economic terms." CFTC Rule 35 (1993). The Commission stated: [M]ost of the terms of exchange-traded futures contracts are set by the contract market, while all of the terms of swap agreements are subject to negotiation...Standardization of terms that are not material economic terms, for example, definitions, representations and warranties...as found in certain forms and master agreements published by various associations, is not by itself violative of this requirement.
\textsuperscript{280} Id. at 5591.
long as all material economic terms are subject to individual negotiation and the transaction does not occur through what the CFTC has called a "multilateral transaction execution facility." 281

With respect to the second part of my proposed standard for classifying Non-Delivery Contracts as forward contracts—marketing to the public—the CFTC needs first to drop its past insistence that forward contracts must have "commercial" counterparties 282 and that these counterparties must enter into transactions "in conjunction with the parties' line of business." 283 These views appear to be corollaries of the Delivery Requirement. As the CFTC noted in the 1990 Interpretation, "forward contracts have been described as transactions entered into for commercial purposes related to the business of a producer, processor, fabricator, refiner or merchandiser who may wish to purchase or sell a commodity for deferred shipment or delivery in connection with the conduct of its business." 284 Thus, in seeking to characterize the 15-day Brent Contracts—unquestionably Non-Delivery Contracts—as similar to traditional forward contracts, the CFTC stated:

These [Brent market] transactions, which are entered into between commercial counterparties in normal commercial channels, serve the same commercial functions as did those forward contracts which originally were the subject of the Section 2(a)(1) exclusion notwithstanding the fact that, in specific cases and as separately agreed to between the parties, the transactions may ultimately result in performance through the payment of cash as an alternative to actual physical transfer or delivery of the commodity. 285

The problem with the CFTC's "same commercial functions" argument is that it is simply not true. 15-Day Brent contracts do not serve the same functions as do forwards contracts that anticipate delivery. As the District Court in Transnor pointed out, the "three major motivations in Brent market activity [are] hedging, speculation and tax spinning. . . . The 15-day Brent market [, therefore,] does not remotely resemble the commercial trading originally excepted from the [CEA]." 286 Indeed, the Brent market "is essentially a 'paper' market for speculative or hedging purposes rather than one for physical trans-

281. Id.
282. See 1990 Interpretation, supra note 86, at 13,191.
fer." 287 Furthermore, recent studies estimate that over half of all transactions in the 15-day Brent contract are accounted for not by commercial counterparties that produce, refine, or merchandise petroleum products, but by international trading firms such as Marubzwi and Goldman Sachs. 288

Given the factual inaccuracies in the 1990 Interpretation, it is hard to gauge just how seriously the CFTC takes its references to "commercial counterparties." For example, despite the actual nature of the participants in the Brent market and their motivations, the CFTC was prepared to describe the transactions in 45-day Brent contracts as "commercial-to-commercial transactions." 289 But such usage stretches the meaning of "commercial" to the point of vacuousness. While the CFTC's 1993 exemptive order for energy products is expressed in terms that limit it generally to "commercial participants," this term is not defined. 290 Nonetheless, all banks, broker-dealers, and FCM's are viewed as commercial participants as are all other corporations and partnerships with one million dollars in net worth or five million dollars in total assets; there is no requirement that such persons' transactions in the covered energy products be in any way related to the production, refining, or marketing of such products. 291 It is hard to see, under these circumstances, what purpose is served by the CFTC's reference to "commercial" transactions in this context except to create a suggestive but highly ambiguous link to the Delivery Requirement. 292

Of course, as should be apparent from the foregoing analysis of the CFTC's brief in the A-Mark case and its MGRM Order, the CFTC is prepared to ignore the "commercial counterparty" concept entirely.

287. Id.


289. 1990 Interpretation, supra note 86, at 31,191. But see In re Bybee, where the Court held, without explanation, that the 1990 Interpretation applies only to "transactions entered into for commercial purposes related to the business of a producer, processor, fabricator, refiner or merchandiser, who may wish to purchase or sell a commodity for deferred shipment or delivery in connection with the conduct of its business." 945 F.2d 309, 314 n.5 (9th Cir. 1991).


291. The energy products exemption exempts from regulation under the CEA transactions in specified energy products entered into by "eligible, appropriate persons" who have a demonstrable capacity or ability to make or take delivery and from which transactions risks relating to the making or taking of delivery occur. See id.

