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Prohibited Floor Trading Activities Under the Commodity Exchange Act

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PROHIBITED FLOOR TRADING ACTIVITIES UNDER THE COMMODITY EXCHANGE ACT

*JERRY W. MARKHAM**

INTRODUCTION

ON January 19, 1989, the Chicago Tribune published the remarkable story of an elaborate sting operation conducted by the FBI and the Office of the United States Attorney in Chicago.[1] Undercover FBI agents had purchased seats on the Chicago Board of Trade and the Chicago Mercantile Exchange.[2] The Tribune reported that the agents, disguised as traders, secretly recorded hundreds of conversations in the trading pits of those two exchanges.[3] The agents leased expensive apartments and provided elaborate entertainment in order to ingratiate themselves into the club-like atmosphere on the exchange floors.[4] The local press reported that the sting operation had uncovered widespread

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1. Drew & Crawford, *FBI Tape Key to Fraud Investigation*, Chicago Tribune, Jan. 19, 1989, § 1, at 1, col. 6. *See* Burns & Drell, *200 New Subpoenas Target 10 Billion Documents*, Chicago Sun Times, Jan. 25, 1989, at 1, col. 1; Jouzaitis & Gaines, *Trading Probe Intensifies; 200 Subpoenas Are Issued*, Chicago Tribune, Jan. 25, 1989, § 1, at 1, col. 4; *Federal Probe Targets 6 Top Futures Traders*, Chicago Sun Times, Jan. 20, 1989, at 7, col. 1; Drew & Crawford, *How FBI Worked Trader Sting*, Chicago Tribune, Jan. 20, 1989, § 1, at 1, col. 2. The FBI conducted its operations at two Chicago exchanges: the Chicago Board of Trade and the Chicago Mercantile Exchange. The FBI code names for the investigations were "Operation Sour Mash" and "Operation Hedge Clipper" respectively. *See* Drew & O'Brien, *2 Agents Linger, Listen at Exchanges*, Chicago Tribune, Jan. 26, 1989, § 1, at 1, col. 5; *see also* Berg, *Merc, Board of Trade Said to Begin Inquiries*, N.Y. Times, Jan. 21, 1989, § 1, at 39, col. 1 (discussing FBI fraud inquiry); Berg, *F.B.I. Said to Study Chicago Cheating in Futures Trades*, N.Y. Times, Jan. 20, 1989, at A1, col. 1 (FBI investigation into broker fraud).

2. *See* Crawford, *Agent in Trading Probe Proves Skill—and Luck*, Chicago Tribune, Jan. 24, 1989, § 1, at 1, col. 2; Burton & Crawford, *Farm Firm's Complaint Led to Probe*, Chicago Tribune, Jan. 22, 1989, § 1, at 1, col. 3.

3. *See* Burton & Marx, *Trader Attorneys Challenge Probe Taping Tactic*, Chicago Tribune, Feb. 19, 1989, § 7, at 1, col. 1; Drew & Possley, *Probers Press for Trader Cooperation*, Chicago Tribune, Jan. 21, 1989, § 1, at 1, col. 1; *see also* Greising, *Traders' Lawyers Attack Secret Tapings as Illegal*, Chicago Sun Times, Feb. 19, 1989, at 81, col. 6 (discussing defense attempts to exclude secret tape recordings).

4. *See F.B.I. Commodities 'Sting': Fast Money, Secret Lives*, N.Y. Times, Jan. 30, 1989, at A1, col. 4; Petacque, *How Traders Got Trapped*, Chicago Sun Times, Jan. 22, 1989, at 1, col. 1; Eichenwald, *FBI Intensifying Commodity Inquiry on Chicago Trades*, N.Y. Times, Jan. 21, 1989, § 1, at 1, col. 1; *see also* Marx, *Only Thin Cover Hid F.B.I. Futures Probe*, Chicago Tribune, Feb. 7, 1989, § 1, at 1, col. 2 (agents "high-rolling" lifestyle supported by very thin cover); Gunset & Cohen, *Probe Shatters Exchanges' Club Atmosphere*, Chicago Tribune, Jan. 22, 1989, § 1, at 14, col. 1 (agents successfully performed "qualifying dance" to gain entry into exchanges).

abuses.[5] Indeed, in July of 1989 federal grand juries in Chicago returned indictments against forty six traders.[6] These events have focused widespread attention on the floor trading practices of the commodity futures exchanges.[7]

5. The Financial Times reported that the probe would uncover schemes of cheating "that run[ ] into tens of millions of dollars." Hargreaves, *Agents Posed as Traders in Their Hunt for Evidence*, Fin. Times, Mar. 8, 1989, Survey, at IV. It was also reported that as many as 100 traders had been systematically cheating customers out of millions of dollars. *See* Petacque, *FBI Probes*, Chicago Sun Times, Jan. 26, 1989, at 1, col. 1 (prosecutors informed judicial officials that FBI sting operation would yield at least 100 indictments); Burton & Crawford, *Farm Firm's Complaint Led to Probe*, Chicago Tribune, Jan. 22, 1989, § 1, at 1, col. 3; *see also* Berg, *Commodity Case Seen Expanding*, N.Y. Times, Jan. 24, 1989, at D1, col. 6 (while more subpoenas issued, government looks for mail and tax fraud in addition to trading abuses); Eichenwald, *F.B.I. Intensifying Commodity Inquiry on Chicago Trades*, N.Y. Times, Jan. 21, 1989, § 1, at 1, col. 1 (long investigation produces 50-100 subpoenas). Subsequent newspaper reports suggested that the operation had uncovered less wrongdoing than had been originally suspected. *See* Berg, *Lawyers See Hurdles for Futures Inquiry*, N.Y. Times, Feb. 20, 1989, at D2, col. 5; Eichenwald, *More Than 100 Subpoenas Served on Commodity Firms*, N.Y. Times, Jan. 25, 1989, at D1, col. 1.

6. *See* United States v. Dempsey, No. 89-666, indictment (N.D. Ill. Aug. 2, 1989) (soybean traders on Chicago Board of Trade indicted for violations of Commodity Exchange Act, mail and wire fraud, false statements, conspiracy, and RICO); United States v. Goberstein, No. 89-667, indictment (N.D. Ill. Aug. 2, 1989) (charges against U.S. Treasury Bond traders on Chicago Board of Trade); United States v. Bailin, No. 89-668, indictment (N.D. Ill. Aug. 2, 1989) (charges against Japanese yen traders on Chicago Board of Trade); United States v. Mosky, No. 89-669, indictment (N.D. Ill. Aug. 2, 1989) (charges against Swiss franc traders on the Chicago Mercantile Exchange). Some traders have pleaded guilty to the charges. *See* Berg, *3 Brokers Plead Guilty in Commodity Inquiry*, N.Y. Times, Aug. 9, 1989, at D2, col. 5.

The government refused to specify the amount of money alleged to have been defrauded from customers as a result of the conduct set forth in the indictments. *See* Litke, *Customers Unaware of Trading Losses as Exchanges Move to Limit Damage*, Associated Press Release, Aug. 4, 1989. A review of the indictments, however, suggests that the total dollar amount involved in the transactions (some 1500 trades) is not great, at least when viewed in the context of the widespread publicity given to the Chicago investigation and in view of the billions of dollars that are at stake in the commodities markets at any one time. Several authorities even characterized the charges as "comparatively minor crimes." Eichenwald, *Business and the Law; Commodity Charges Widen Use of Racketeering Statute*, N.Y. Times, Aug. 7, 1989, at D1, col. 1. Nevertheless, such practices could be destructive of consumer confidence in the integrity of the markets. *See generally The Chicago Indictments*, Washington Post, Aug. 5, 1989, at A16, col. 1 (discussing need for careful regulation of commodities markets); Dishneau, *Gov't: Charges Against 46 Traders Only "First Step,"* Associated Press Release, Aug. 3, 1989 (probe part of expanding crackdown on white collar crime). Additional indictments may be returned. *See* Dishneau, *Commodities Scandal Lives Up to Advance Billing*, Associated Press Release, Aug. 6, 1989.

In any event, controversy about the government's investigation continues, with charges being made that the press was used to leak the government's case and to place pressure on traders under investigation. *See They Can Dish It Out, But They Can't Take It*, Chicago Times Mag. Sept.-Oct. 1989, at 11; Protess, *Did the Press Play Prosecutor in Covering the FBI Sting*, C.J. Rev. July-Aug. 1989, at 37; Dishneau, *Commodities Scandal Lives Up to Advance Billing*, Associated Press Release, Aug. 6, 1989.