292. It should be noted that in its brief in A-Mark, the CFTC never mentions the "commercial" issue, but in Noble Metals it supported the District Court's judgment based on the fact that the parties were not "commercial merchandisers." Bybee, 945 F.2d 309; CFTC v. Noble Metals Int'l Inc., 67 F.3d 766 (9th Cir. 1995).
when it suits its purposes to do so. In its brief to the Ninth Circuit in *CFTC v. Noble Metals International, Inc.*\(^{293}\) the CFTC effectively ignored the District Court’s holding that *because* the purchasers under a so-called Forward Delivery Program ("FDP") were "members of the general public" and not commercial merchandisers, the 1990 Interpretation was inapplicable to them and, therefore, the contracts sold under the FDP did not fall within the forward contract exclusion.\(^{294}\) Instead, the CFTC argued simply that because the customers involved "never expected any physical delivery of metal under their contracts," the contracts were not forward contracts.\(^{295}\)

The CFTC has demonstrated it cannot apply the commercial counterparty requirement consistently. When the CFTC has applied the requirement it has lacked content or purpose, and there is no reason to believe that the CFTC actually uses the requirement in its own deliberations, except perhaps as a fig leaf to cover the nakedness of its jurisdictional claims. The commercial counterparty concept should be discarded.

Assume that I have been persuasive, and that the CFTC and, of course, the courts and private litigants, drop the "commercial" gloss on the forward contract exclusion. What then is to be understood by my proposal that Non-Delivery Contracts are forward contracts only if they are not marketed or sold to the general public? At least three approaches are available, and I have no strong preference among them provided the CFTC chooses one and remains consistent. First, in both the Swaps Policy Statement and the Swaps Exemption, the CFTC identified the need for individualized credit determinations as a highly determinative factor in assessing the need for jurisdictional scrutiny.\(^{296}\) Requiring such credit determinations (and prohibiting credit risk mutualization) might be an effective and unintrusive way in which to make the distinction between the general public and those that are appropriate OTC market participants.\(^{297}\)

\(^{293}\) 67 F.3d 766.


\(^{295}\) *Id.* at 24. Not surprisingly, the Ninth Circuit opinion in *Noble Metals* focuses exclusively on the absence of an intent to deliver citing *Co-Petro, Stovall,* and *Bybee* but making no references to the 1990 Interpretation or the commercial/general public distinction made therein. *Noble Metals*, 67 F.3d at 772-3.


\(^{297}\) There are many questions raised by this approach. For example, in selling options otherwise then on margin, one hardly cares about the credit worthiness of the buyer. Fair enough, but we are here only discussing the bases for making the distinction between forward contracts and futures contracts and presumably in such circumstances there will always be credit
Another possible approach, which might be used in connection with the first, would be for the CFTC to establish minimum contract size requirements for permissible forward market transactions. For example, in the Brent market a 45-day contract has an approximate market value of sixty million dollars. This is not a market for the faint of heart, the credit impaired, or those who lack confidence in their counterparties. I acknowledge that determining the minimum size for all types of OTC Non-Delivery Contracts would be a formidable undertaking, but it would be an objective undertaking, and would certainly contribute to "regulatory certainty."

A third approach would be for the CFTC to distinguish between the general public and everyone else based on the concept of "appropriate persons" contained in the amendments the Futures Trading Practices Act of 1992 made to section 4(a) of the CEA. In 1992, the CFTC was given authority, subject to certain broad public interest standards, to exempt from any provision of the CEA transactions entered into solely between appropriate persons.298 I recognize that this provision is not a gloss on the forward contract exclusion. Neverthe-

---

298. C.E.A. § 4c(3), 7 U.S.C. § 4c(3), provides that the term "appropriate person" shall be limited to the following:

(A) A bank or trust company (acting in an individual or fiduciary capacity).
(B) A savings association.
(C) An insurance company.
(D) An investment company subject to regulation under the Investment Company Act of 1940 (15 U.S.C. 80a-1 et seq.).
(E) A commodity pool formed or operated by a person subject to regulation under the CEA.
(F) A corporation, partnership, proprietorship, organization, trust or other business entity with a net worth exceeding $1,000,000 or total assets exceeding $5,000,000 or the obligations of which under the agreement, contract or transaction are guaranteed or otherwise supported by a letter of credit or keepwell, support or other agreement by any such entity referred to in subparagraph (A), (B), (C), (H), (I) or (K) of this paragraph.
(G) An employee benefit plan with assets exceeding $1,000,000, or whose investment decisions are made by a bank, trust company, insurance company, investment adviser registered under the Investment Advisers Act of 1940 or a commodity trading advisor subject to regulation under [the CEA].
(H) Any governmental entity (including the United States, any state, or any foreign governments) or political subdivision thereof, or any multinational or supranational entity or any instrumentality, agency, or department of any of the foregoing.
(I) A broker-dealer subject to regulation under the Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.) acting on its own behalf or on behalf of another appropriate person.
(J) A futures commission merchant, floor broker, or floor trader subject to regulation under [the CEA] acting on its own behalf or on behalf of another appropriate person.
less, the CFTC might well, without in any way offending legislative history or restricting its own legitimate authority, choose to interpret the forward contract exclusion along lines that mirror those in the CEA for "appropriate persons."