7. *See* Hargreaves, *Agents Posed as Traders in their Hunt for Evidence*, Fin. Times, Mar. 8, 1989, Survey, at IV; Hargreaves, *Fraud Inquiry Stills the Hubbub of Chicago Trading*, Fin. Times, Feb. 9, 1989, § 1, at 8; Behof, *Life in the Pits Will Never Be the*

This article reviews the nature and background of the federal regulatory scheme imposed on trading activities on the floors of the commodity exchanges.[8] The article discusses the need for a better "audit trail" to uncover trading abuses[9] and examines the phenomenon of "dual" trad-

Same, Bus. Wk., Feb. 6, 1989, at 32; Pauly, *More Shoes Drop in the Pits*, Newsweek, Feb. 6, 1989, at 50; McWhirter, *A Bid to Salvage a Go-Go Legacy; Chicago's Commodities Guru Pledges to Clean Up the Pits*, Time, Feb. 6, 1989, at 52; Work, Black, Sheets & Adkins, *In the Futures Pits, Life Is No Longer a Bowl of Cherries*, U.S. News & World Report, Feb. 6, 1989, at 44; Szymczak & Gaines, *CFTC Put on Hold For Probe*, Chicago Tribune, Feb. 2, 1989, § 3, at 1, col. 6; McCormick, *The Sting in the Pits*, Newsweek, Jan. 30, 1989, at 54; Yates, *Futures Probe Has Tokyo's Attention*, Chicago Tribune, Jan. 30, 1989, § 4, at 1, col. 2. The Chicago investigations led to further action by the Department of Justice, which created special task forces in five other cities: New York, Los Angeles, San Francisco, Kansas City and Denver. The Department of Justice directed these task forces to examine futures and other financial activities, including securities sales. *See* Briggs, *'Crime in the Suites' Targeted*, Chicago Sun Times, Feb. 1, 1989, at 1, col. 3; Horrock, *U.S. Widens Probe of Trading*, Chicago Tribune, Feb. 1, 1989, § 1, at 1, col. 2. In May of 1989, the New York Times and Wall Street Journal reported that the CFTC and a grand jury were investigating the New York exchanges. *See* Gilpin, *A Painful Way to Be Noticed*, N.Y. Times, May 10, 1989, at D1, col. 3; Siconolfi & Power, *New York Futures Trader Subpoenaed by U.S. Grand Jury, Individuals Say*, Wall St. J., May 9, 1989, at C25, col. 1; Eichenwald, *Commodity Inquiry Focuses on Sharing of Order Data*, N.Y. Times, May 9, 1989, at D1, col. 1; Power & Siconolfi, *Key Traders Face Glare of Inquiry*, Wall St. J., May 8, 1989, at C1, col. 6; Eichenwald, *Commodity Inquiry Said to Have a Second Focus*, N.Y. Times, May 6, 1989, at 43, col. 3; Eichenwald, *New York Commodity Inquiry*, N.Y. Times, May 5, 1989, at D1, col. 6; Siconolfi & Power, *New York Commodity Markets Raided*, Wall St. J., May 5, 1989, at C1, col. 3.

8. Commodity futures contracts and commodity options contracts are traded on the exchange floors. A commodity futures contract imposes an obligation on the purchaser to buy a stated commodity of a given quality or specification. The seller incurs a reciprocal obligation to deliver the commodity on the agreed upon date. A commodity option contract gives a purchaser the right (but not the obligation) to acquire the commodity at a specified price (the "exercise" price) during the life of the option contract. The purchaser pays a premium for that right. The price of commodity futures and commodity options are negotiated in "pits" or "rings" on the commodity futures exchanges. The commodity exchanges guarantee performance of their contracts. *See generally* Merrill Lynch, Pierce, Fenner & Smith v. Curran, 456 U.S. 353, 358 (1982) (historical development of futures exchanges); S. Rep. No. 384, 97th Cong., 2d Sess., 188 (1982) (role of clearinghouse in deliveries on futures contracts); Markham & Gilberg, *Stock and Commodity Options—Two Regulatory Approaches and Their Conflicts*, 47 Alb. L. Rev. 741 (1983) (discussing stock and commodity trading abuses and subsequent regulation by SEC and CFTC); Futures Industry Association, An Introduction to The Futures Markets 7 (1984) (discussing workings of futures contracts); Chicago Board of Trade, Commodity Trading Manual 8 (1973) (defining futures contract).

9. An audit trail is a system that permits the reconstruction of the sequence of the execution of commodity futures transactions. To illustrate, a large brokerage firm receives an order from a customer at its branch office in Louisville, Kentucky. The order is transmitted to the exchange floor to a booth of the brokerage firm, then to a pit or ring on the floor where orders are executed against other orders of customers or floor traders. The execution of the order is reported back to the brokerage firm's booth, then to the brokerage firm's office, and finally to the customer. In order to determine whether the order was handled properly and executed competitively, it is often necessary to pinpoint the time of the receipt of the order at the brokerage firm's office, its transmission to the floor, its execution time, and the time of the report back to the booth on the floor and eventually to the customer. An audit trail times the receipt of the order at each phase of its processing, execution, and handling. *See generally* Proposed Regulations Regarding

ing, in which floor brokers execute orders for customers as well as for their own accounts, creating potential conflicts of interest.[10] The article also reviews cases that have raised trade practice issues and discusses the appropriateness of reforms that have been suggested as a result of the Chicago sting operation.

I. REGULATION OF COMMODITY FUTURES

A. *Background of the Regulatory Framework*

Commodity futures are regulated under the Commodity Exchange Act of 1936.[11] That statute was substantially amended by the Commodity Futures Trading Commission Act of 1974 (the "CFTC Act of 1974")[12] which created the Commodity Futures Trading Commission ("CFTC" or the "Commission"), an independent federal agency which was envisioned to be the futures industry equivalent of the Securities and Exchange Commission.[13] The Commodity Exchange Act imposes federal regulation through a licensing scheme that requires exchanges to register with the CFTC as "contract markets,"[14] and traders who execute customer orders on the floor of a contract market to register as "floor brokers."[15] The Commodity Exchange Act also prohibits certain fraudulent trading practices such as "fictitious" trades, "wash" sales, "accommoda-

Dual Trading by Floor Brokers and Futures Commission Merchants, [1975-1977 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,118, at 20,843-44 (Dec. 18, 1975) [hereinafter *Proposed Dual Trading Regulations*] (discussing audit trail); J. Markham, The History of Commodity Futures Trading and Its Regulation 90-91 (1987) (defining time-stamping requirements).

10. A floor broker is a trader on the exchange floor who executes customers' orders. As such, he is required to register with the CFTC. *See* 7 U.S.C. § 6(e) (1982). A floor trader trades only for his own account. Floor brokers may also trade for their own accounts, giving rise to the concept of dual trading, in which floor brokers trade both as principal and as agent. The CFTC allows dual trading only in situations in which a floor broker trades for himself on the same day in which he trades for another person in the same commodity for future delivery. *See Proposed Dual Trading Regulations, supra* note 9, at 20,843 n.3.

11. 7 U.S.C. §§ 1-26 (1982).

12. Pub. L. No. 93-463, 88 Stat. 1389 (1974) (codified as amended at 7 U.S.C. §§ 1-26 (1982)).

13. In fact, the CFTC was "patterned" after the SEC. *See* 120 Cong. Rec. 30,467 (1974) (remarks of Sen. Taft).

14. *See* 7 U.S.C. § 7 (1982). Contract markets must meet certain minimal requirements before being licensed by the CFTC. Their operations are subject to regulation. *See* 7 U.S.C. § 7-7(a) (1982). *See generally*, 1 P. Johnson & T. Hazen, Commodities Regulation §§ 1.20-1.30, at 85 (2d ed. 1989) (describing rules and regulations of contract markets).

15. *See* 7 U.S.C. § 6e (1982). Individuals who trade only for their own accounts on the floor of the exchange are not presently required to register with the CFTC. *See* T. Russo, Regulation of the Commodity Futures and Options Markets § 1.01 (1983); Markham & Bergin, *The Role of the Commodity Futures Trading Commission in International Commodity Transactions*, 18 Geo. W.J. Int'l. L. & Econ. 581, 586 n.26 (1985). A bill recently passed by the House, however, would require such registration. *See* H.R. 2869, 101st Cong., 1st Sess. § 205 (July 12, 1989); H.R. Rep. No. 236, 101st Cong., 1st Sess. § 205 (1989).

tion" trades,[16] the improper "offset" of customer orders[17] and certain "cross" trades.[18]

Since its inception, the CFTC has sought to strengthen its regulatory control over the futures industry, an industry that prides itself on being a last bastion of free enterprise and that has strongly resisted federal regulatory efforts.[19] Much of the CFTC's resources, however, has been diverted by the widescale fraudulent practices in off-exchange instruments which the CFTC has only in recent years brought under control.[20] Despite such distractions, the CFTC has mounted several regulatory efforts to control floor trading abuses. These efforts included, as will be discussed below, a fourteen-year program to prevent dual trading abuses and to enhance the "audit trail" requirements for futures trading, so that abuses could be uncovered more readily.[21] In the 1970s, the CFTC also spearheaded criminal investigations of schemes to evade income taxes through fraudulent and fictitious trading practices on the floors of the exchanges in Chicago and New York.[22] The events reported in Chicago have again raised the issue of whether additional regulatory efforts are needed to detect and prevent abuses.