To summarize, my proposal for dealing with the futures/forwards distinction and eliminating (much of) the CFTC's incentive to resort to ambiguity in asserting its jurisdictional claims is as follows: Forward contracts would be identified in a CFTC statutory interpretation as those contracts, and only those contracts, either that involve the expectation and general occurrence of physical delivery or that were neither executed on a contract market nor marketed or sold to the general public. All other Non-Delivery Contracts would be identified as futures contracts.

If this proposal had been the "law" in 1994 and 1995, how might the CFTC have decided the BT and MGRM matters? As for the BT matter, it would have been clear that no Appendix A transaction was a futures contract. Although all of these transactions were Non-Delivery Contracts, none of them was executed on a board of trade or sold to the general public. What would not have been clear was the legal status of the various option-like transactions described in Appendix A. In the BT Order, the CFTC did not address the circumstances under which swaps with option-like elements are deemed to be commodity options, and has not done so subsequently. Perhaps another article is needed to discuss and recommend how the CFTC should proceed on this option issue. It may be, however, that if the CFTC is no longer able to resort to ambiguity in distinguishing between forward contracts and futures contracts, it will move on its own to articulate clearly the parameters of the commodity option concept.

As for the MGRM matter, we simply do not have enough information about the 45-day Agreements to classify them under the proposed standards one way or the other. Nevertheless, the existence of these standards would have substantially shifted the nature of the inquiry that should have occurred. The fact that these agreements were Non-Delivery Contracts would have been irrelevant to that inquiry, as would have been the status of MGRM's counterparties as "commercials." What would have been relevant, and presumably relatively easy to answer, would have been whether all material aspects of the

(K) Such other persons that the Commission determines to be appropriate in light of their financial or other qualifications, or the applicability of appropriate regulatory protections.
agreements were subject to negotiation and whether the counterpar-
ties—under whatever approach the CFTC were to adopt—should be
classified as members of the general public.

VII. Conclusion

The CFTC has, at least, arguable jurisdiction over much of the
OTC derivatives market. Yet in its judicial filings, consent orders, and
public statements, the CFTC has quite purposefully chosen not to
clarify the precise scope of that jurisdiction or to articulate the bases
on which that jurisdiction can be asserted. Instead, it has asserted ju-
risdiction through ambiguity (e.g., ambiguity as to Bybee's status as a
commercial, ambiguity as to the legal status of the derivative products
BT Securities sold to Gibson, and ambiguity as to why the 45-day con-
tracts MGRM sold were futures contracts).

I have argued that a principal motivation for the CFTC's resort to
ambiguity has been its inability to resolve the jurisdictional dilemma
created by the use of the Delivery Requirement as the touchstone for
distinguishing forward contracts from futures contracts. I have also
argued, however, that the use of the Delivery Requirement in this way
(or even its replacement by the Right of Offset standard in the 1990
Interpretation) is unjustified and inappropriate. What is called for is a
new paradigm of the futures/forwards distinction, and I have sug-
gested how the CFTC might go about articulating and justifying such a
paradigm. The question now is whether the CFTC will recognize the
jurisdictional trap in which it has been caught by the Delivery Re-
quirement and seek to extricate itself in a manner similar to that I
have proposed, or whether the CFTC will continue to respond with
purposeful ambiguity to jurisdictional temptations of the sort with
which it was presented in the BT and MGRM situations. Based on
the CFTC's recent actions and public statements, I find no basis for
being optimistic about the answer to this question. Although not in
the financial product area, the CFTC's recent Policy Statement Re-
garding Contracts for the Delivery of Grain is once again dishearten-
ing confirmation of the Agency's inability to define the scope of its
authority.299 In its statement, the Division made clear that it is not
taking "a position on the validity or legality of any individual con-
tract,"300 but at the same time suggested that individually negotiated

300. Id. at 43,851.
contracts for delivery in the next crop year "is inconsistent with the principle of prudent-risk reduction."301 Do these contracts thus become futures contracts because of their imprudent nature? The CFTC may be a better adviser on "prudent risk reduction" than it is as a financial product regulator.

301. *Id.*