B. *The Time-Stamping Issue and Dual Trading*

1. The Audit Trail

An audit trail for surveillance and investigative purposes is a means to reconstruct trading by time-stamping orders for commodity futures contracts at each phase of their handling and execution.[23] A complete audit

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16. *See* 7 U.S.C. § 6c(a)(3)(A) (1982).
17. *See* 7 U.S.C. § 6b(2)(c) (1982).
18. *See* 7 U.S.C. § 6c(a)(3)(A) (1982); 17 C.F.R. §§ 1.38, 1.39 (1987).
19. *See* Laing, *U.S. Study of Soybean Trading is Seen Leading to Tax-Law, Other Indictments*, Wall St. J., Aug. 9, 1976, at 18, col. 2. *See generally* J. Markham, *supra* note 9 (discussing history of commodities regulation).
20. These off-exchange instruments involved commodity options that were not backed by actual commodities and often resulted in the bankruptcy of firms marketing them, with commensurate loss to customers who had been induced to invest by fraudulent promises of great profits. *See* Lower, *The Regulation of Commodity Options*, 1978 Duke L.J. 1095, 1113; Markham & Gilberg, *Stock and Commodity Options—Two Regulatory Approaches and Their Conflicts*, 47 Alb. L. Rev. 741, 759-69 (1983). *See generally* Gilberg, *Regulation of New Financial Instruments Under the Federal Securities and Commodities Laws*, 39 Vand. L. Rev. 1599 (1986) (analyzing jurisdictional dispute between CFTC and SEC over new financial instruments); Schroeder, *Inadvertent Futures Contracts*, 19 Rev. Sec. & Comm. Reg. 896 (1986) (discussing new financial instruments and recommending lifting the ban on off-exchange futures contracts); Young & Stein, *Swap Transactions Under the Commodity Exchange Act: Is Congressional Action Needed?*, 76 Geo. L.J. 1917 (1988) (analyzing swaps as futures contracts and studying exclusion of swaps from CEA provisions).
21. *See infra* notes 23-97 and accompanying text.
22. *See infra* notes 128-156 and accompanying text.
23. *See supra* note 9. The processing of commodity futures orders has been described as follows:

> [t]he order is sent via phone or telex to the exchange trading floor, where it is received by an order clerk. A messenger carries the order to the appropriate

trail allows the government to determine, for example, whether customer orders were executed at prices prevailing in the market at the time of execution or whether traders took unfair advantage of customer orders.[24]

Under CFTC regulations, a brokerage firm receiving a customer order is required to prepare a written record of the order and to time stamp that record to the nearest minute.[25] If transmitted to the floor orally, the order must be recorded again on a "floor" order and this document must also be time-stamped.[26] In addition, the floor order has to be time-stamped when it is returned to the broker's floor booth after execution in

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> member in the pit. If it is a market order it is filled immediately. If it is a contingent order and not immediately executable, the floor broker puts it into his "deck" of resting unexecuted orders, filed by price and time received. When the order is filled the above process reverses, terminating with the customer's receipt of the reported execution and price. As each transaction is completed in the pit, an observing reporter records the trade and price. This information is immediately displayed on the quotation board visible from the trading floor, and is also flashed to other markets, brokerage offices, and trading centers throughout the U.S. and overseas via wire services and other media.

Futures Industry Association, An Introduction to the Futures Market 3 (1984); *see* S. Rep. No. 1131, 93rd Cong., 2d Sess. 16-17 (1974); H.R. Rep. No. 975, 93rd Cong., 2d Sess. 136-37 (1974).

24. The following excerpt from a CFTC report indicates the importance of an adequate audit trail:

> In developing evidence that a broker has traded ahead of a customer order, a precise reconstruction of trading usually is essential. The current procedures . . . are inadequate in many cases for staff to determine clearly that a broker had a customer order in his possession when he traded for himself. For instance, in a recent administrative action, Enforcement was unable to persuade the administrative law judge that a trading ahead violation occurred because of the inability to sequence trades clearly with available timing and other data. This occurred despite the fact that the exchange had found the broker's actions violative of the exchange's trading ahead rules.

CFTC Division of Trading and Markets, Memoranda: Audit Trail Enhancements, Proposed Amendments to Commission Regulation 1.35, at 41-42 (1985) (footnote omitted). The CFTC also noted the importance of timing data in price manipulation investigations. For example, in one case, the CFTC staff concluded that, because of the lack of precise trade timing information, it could not meet its burden of establishing that a specific floor broker caused a large price increase. *See id.* at 42-43.

25. *See* 17 C.F.R. § 1.35(a-1)(1) (1988); CFTC Interpretive Letter No. 75-15, Recording of Customers' Orders by Futures Commission Merchants, [1975-1977 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,103, at 20,774 (Oct. 8, 1975). The exchanges were required to submit a plan by January 16, 1977, showing how they were developing a "method, through time-stamping or otherwise, for recording the sequence of futures transactions executed on the contract market." Proposed Change in the Records of Commodity Futures Transactions, [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,764, at 23,134 (Feb. 20, 1979).

26. *See* 17 C.F.R. § 1.35(a-1)(2) (1988); CFTC Interpretive Letter No. 75-14, Recording of Customers' Orders by Members/Brokers on the Floor, [1975-1977 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,102, at 20,772 (Oct. 8, 1975). Some orders are wired to the floor where they are printed out and time-stamped automatically. *See* Chicago Board of Trade, Commodity Trading Manual 158 (1982). *See generally* T. Hieronymus, Economics of Futures Trading 56-57 (2d ed. 1977) (emphasis placed on minimizing time from order receipt to execution in pit).

the pit.[27]

There is, however, no requirement that the order be time-stamped upon its execution in the pit. As a result, there is often a significant gap in the audit trail.[28]

During congressional consideration of the CFTC Act of 1974, Representative Poage expressed concern that the gap between the receipt on the floor of the exchange and its return to the broker's booth, as well as the absence of time-stamping for floor traders, permitted abuses to go undetected.[29] During such gaps, prices often fluctuated broadly, allowing unscrupulous floor brokers to take advantage of those price swings and profit at the customer's expense by changing the order execution prices to make them more advantageous to the opposite trader, or through other fraudulent acts.[30]

Congressman Wampler of Virginia stated before the Congress that the importance of time-stamping order executions in the trading pit could not be over-emphasized because it would permit the CFTC to determine "whether floor brokers trade ahead of their customers in order to get the best price themselves," and whether floor traders were increasing price fluctuations by "jumping in en masse when prices have begun moving in a certain direction."[31] Congressman Wampler said that time-stamping order executions would allow the CFTC to determine whether floor brokers actually minimized price swings, as claimed by floor brokers to justify the time and place advantage on the trading floor. Time-stamping would also enable the CFTC to determine whether floor brokers were justified in trading for themselves as well as for customers and to ascertain "whether the abuses are so rampant that this practice should not be allowed."[32]

Representative Wampler also noted that many abuses associated with traders on the floor could not be detected because the time sequence of their trades could not be determined from the records.[33]

> This omission bears heavily on the question of whether or not dual trading—trading by brokers both for customers and for their own accounts—should be prohibited or restricted .... Neither the CEA nor the commodity futures trading industry knows the extent of dual trading abuses, and neither can know in the absence of timing

27. *See* 17 C.F.R. § 1.35(a-1)(4) (1988).

28. The CFTC has attempted to require exchanges to implement trade sequencing systems that will allow a determination of the time of the execution of an order within one minute of its execution in a pit on the floor of an exchange. *See infra* notes 44-97 and accompanying text.

29. *See, e.g.*, 120 Cong. Rec. 34,736-55 (1974) (statement of Representative Poage concerning congressional efforts to strengthen commodities regulation); CFTC Division of Trading and Markets, Memoranda: Audit Trail Enhancements, Proposed Amendments to Commission Regulation 1.35, at 6-8 (1985) (recommending time-stamping).

30. *See* 120 Cong. Rec. 34,751 (1974).

31. *Id.* at 34,751.

32. *Id.*

33. *See id.*

information.[34]

Mr. Wampler also asserted that strengthened surveillance of floor traders who trade only for themselves was necessary. Indeed, the CFTC regulatory predecessor, the Commodity Exchange Authority ("CEA"), had informed the Comptroller General that without better timing information it could not determine whether floor traders were perpetrating abuses, nor could it ascertain the extent of traders' influence on futures prices. A record of the time of execution was needed to discover whether floor traders were buying on price advances and selling on price declines, thereby accentuating price movements.[35]

It was further claimed that the importance of timing of order execution had been demonstrated during a Senate investigation of the Russian grain sales in the 1970s.[36] A Congressional committee, the Permanent Subcommittee on Investigations of the Senate Committee on Government Operations, had concluded that "it was impossible to determine whether orders to buy and sell on the Kansas City Board of Trade had affected the closing price[s] because the times of such trades were not recorded."[37] The Committee pointed out that this information "was needed to determine whether large grain exporters were pushing up closing prices in order to increase their export subsidies."[38]

A proposed Senate amendment to the 1974 legislation would have required exchanges to submit to the CFTC a record showing each trade made on the exchange, including the time the contract was executed.[39] A conference committee, however, modified the proposal.[40] Although the committee saw time-stamping as an effective means of policing trading, it did not believe that time-stamping should be mandated by statute. The committee believed that it was technically impossible to implement time-stamping on the effective date of the 1974 legislation. Instead, the conference committee allowed the CFTC to use its powers to require time-stamping. In so doing, the committee urged the CFTC to move

34. *Id.* at 34,752 (letter from Elmer B. Staats, Comptroller General of the United States, to Sen. Clark).

35. *See id.*

36. *See id.* Congress expressed concern over commodity futures trading in connection with large grain sales to the Soviet Union in the early 1970s. *See, e.g.*, 120 Cong. Rec. 10,751 (1974) (statements of Rep. Smith) (Russians bought more grain than needed, then sold it at higher price, thereby profiting from manipulation that would be illegal if done by domestic purchaser); *Russian Grain Transactions: Hearings Before the Permanent Subcommittee on Investigations of the Senate Committee on Government Operations, United States Senate*, 93rd Cong., 1st Sess. Part I (1973) (analyzing Russian grain purchase and resale). In fact, although no wrongdoing was uncovered, the "Great Grain Robbery" has been described as "one of those economic events that, like the OPEC oil embargo . . . can truly be said to have changed the world." Morgan, Merchants of Grain 120-21 (1979).

37. 120 Cong. Rec. 34,752 (1974) (letter from Elmer B. Staats, Comptroller General of the United States, to Sen. Clark).

38. *Id.*

39. *See* S. Rep. No. 1194, 93rd Cong., 2d Sess. 1-32 (1974).

40. *Id.* at 42.

quickly to develop and implement a technically feasible approach to time-stamping.[41] Several conferees wanted the CFTC to require the reporting of the trade as soon as it was practical for the exchange to provide that information. The committee thought, however, that maximum discretion should be given to the CFTC which would become the true expert.[42] Congress expected and hoped that the CFTC would "require whatever information that is necessary to allow the Commission to do an adequate job of policing abuses."[43]

2. The Time-Stamping Odyssey

In a release issued on December 18, 1975, the CFTC announced its intention to require all contract markets that allowed dual trading[44] to establish a system for time sequencing trades in order to detect abuses more readily.[45] Approximately one year later, the CFTC stated that the detection and prevention of market manipulation and trading abuses such as "trading ahead" of customers[46] and "three-cornered deals"[47] were dependent upon rapid and accurate transaction time sequence reconstruction.[48] While the CFTC found little evidence that such trading abuses occurred with significant frequency, it was not prepared to assume that those abuses were isolated, because the exchanges were unable to determine whether they were occurring.[49] The CFTC also cited a report of the Comptroller General which had concluded that without time-stamping it was virtually impossible to detect dual trading, in which a broker trades for his own account while holding customer orders.[50]

41. *See* 120 Cong. Rec. 34,751 (1974); 120 Cong. Rec. 34,997-35,001 (1974).

42. *See* 120 Cong. Rec. 34,998 (1974) (statements of Rep. Talmadge).

43. *Id.*

44. Dual trading takes place when a broker trades for his own account either on the same day he trades for his own account or while holding customer orders. 1988 CFTC Ann. Rep. 129.

45. *See* 40 Fed. Reg. 58660, *reprinted in*, Proposed Regulations Regarding Dual Trading by Floor Brokers and Futures Commission Merchants, [1975-1977 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,118, at 20,843 (Dec. 18, 1975).

46. Trading ahead of customers means that a broker, aware that a large order coming to the exchange will likely influence prices, trades prior to that order and benefits from the effect of the large order on prices. *See* 1988 CFTC Ann. Rep. 132. In United States v. Dial, 757 F.2d 163 (7th Cir.), *cert. denied*, 474 U.S. 838 (1985), the Seventh Circuit upheld a criminal conviction for such conduct under the mail and wire fraud statutes. *Id.*; *see* 18 U.S.C. §§ 1341, 1343 (1982); *see also* Markham, *"Front-Running"—Insider Trading Under the Commodity Exchange Act*, 38 Cath. U.L. Rev. 69 (1988) (discussing background regulation and statutory framework of front-running prohibitions).

47. Three-cornered deals take many forms. *See infra* notes 136-137 and accompanying text.

48. *See* 41 Fed. Reg. 56,134, 56,139 (1976), *reprinted in*, Adoption of Dual Trading Regulations—Records of Cash Commodity and Futures Transactions; Trading Standards for Floor Brokers and Futures Commission Merchants, [1975-1977 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,242, at 21,299 (Dec. 23, 1976) [hereinafter *Dual Trading Regulations; Trading Standards*].

49. *See id.*

50. *See* Comptroller General of the United States, Report to the Congress on Improvements Needed in Regulation of Commodity Futures Trading, (June 24, 1975) (cited

The exchanges contended that the time gaps were insignificant because price changes on the floors of the exchanges were reported by traders to exchange officials and those reports were timed. The exchanges claimed that by comparing this "time and sales" data to the time stamps on the floor order an audit trail could be established with some degree of accuracy.[51] Nevertheless, gaps in the audit trail persisted because time and sales data did not record the size of transactions. Consequently, in markets with rapidly fluctuating prices,[52] it was often difficult to determine execution times for particular orders executed at the same prices.[53]

The CFTC also found that detecting trading abuses through the current records kept by contract markets required a laborious cross-referencing of data,[54] which effectively precluded an efficient contract market surveillance program. The absence of computerized data retrieval systems correlating the price of executions with the time of price changes also made market surveillance efforts extremely time consuming and inefficient.[55] While time and sales data permitted some trade reconstructions, that data was not effective in cyclical markets, in which prices move up and down repeatedly. The CFTC noted that several cyclical variations could occur during the time gap between a floor order being time-stamped upon receipt on the floor and its being time-stamped back at the booth on the floor upon the report of execution. As a result, it would be difficult to assign a specific time to a particular transaction. Moreover, because many trades took place in a matter of seconds, time and sales information was frequently inaccurate.[56]

In order to remedy these problems, the CFTC believed that each contract market should be required to maintain an accurate price change

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in *Proposed Dual Trading Regulations, supra* note 9, at 20,844 n. 10). The Comptroller General had made a similar statement to Congress concerning the legislation that became the CFTC Act of 1974. *See* 120 Cong. Rec. 34,752 (1974) (letter from Elmer B. Staats, Comptroller General of the United States, to Senator Clark).

The CFTC has said that "trade reconstruction presently is largely a manual, labor intensive and time consuming activity. Numerous documents must be examined, sorted and compared just to determine whether the evidence of a suspected violation is probative enough to warrant further investigation." CFTC Division of Trading and Markets, Memorandum: Audit Trail Enhancements: Proposed Amendments to Commission Regulation 1.35, at 43 (Nov. 19, 1985).

51. *See Dual Trading Regulations; Trading Standards, supra* note 48, at 21,300.

52. *See infra* note 56 and accompanying text.

53. *See Dual Trading Regulations; Trading Standards, supra* note 48, at 21,300. The CFTC proposed a way to increase the usefulness of the time and sales data, requiring that each contract market maintain an accurate price change register to record price changes within ten seconds. *See id.* at 21,301; *infra* notes 57-58 and accompanying text. This requirement was subsequently adopted. *See* 17 C.F.R. § 1.35(h) (1987).

54. *See Dual Trading Regulations; Trading Standards, supra* note 48, at 21,300.

55. *See id.*

56. *See id.* The CFTC also stated that time and sales data of the contract markets was often inaccurate "[s]ince a large number of trades can take place in a matter of a few seconds or minutes on any exchange, such inaccurate price change timing can easily invalidate the accuracy of any reconstruction of the time and sequence of transactions based upon such timing." *Id.*

register to record each price change within ten seconds.[57] Further, the CFTC was of the view that the execution of each transaction should be matched to a time period within which the possibility of a cyclical movement was reduced to the greatest extent possible. The CFTC stated that to achieve this measure of accuracy times would have to be stamped at least to the nearest minute. The CFTC also asserted that its studies had shown that "technology [was] adequate to enable contract markets to record each detected price change within ten seconds."[58]

In March of 1976, the CFTC held hearings[59] during which industry representatives contended that, with current technology, time-stamping executions would hamper the effective execution of transactions.[60] The industry representatives asserted that it would be possible to identify the specific half hour interval within which a transaction was executed.[61] In response to those assertions, the CFTC established a task force in April of 1976 to consider "bracketing" as an alternative interim measure to one minute time-stamping. In a bracketing system, traders would use symbols on their trading cards to indicate transactions which took place within the same half hour period.[62]

The CFTC task force concluded that, while time sequencing should continue to be the ultimate goal for all markets, bracketing would be a significant step forward for many markets and might be an acceptable interim step.[63] By bracketing, the price of the execution and its bracketed period of execution could be compared with time and sales and the entry and exit time-stamps on the floor orders to focus more narrowly on the exact time of the trade.[64]

The CFTC adopted a one minute stamping requirement for executions in the trading pit, but it allowed the exchanges to petition for more time to implement the system.[65] Before granting such an extension the CFTC required that the exchange show that the one minute timing requirement

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57. *See Dual Trading Regulations; Trading Standards, supra* note 48, at 21,301.

58. *Id.* This requirement was subsequently adopted by the CFTC. *See* 17 C.F.R. § 1.35(h) (1987); *supra* note 53.

59. *See Dual Trading Regulations; Trading Standards, supra* note 48, at 21,291.

60. *See* Proposed Changes in the Records of Commodity Futures Transactions, [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,764, at 23,134-35 (Feb. 20, 1979) [hereinafter *Bracketing of Trades*]; *Dual Trading Regulations; Trading Standards, supra* note 48, at 21,291.

61. *See Bracketing of Trades, supra* note 60, at 23,134.

62. *See id.* at 23,139.

63. *See id.* at 23,135.

64. *See Bracketing of Trades, supra* note 60, at 23,137-38; *Dual Trading Regulations; Trading Standards, supra* note 48, at 21,302.

65. *See Dual Trading Regulations; Trading Standards, supra* note 48, at 21,302-04. The target date for compliance, from which an extension could be sought, was April 17, 1977. *See id.* at 21,291. June 13, 1977 was the effective date of the time-stamping requirement. *See* Trading Standards for Floor Brokers and Futures Commission Merchants and Records of Cash Commodity and Futures Transactions; Extension of Comment Period, [1975-1977 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,263, at 21,429 (Jan. 24, 1977).

would seriously disrupt the functions of the marketplace. Further, an extension would be limited to one year.[66] During the spring of 1977, however, all ten of the existing exchanges petitioned the Commission for extensions to comply with the time-stamping requirement. The CFTC granted only four of the requests. The CFTC found that the exchanges whose petitions were denied did not submit an acceptable plan for achieving one minute trade timing.[67]

In February of 1979, the CFTC reevaluated its position on time-stamping. It proposed that its regulations be revised to permit trades to be bracketed in thirty minute periods rather than time-stamped to the minute. The CFTC took this action after determining that it might be impossible for contract markets to submit plans for speedy order executions within the time envisioned by the CFTC.[68] The CFTC thereafter eliminated its one minute time-stamping requirement and substituted a bracketing provision, concluding that thirty minute bracketing would be a step forward in policing floor brokers engaged in dual trading.[69]

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66. *See Bracketing of Trades, supra* note 60, at 23,135.

67. *See id.* at 23,135-36; 17 C.F.R. 1.35 (g)(2) (1987) (extension requirements). The exchanges whose petitions were denied included the Chicago Board of Trade, the Chicago Mercantile Exchange, the New York Coffee and Sugar Exchange, and the New York Cotton Exchange. *See Bracketing of Trades, supra* note 60, at 23,136 & n.16.

68. *See Bracketing of Trades, supra* note 60, at 23,137. In adopting the bracketing provision, the CFTC was exempting exchanges from the one minute time-stamping requirement only until January 1, 1981. *See* Temporary Exemption From One-Minute Time Sequencing Requirement, [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,931, at 23,750 (Dec. 12, 1979). The CFTC also was continuing its efforts to seek a one minute time-stamping requirement in order to meet four objectives:

> (1) [t]o help prevent dual trading abuses, (2) to enable each contract market and the Commission to reconstruct the sequence of transactions to facilitate the detection of other trade practice abuses, (3) to make available further data to prove trade practice abuses detected by other means, and (4) to provide accurate time of execution information for the purpose of conducting general market studies to evaluate the impact of trading activity over a given period of time.

Id. at 23,751 (footnote omitted).

69. *See* Recording of Trades by Contract Markets by Time Brackets, [1980-1982 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,112, at 24,486-88 (Dec. 2, 1980). The CFTC pointed out that its

> determination not to continue with one-minute timing as a requirement of its regulations is influenced considerably by the lack of evidence that technology is currently available to permit all of the exchanges to adopt one-minute timing systems and the concern that, absent such technology, the adoption of one-minute timing as an absolute requirement would invite major disruptions to the effective performance of the nation's commodity futures markets. Until such time as the Commission is persuaded that technological or other program or systems developments are capable of implementing more precise timing, time-stamping or transaction sequencing systems, without posing a significant threat of market disruption, the Commission does not believe that a continued commitment to one-minute timing is in the public interest.

Id. at 24,488. *See generally* Revocation of Regulation Permitting Exemption of One-Minute Timing of Trades, [1982-1984 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,718 (May 10, 1983) (deleting requirements concerning one minute time-stamping for exchanges).

In 1984, however, the CFTC determined that bracketing was not providing the data that it needed. The CFTC's change of heart was spurred by a congressionally directed study that required the CFTC to determine whether insider trading was a problem in the commodity futures industry.[70] Although the CFTC concluded that insider trading did not pose a danger to commodity futures trading, the Commission expressed its concern over the potential harm of dual trading. The CFTC's concern was heightened by deficiencies in the trade reconstruction systems on many exchanges, which had created difficulties in enforcing the CFTC's regulations governing dual traders.[71] The CFTC declared that if dual trading by floor brokers was not prohibited, as it is in the stock options markets, a method of accurate and rapid transaction time sequence reconstruction was needed.[72]

The inaccuracy of bracketing also helped to prevent the CFTC from developing a capability to conduct computerized trade practice investigations. The CFTC noted that in September 1980, its Division of Trading and Markets found that bracketing accuracy levels were low and that the exchanges had made little or no effort to improve compliance with bracketing requirements through disciplinary sanctions. The CFTC also noted that bracketing data was often insignificant in investigations.[73] Additionally, none "of the six exchanges using thirty-minute bracketing had made any effort to implement a system of one minute timing"[74] and they had not been diligent in using bracketing to ensure accuracy or to achieve the objective of one minute timing.[75] In fact, the rate of accuracy for bracketing systems was only 69%.[76]

The CFTC noted that the General Accounting Office ("GAO") had presented two additional reports to Congress stressing the importance of time-stamping.[77] In fact, the GAO criticized the CFTC's decision not to

70. *See* CFTC, A Study of the Nature, Extent and Effects of Futures Trading by Persons Possessing Material, Non-Public Information (Sept. 1984) (hereinafter *Insider Trading Study*).

71. *See id.* at 9-10.

72. *See id.* at 105.

73. *See* Trade Time-Sequencing Standards and Exchange Audit Trail Systems, [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,450, at 29,968 (Dec. 27, 1984) [hereinafter *Trade Time-Sequencing*].

74. *Id.*

75. *See id.* at 29,968-70. The CFTC also noted that its Division of Trading and Markets had prepared a memorandum entitled *Thirty-Minute Bracketing and Exchange Audit Trail Systems*, dated September 26, 1984. In that memorandum, the Division concluded that data generated by the bracketing system was not as useful or effective as data generated by one minute timing systems and that this prejudiced the ability of the CFTC and exchanges to detect and prosecute trade practice abuses. *See Trade Time-Sequencing, supra* note 73, at 29,971 & n.10.

76. *See id.* at 29,968 n.7.

77. *See id.* at 29,967 n.5 (citing GAO, Report to the Congress—Commodity Futures Regulation—Current Status and Unresolved Problems 127 (July 15, 1982)); GAO, Report to the Congress, Regulation of Commodity Futures Market—What Needs To Be Done 79 (May 17, 1978).

adopt one minute time-stamping despite its clear benefits.[78] The CFTC also concluded that it was often difficult to reconstruct trades using bracketing as a means of determining the actual time of execution. Because futures prices are volatile, prices recur several times during a half hour period. It was impossible to determine independently the sequence of trading when there were recurring prices in the same bracket period, when order tickets lacked time stamps, or when the opposite side of the transaction involved a floor trader trading for his own account (and thus having no time stamp). This severely hampered the detection and prosecution of potential trading abuses. On the other hand, where prices were moving in one direction or when time stamps from the trading booths were relatively close in time, the order tickets could be compared to time and sales reports and those two documents compared to broker trading cards to pinpoint the execution time of a particular trade. Even then, however, the process was time consuming.[79]

In contrast, some contract markets had developed one minute timing systems, and the CFTC found that these exchanges had greatly enhanced surveillance capabilities. From this data, the exchanges' compliance staffs could more readily determine whether a particular pattern of trading was suspicious and whether further investigation was needed.[80] The CFTC also noted that computerized trade practice surveillance was a practical necessity for the more active contracts. By adding trade time execution data to a computerized surveillance system, more precise analysis could be made and the potential for accurate identification of possible trading abuses was increased.[81]

The CFTC also examined time-stamping practices on the securities exchanges. Trading on the Chicago Board Options Exchange ("CBOE"), for example, was conducted by open outcry in a pit where approximately two hundred traders handled order volumes comparable to those on the futures exchanges. The CBOE had adopted rules which required that both parties to a transaction manually note transaction times to the nearest minute.[82]

78. *See* GAO, Report to the Congress—Commodity Futures Regulation—Current Status and Unresolved Problems 127-28 (July 15, 1982); *see also Trade Time-Sequencing, supra* note 73, at 29,967 n.5 (GAO report found Commission's decision not to adopt one minute timing a "serious flaw in the exercise of its rule-making authority").

79. *See Trade Time-Sequencing, supra* note 73, at 29,969 (Dec. 27, 1984).

80. *See id.*

81. *See id.*

82. *See id.* at 29,972. Three futures exchanges did employ one minute timing systems. On two of these exchanges, the broker or the trader noted the trade execution time. At another exchange, officials of the exchange time-stamped brokers' cards within one minute of the execution. *See id.* A fourth futures exchange required one minute timing for one of its contracts, but not others. *See id.* at 29,972 n.11. At a futures exchange that required exchange officials to time-stamp cards, one of its contracts reached a record volume of over 18,000 contracts in approximately 4,150 transactions. The CFTC noted that in average daily transactions figures for all futures contracts traded in 1983 there were only 10 contracts that averaged more than 4,000 transactions per day. *See id.* at

In view of these developments, the CFTC proposed amendments to its regulations which would require sequential reconstruction to the nearest minute of each future or options contract executed on a contract market.[83] This proposal, however, did not call for a time-stamping requirement. Rather, it required that the exchanges develop a system to verify the time of the execution within one minute. "The proposal would not require any specific mechanical or electronic approach for assuring that such time would be recorded."[84]

The CFTC later noted that the exchanges had suggested ways to establish an audit trail for orders. One plan would record "exit" times (the moment that the order is reported out of the pit) in order to reconstruct the trade. The CFTC noted, however, that the execution times were not affixed, on the average, until some five minutes after the trade execution, which would not meet the one minute recording goal of the CFTC.[85] The CFTC also noted a proposal by one exchange to reduce the thirty minute bracket to fifteen minutes as an alternative to one minute time-stamping.[86] The CFTC found that while these suggestions were constructive, the Commission still needed verifiable one minute timed executions because some commodities market participants and investors still suspected that the commodities market was fundamentally unfair. The CFTC hoped that such trade timing systems might improve the public perception of the fairness of the commodity futures markets, and thereby increase participation in those markets.[87]

On January 14, 1986, the CFTC amended its regulations to require the exchanges to establish systems to determine the minute of execution for each trade. The exchanges were to implement the improved trade timing systems requirement by October 1, 1986 and to demonstrate the use of those systems by January 1, 1987.[88] The CFTC stated that it would permit a wide range of approaches to achieve verifiable one minute timing of executions. Indeed, the rule "permits each contract market to comply

29,972. This suggested that most exchanges could develop a one minute time-stamping mechanism for a great number of its futures contracts. *See id.*

83. *See id.* at 29,974.

84. *Id.* Contract markets that could not establish a verifiable mechanical or electronic trade reconstruction system within 90 days of the effective date could petition the CFTC for approval of interim rules for alternative trade reconstruction that would include both parties manually recording each transaction execution time to the nearest minute. *See* Time-Sequencing Standards and Audit Trail Systems, [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,499, at 30,213 (Mar. 4, 1985).

85. *See* Trade Timing Standards and Exchange Audit Trail Systems, [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,861, at 31,537 (Jan. 21, 1986) [hereinafter *Trade Timing Standards*]. *See generally* CFTC Division of Trading and Markets, Memorandum: Audit Trail Enhancements, Proposed Amendments to Commission Regulation 1.35, at 10 (Nov. 19, 1985) (current data from contract markets indicates exit time not affixed until five minutes after execution).

86. *See Trade Timing Standards, supra* note 85, at 31,536.

87. *See id.* at 31,533-34.

88. *See id.*

with the standard in the manner it chooses."[89]

The result of the CFTC's open policy, however, was that the Commission failed to achieve universal one minute time-stamping. The Chicago Board of Trade, for example, developed a computerized system to estimate execution times through the correlation of exchange data, rather than through time-stamping of execution tickets.[90] This computerized trade reconstruction ("CTR") system incorporated data from the bracketing of trades and time and sales data to impute the one minute time of execution. The CTR system also required traders to record their personal trades on pre-numbered sequential cards. Trades were required to be entered on the trading cards in the same chronological sequence in which they were executed. The system also required exchange members to record the time of execution for all trades executed *for other members* on the floor, either on a trading card or on an order ticket. In addition, the CTR system required clearing members to collect trading cards at times designated by the exchange, in theory preventing cards from being changed long after the fact. Clearing members were also required to synchronize their time clocks with the official time of the exchange.[91]

Following the disclosure in the *Chicago Tribune* of the FBI sting operation, the CFTC's Division of Trading and Markets examined the effectiveness of the Chicago Board of Trade's CTR system.[92] The Division concluded that the CTR processing logic was deficient in several respects. For example, the CFTC discovered that manual time information was not being placed on orders executed for other members, that

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89. *Id.* at 31,533. In adopting this requirement, the CFTC again stressed the difficulties it had encountered in trying to reconstruct trading while investigating suspected abuses:

> Enforcement staff sometimes spend hundreds of staff hours reconstructing trading in a single case, only to find that the timing, price, and other available data are not sufficiently precise to prove that the suspected trading abuses occurred, but also are so ambiguous that staff can not disprove such abuses.
>
> A principal reason many current reconstructions are unable to prove or disprove suspected trading abuses is because of price repetition within the time frame in which suspect trades are narrowed. Because of the volume of transactions, speed, and volatility of commodities trading, prices often recur, even within relatively short time periods. Consequently, even though order tickets and other data (*e.g.*, order tickets from members on the other side of the trade, and the time and sales register) sometimes may narrow the period in which a trade occurred to five minutes or less, unless the trade price occurred uniquely within that time period, often it is not possible to reconstruct trading accurately and precisely. The usefulness of the data obtained is inversely related to the ambiguities created by price repetition. The Commission found that a significant reduction in price repetition and such ambiguities does not occur unless the actual time of execution is established in one minute increments.

Id. at 31,540.

90. *See* CFTC Division of Trading and Markets, Rule Enforcement Review of the Chicago Board of Trade 55-56 (Feb. 17, 1989) [hereinafter *Rule Enforcement Review*].

91. *See id.* at 54-61.

92. *See id. passim* (CFTC report on Chicago Board of Trade efficiency); Berg, *C.F.T.C. Criticizes Exchange*, N.Y. Times, Feb. 22, 1989, at D1, col. 3 (CFTC criticized Chicago Board of Trade for lack of effectiveness).

many trades were missing time bracket designations, that time stamps on floor orders were sometimes missing, and that other entry information was sometimes in error. The Commission also discovered that trades were often bracketed incorrectly. The Division of Trading and Markets recommended that the Chicago Board of Trade improve the CTR system.[93] Subsequently, the Chicago Board of Trade announced several changes in the system, including a reduction of its bracketing period from 30 minutes to 15 minutes.[94] In contrast to these findings, a CFTC staff review conducted before public disclosure of the FBI sting operation found that the time input system of the Chicago Mercantile Exchange was a generally effective system, and that the exchange had an adequate audit trail system.[95] Like the Chicago Board of Trade's CTR, the Chicago Mercantile Exchange employed a computerized system that imputed times of execution by a mathematical formula.[96] The CFTC, however, did recommend various improvements in the Chicago Mercantile Exchange's CTR system.[97]

3. Dual Trading

During the hearings on the CFTC Act of 1974, the Administrator of the Commodity Exchange Authority said that floor brokers should be prohibited from trading for their own accounts while executing orders from customers, except where such a prohibition would unduly restrict the liquidity of trading or hinder the execution of customer orders.[98] "Prohibiting floor brokers from trading for their own accounts or for accounts in which they have an interest when they also are executing trades for customers would eliminate the possible conflict of interest now present when they are permitted to trade for customers and for their personal accounts."[99]

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93. *See Rule Enforcement Review, supra* note 90, at 101-04.

94. *See CBOT Board Approves Further Surveillance Enhancements,* Chicago Board of Trade News Release, Mar. 3, 1989; *see also CBOT to Set Up New Surveillance by Fall,* Investor's Daily, Mar. 6, 1989 (CBOT to implement system changes, including reduction in bracketing periods from 30 minutes to 15 minutes); *Chicago Board of Trade Plans Surveillance Steps,* Wall St. J., Mar. 6, 1989, at C12, col. 6 (same); Berg, *Chicago Board Acts on Its Timing,* N.Y. Times, Mar. 4, 1989, at 37, col. 3 (same). The Chicago Board of Trade also proposed requiring that members' trading cards be picked up at one hour intervals, that all trading cards be time-stamped by the exchange as they are taken from the floor, and that trades be submitted to the exchange within one hour after the trading cards have been collected for clearing. *See CBOT Board Approves Further Surveillance Enhancements,* Chicago Board of Trade News Release, Mar. 3, 1989; *see also CBOT To Set Up New Surveillance By Fall,* Investor's Daily, Mar. 6, 1989, at 21 (discussing additional regulations to enhance internal surveillance); *Chicago Board of Trade Plans Surveillance Steps,* Wall St. J., Mar. 6, 1989, at C12, col. 6; Berg, *Chicago Board Acts on Its Timing,* N.Y. Times, Mar. 4, 1989, at 37, col. 3.

95. *See* CFTC Division of Trading and Markets, Audit Trail Rule Enforcement Review of the Chicago Mercantile Exchange 67-68 (Sept. 27, 1988).

96. *See id.* at 3.

97. *See id.* at 3-5.

98. *See* H.R. Rep. No. 975, 93rd Cong., 2d Sess. 50 (1974).

99. *Id.* at 50-51. The witness for the Commodity Exchange Authority recommended

Congress did not adopt such a trading prohibition, but the CFTC Act of 1974 required the CFTC to determine whether floor brokers should be allowed to engage in dual trading.[100] The statute further provided that if the CFTC determined that dual trading should be permitted, the Commission was to specify the terms and conditions under which it would be conducted. In making those determinations, the CFTC was required to consider the effect on each affected market's trading liquidity. In addition, the Commission was allowed to make separate determinations for each contract market as to whether dual trading should be permitted.[101]

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that exchanges be required to adopt written rules designed to protect the interests of customers in the limited situations where dual trading was needed to assure liquidity on the floor of the exchange. *See id.* at 50. In a separate report the Subcommittee on Special Small Business Problems of the Permanent Select Committee on Small Business had recommended the elimination of dual trading. *See* Evans, Report of the Subcommittee on Special Small Business Problems of The Permanent Select Committee on Small Business, H.R. Rep. No. 963, 93rd Cong., 2d Sess. 52-54 (1974).

100. *See* 7 U.S.C. § 6j (1974). In connection with this legislation, the Comptroller General informed the Chairman of the House Agriculture Committee that

> [b]ecause of the inherent conflict of interest wherein a broker may in one instance be trading for a customer's account and in the next instance trading for his personal account, we believe that such practices should be closely regulated. We note that the Securities and Exchange Commission regulations do not permit a member of a national securities exchange to initiate, while on the exchange floor, any transaction in any security trading on the exchange for any account which he has discretion over or in which he has an interest.

CFTC Program Study Group, Report for the Commodity Futures Trading Commission: Dual Trading by Floor Brokers and FCM's, Projects No. 203-a and 203-b, at 2 (Feb. 4, 1975) (quoting Letter from the Comptroller General to the Chairman of the House Agriculture Committee (Feb. 13, 1974)). The reference by the Comptroller General to SEC regulations concerned the SEC's effort over several years to limit floor trading. *See, e.g.*, SEC, Report on the Feasibility and Advisability of the Complete Segregation of the Functions of Dealer and Broker 109-14 (1936) (recommendation to prohibit dual trading); Report of the Special Study of Securities Markets of the Securities and Exchange Commission, H.R. Doc. No. 95, 88th Cong., 1st Sess., Part 4, at 5-7, 166 (1963) (discussing SEC regulations concerning dual trading). *See generally* J. Seligman, The Transformation of Wall Street 327-35 (1982) (discussing studies of floor trading and SEC's attempts to limit it).

101. *See* 7 U.S.C. § 6j (1974). The statute required the CFTC to make this determination within nine months after the effective date of the Act, and subsequently upon determination that changes were necessary. Specifically, the CFTC was to determine

> whether or not a floor broker may trade for his own account or any account in which such broker has trading discretion, and also execute a customer's order for future delivery and, if the Commission determines that such trades and such executions shall be permitted, the Commission shall further determine the terms, conditions, and circumstances under which such trades and such executions shall be conducted: *Provided*, That any such determination shall, at a minimum, take into account the effect upon liquidity of trading of each market: *And provided further*, That nothing herein shall be construed to prohibit the Commission from making separate determinations for different contract markets when such are warranted in the judgment of the Commission, or to prohibit contract markets from setting terms and conditions more restrictive than those set by the Commission.

7 U.S.C. § 6j(1) (1974). The Act required the CFTC to make a similar determination about trading conducted by a brokerage firm. *See* 7 U.S.C. § 6j(2) (1974).

Initially, the CFTC staff conducted an internal review of dual trading[102] and created the Advisory Committee on Market Regulation to consider the issue.[103] The Advisory Committee concluded that dual trading was necessary to provide liquidity in the marketplace and that the practice promoted expertise among floor brokers.[104] The Committee believed, however, that additional regulations were needed to control potential abuses, and it urged the CFTC to conduct a study of time-stamping mechanisms that would permit more precise recording of the time of execution of trades in order to detect abuses.[105] The Committee further recommended that a study be made of the liquidity provided by dual trading.[106]

On December 12, 1975, the CFTC proposed regulations that would have required all contract markets that wished to continue to permit dual trading to adopt CFTC approved regulations governing such trading. The Commission proposed banning dual trading by floor brokers after January 16, 1977 on any contract market that had not submitted a plan to record order executions which permitted reconstruction of the sequence for futures transactions executed on the exchange.[107] The CFTC, however, never adopted this requirement.[108]

Instead, the CFTC concluded that the exchanges should adopt certain minimum standards for dual traders.[109] Some of the requirements

102. *See generally* CFTC Program Study Group, Report for the Commodity Futures Trading Commission—Dual Trading by Floor Brokers and FCM's, Projects No. 203-a and No. 203-b (Feb. 4, 1975) [hereinafter *Dual Trading by Floor Brokers*] (investigation of dual trading and recommendations).

103. *See Proposed Dual Trading Regulations*, *supra* note 9, at 20,842-43 (discussing Advisory Committee recommendations).

104. *See id.*

105. *See id.*

106. *See id.*

107. *See id.*

108. As discussed above, the CFTC eventually required exchanges to adopt programs that identify trade executions within one minute, but it did not tie this requirement to dual trading.

An early CFTC study group stated that "[i]t seems obvious that if on a particular exchange floor brokers do not have sufficeint [sic] time to record time of execution, it must follow that trading thereon is in such volume that liquidity thereon would not be reduced if dual trading were prohibited." *Dual Trading by Floor Brokers*, *supra* note 102, at 8. In other words, the CFTC argued that if dual trading was needed to assure sufficient liquidity in the pit then the trading volume could not be so high as to impair the ability to time-stamp trades. On the other hand, if there was so much liquidity that time-stamping was not possible, then it did not seem that dual trading was necessary. *See id.* at 8; *see also* Letter from James M. Stone, Chairman CFTC, to Congressman Ed Jones 10 (Feb. 23, 1982) (on file at *Fordham Law Review*) (balancing need for time-stamping against interest in maintaining market liquidity). The House of Representatives has passed a bill that would allow dual trading only in pits with low volume. *See* H.R. Rep. No. 236, 101st Cong., 1st Sess. 2-97 (1989); *infra* note 237 and accompanying text.

109. *See* 17 C.F.R. § 155.2 (1988). The CFTC stated that:

> Although the Commission is continuing its study of dual trading, and although the extent of the actual abuses of dual trading by floor brokers cannot be determined until some adequate method of reconstructing the sequence of

adopted were based on agency principles. Other restrictions considered but not adopted, such as a prohibition against "prearranged trading and other illegal noncompetitive trading," were viewed as already being violations of the existing Commodity Exchange Act and regulations thereunder.[110]

On December 23, 1976, the CFTC adopted regulations that required the exchanges to enact specified rules to prevent such trading practices.[111] Some of the requirements adopted were intended to prohibit floor brokers from purchasing or selling futures contracts for their own accounts while holding customer orders executable at the market price or at the price at which such purchase or sale could be made for the floor broker's own account.[112] The CFTC adopted this regulation to prevent floor brokers from placing their personal interests ahead of their customers' when exercising trading discretion over customer accounts.[113] The prohibition did not extend to accounts where the floor broker's discretion

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> floor trades is implemented, the Commission believes that, because of the possible conflict of interests which is inherent in dual trading, such trading should be permitted only if it is subject to a regulatory program which includes certain minimum standards . . . .

Proposed Dual Trading Regulations, *supra* note 9, at 20,843.

110. *See id.* at 20,843 & n.6. These regulations also addressed frontrunning or trading ahead of customer orders, where a dual trading floor broker, with a customer's order in hand, executes an order for his personal account ahead of the customer's order. *See* Trade Time-Sequencing Standards and Exchange Audit Trail Systems, [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,450, at 29,970 (Dec 27, 1984). Frontrunning was thus equated with trading ahead. *See id.* Frontrunning may also take other forms. *See* Markham, *"Front-Running"—Insider Trading Under the Commodity Exchange Act*, 38 Cath. U.L. Rev. 69, 83-92 (1989). Prearranged trading includes the situation in which a dual trading floor broker allocates favorable trades to his personal account or other accounts he controls, rather than to those of his customers. *See* Trade Time-Sequencing Standards and Exchange Audit Trail Systems, [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,450, at 29,970 (Dec. 27, 1984). Other forms of targeted trading abuses included bucketing or offsetting customer orders, as when a dual trading floor broker takes the opposite side of a customer's order into his own account or where a third account is used, resulting in the floor broker's account trading opposite a customer's account. *See id.* Wash trading also concerned the CFTC. Wash trading is the practice of entering into a transaction for the purpose of giving the appearance that purchases and sales are being made without actually taking a bona fide position in the market. *See id.*

111. *See, e.g.,* 17 C.F.R. § 155.2 (1988) (prohibiting prearranged dual trading). In adopting these requirements, the CFTC did not make dual trading contingent upon time-stamping. Instead, the CFTC stated that it was making an interim determination to permit dual trading while it gathered information necessary to determine whether dual trading abuses were of a magnitude that dual trading should be banned. *See Dual Trading Regulations; Trading Standards*, *supra* note 48, at 21,290-91. In deciding whether to allow dual trading to continue, the CFTC considered a report by its Advisory Committee on Regulation of Contract Markets and Self-Regulatory Associations, and a report prepared by two advisory committee members. The CFTC also received the testimony of more than thirty witnesses. *See id.*

112. *See* 17 C.F.R. § 155.2(a) (1988).

113. *See Dual Trading Regulations; Trading Standards*, *supra* note 48, at 21,294. "Simply stated, the newly adopted regulation is intended to require that under all circumstances the customer must come first." *Id.*

was simply limited to such matters as the selection of the precise time and price at which an order originated by the customer was executed, as in the case of a "not held" order.[114]

Although the requirements sought to prevent floor brokers from taking the best trades for their own accounts, the CFTC noted that there may be instances where a floor broker must allocate trades, as where the broker holds ten individual orders calling for the purchase of one contract each in the same commodity and delivery month. The floor broker could fill those orders almost simultaneously at different prices. In such instances, the executions at the lower price intervals should be assigned to the first orders received by the floor broker. Any other non-random assignment would constitute the discretionary allocation of trades among accounts which the CFTC regulations sought to prevent.[115]

The CFTC also required that contract markets adopt provisions to preclude floor brokers from disclosing the orders of their customers.[116] The CFTC stated that the prohibition against disclosure must be interpreted in light of its underlying purpose: "to prohibit a floor broker from disclosing customer orders to other persons who may take advantage of that knowledge."[117] The CFTC noted, however, that certain disclosures may take place in the normal course of a floor broker's legitimate business, as where a brokerage firm requests a status report on orders which it has previously placed with the floor broker.[118]

The CFTC also prohibited brokers from knowingly taking the opposite side of an order placed by someone with whom the broker has a relationship.[119] This requirement is similar to those of Section 4b[120] of the Com-

114. *See id.* at 21,295. The CFTC has interpreted the scope of this discretionary trading authority. *See* Interpretive Statement and Specification of Terms and Conditions for Certain Exemptions, [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,441, at 21,797-99 (July 7, 1977). The CFTC allows floor brokers discretion over the delivery month, in addition to time and price discretion. *See* Interpretation of Discretion Available to Floor Brokers with Regard to Hand-Off Requirements, [1980-1982 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,358, at 25,680-81 (Mar. 16, 1982).

A "not-held" order is generally an order in which the broker is given time and place discretion but is not responsible for losses. *See* T. Hieronymus, Economics of Futures Trading 63 (1977).

115. *See Dual Trading Regulations; Trading Standards, supra* note 48, at 21,295 n.13. The CFTC subsequently changed its rules to allow exchanges to promulgate regulations establishing appropriate allocation systems. *See* Proposed Rule Changes to Reg. § 155.2 to Eliminate Prohibition Against Allocation of Trades, [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,442, at 21,802 (July 7, 1977). This provision was subsequently adopted. *See* 17 C.F.R. § 155.2(g) (1988).

116. *See* 17 C.F.R. § 155.2(d) (1988).

117. *Dual Trading Regulations; Trading Standards, supra* note 48, at 21,295.

118. *See id.*

119. *See* 17 C.F.R. § 155.2(e) (1988).

120. *See* 7 U.S.C. § 6b (1982). Section 4b is the principal antifraud provision of the Commodity Exchange Act. *See* 7 U.S.C. § 6b (1982). *See generally In re* Wilkins, 2 Comm. Fut. L. Rep. (CCH) ¶ 24,390, at 35,699 (Jan. 26, 1989) (discussing broker taking opposite side of customer order as violation of § 4b).

modity Exchange Act and existing Regulations 1.38[121] and 1.39.[122] An exchange prohibition against prearranged trading[123] was also imposed to supplement Regulation 1.38,[124] which required transactions to be executed openly and competitively by open outcry on the floor of an exchange.[125]

The CFTC decided not to adopt regulations that would have required floor brokers to use due diligence in executing customer orders.[126] Instead, the Commission stated that it would consider that issue in the context of future rulemaking efforts which, subsequently, required registered persons to use due diligence in supervising their employees. The CFTC also noted that floor brokers were already implicitly obligated to exercise due diligence in all of their activities on behalf of customers.[127]

C. *Trade Practice Issues*

1. The Tax Trading Scandals and the First Chicago Grand Jury Inquiry

Long before 1982, traders used the commodity futures market as a tax shelter through tax straddles.[128] A trader wishing to defer gains or to convert short-term gains into long-term capital gains would purchase the right to buy a commodity under a futures contract in a particular delivery month. At the same time, the trader could sell the same futures contract with a different delivery month. If commodity prices thereafter dropped uniformly in both contracts, the futures customer would have a gain in one leg of the transaction and a loss in the other. To illustrate, assume that a trader entered into a futures contract to sell 5,000 ounces

121. 17 C.F.R. § 1.38 (1988). This regulation requires that all purchases and sales of futures contracts be "executed openly and competitively by open outcry or posting of bids and offers or by other equally open and competitive means, in the trading pit or ring or similar place provided by the contract market, during the regular hours prescribed by the contract market for trading" futures contracts. *See* 17 C.F.R. § 1.38(a) (1988).

122. 17 C.F.R. § 1.39 (1988). Regulation 1.39 governs how a broker is to execute opposing buy and sell orders of different customers that meet each other for execution. *See Dual Trading Regulations; Trading Standards, supra* note 48, at 21,295; *see also* CFTC Interpretive Letter No. 77-18, Interpretations of Section 4b(d) Regarding Affiliated Floor Brokers and FCM's, [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,508, at 22,101-03 (Oct. 21, 1977) (discussing crossing customer orders with proprietary accounts).

123. *See* 17 C.F.R. § 155.2(f) (1988).

124. 17 C.F.R. § 1.38 (1988).

125. *See Dual Trading Regulations; Trading Standards, supra* note 48, at 21,295. *See also infra* notes 200-207 and accompanying text (discussing CFTC regulation of noncompetitive trading).

126. *See Dual Trading Regulations; Trading Standards, supra* note 48, at 21,297.

127. *See* Adoption of Customer Protection Rules, [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,642, at 22,625 & n.5 (July 19, 1978); Proposed Standards of Conduct for Commodity Trading Professionals for the Protection of Customers, [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,474, at 21,936-37 (Sept. 6, 1977); *Dual Trading Regulations; Trading Standards, supra* note 48, at 21,297.

128. *See generally* J. Markham, *supra* note 9, at 153-56, 207-08 (discussing tax straddles and how they work).

of silver at $10 with delivery to be in March; such a tactic is called going short. At the same time, the trader agreed to buy 5,000 ounces of silver at $10.10 with delivery to be in November. The trader, in the second transaction, was going long.[129] Assume silver prices subsequently rose $1.00 in both contracts. The trader would then have a gain of $5,000 in the long transaction and an offsetting $5,000 loss in the short leg. In the short transaction, he was agreeing to sell something that was worth more than what he had agreed to sell it for and, in the long transaction, he had agreed to buy something that was worth more than what he had agreed to pay for it.[130]

If the taxpayer then liquidated the short leg in which there was a loss, he would realize a loss for tax purposes. If he offset the gain from the profitable leg of the transaction in the following tax year, the overall result would be a loss in the first year that could be used to offset other income or to convert income into long-term capital gain, while the overall transaction had no real economic effect.[131]

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129. The higher price for the November delivery reflects a phenomenon known as "contango." Generally, a futures contract with a more distant delivery date will trade at a higher price than a futures contract with a nearer term delivery date. The difference is attributable to theoretical storage charges and interest costs. *See id.* at 208; CFTC, Glossary of Some Terms Commonly Used in the Futures Trading Industry (1979).

130. *See* J. Markham, Commodities Regulation: Fraud, Manipulation and Other Claims § 14.01, at 14-1 to 14-2 (1988). The CFTC has described a spread as follows:

> The term spread (with its variants "switch," "straddle" and "exchange") is used generally by the industry to describe the purchase of one future against the sale of another future of equal size, where both futures are in the same or related commodities. This purchase and sale constitute the two "legs" of the spread. A significant, although not the only, impetus to spread trading is the expectation that the difference in the prices of these two legs (called the "differential" or "point spread") will either narrow or widen to approach what the market considers to be the appropriate differential at a subsequent point in time. For this reason spread trading appears to serve the constructive purpose of keeping the prices for various months aligned and offers other advantages to hedgers.
>
> . . . .
>
> A spread may be executed in one of two ways: By "trading the differential," or by "legging in" or "legging on." The term "trading the differential" refers to the practice of providing a bid or offer on the size of the differential. Acceptance of this quote results in the simultaneous purchase of 1 month and sale of another at the agreed-upon differential. One trades the differential in the "spread market," a reference not to a physically separate market but rather to a manner of executing both legs simultaneously at a differential.
>
> The terms "legging in" or "legging on" refer to the practice of obtaining the legs of the spread one at a time.

Advance Notice of Proposed Rulemaking on Spread Trading, [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,643, at 22,626-27 (July 24, 1978); *see* 80 Cong. Rec. 8089 (1936).

131. As the Seventh Circuit stated in *United States v. Winograd*:

> The key to the transaction is to liquidate the loss-bearing account or "leg" during the first tax year or in the short-term, and to liquidate the gain-bearing account or "leg," if possible, in the following tax year or in the long-term. The legs are usually immediately reestablished for future months, thus "rolling over" the transaction. If all goes as expected, the losses should nearly or exactly

If done legitimately, the tax straddle was an acceptable means of deferring taxes.[132] Not all traders, however, wanted to engage in legitimate tax straddles because they presented a risk that actual trading losses could be incurred that would not offset the tax benefits of a transaction. For example, if silver prices reversed themselves after liquidating the loss transaction, the trader could have an actual economic loss that would not be offset by the liquidated leg of the transaction. To legitimately foreclose this possibility, traders would, after liquidating the loss leg, reestablish a similar leg, which would continue to offset any further changes in futures prices. In the following year, the trader could then liquidate both legs and thereby avoid the possibility of large losses.[133]

Nevertheless, there remains a small risk of loss between the liquidation of the first leg and its reestablishment. In addition, variations in silver prices between different delivery months could actually result in a loss or, if a trader was lucky, an outright gain. Possible price fluctuations motivated so-called spread or straddle traders to profit from changes between delivery months. These changes were caused by events that might not affect all prices the same way because of differing perceptions of the long-term effects of the events.[134] To negate such risks in tax straddles, traders sometimes engaged in illegal wash transactions by entering into buy and sell transactions in the same commodity for the same delivery month. These wash sales effectively eliminated the risk of price variations in the liquidation and reestablishment of the loss legs.[135]

Tax straddle traders also engaged in transactions that were fictitious and prearranged to ensure that no outright losses occurred.[136] These transactions sometimes took the form of round-robin or rollover tax

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> equal the gains and thus there would be no real economic impact on the investor. Beneficial tax treatment results, however, when . . . the short term "losses" shelter other unrelated short-term gains in the first year, in effect converting the amount which would have been short-term gain in the first year into gain in the second year.

United States v. Winograd, 656 F.2d 279, 281 (7th Cir. 1981), *cert. denied*, 455 U.S. 989 (1982).

132. *See* Landreth v. Commissioner, 859 F.2d 643 (9th Cir. 1988); *Winograd*, 656 F.2d at 281; King v. Commissioner, [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,392, at 33,055 (T.C. Dec. 2, 1986); United States v. Atkins, [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,706, at 33,844 (S.D.N.Y. June 2, 1987); *see also* DeMartino v. Commissioner, 2 Comm. Fut. L. Rep. (CCH) ¶ 24,372, at 35,597 (2d Cir. Nov. 23, 1988) (losses incurred in crude oil futures by virtue of sham agreement not recognized for federal tax purposes); Yosha v. Commissioner, 2 Comm. Fut. L. Rep. (CCH) ¶ 24,368, at 35,573 (7th Cir. Nov. 8, 1988) (disallowing deduction where tax straddle designed solely to avoid tax liability); Forseth v. Commissioner, 845 F.2d 746 (7th Cir. 1988) (straddle transactions were shams and thus deduction of tax losses disallowed).

133. *See Winograd*, 656 F.2d at 281.

134. *See supra* notes 129-130.

135. *See, e.g.*, *In re* Jean Goldwurm, 7 Agric. Dec. 265 (CEA 1948); cases cited *infra* notes 149-202.

136. *See United States v. Winograd*, 656 F.2d 279, 281 (7th Cir. 1981), *cert. denied*, 455 U.S. 989 (1982).

spreads. In these prearranged transactions, three exchange members engaged in multiple round-robin transactions in particular futures contracts. The buy and sell orders for these transactions, entered simultaneously on the floor, were generally for large blocks of futures in illiquid delivery months. Because of their simultaneous entry, large size and the illiquidity of the contracts, the participants usually were assured that their prearranged buy and sell orders would be matched. The first round of those transactions resulted in large tax losses to participants in the current tax year. In the next tax year, however, the round-robin transactions were reversed so that the prior year's loss was, for the most part, recovered as a taxable gain. Predictably, a similar but greater series of such transactions would be conducted in subsequent tax years to create tax losses to apply against the gains from the prior rollover tax spreads and from other trading activities.[137]

Tax straddle traders also sometimes manipulated prices in illiquid commodity markets to acquire the necessary gains and losses and to protect against actual outright losses.[138] These and other fraudulent trading practices became the subject of several CFTC enforcement actions.[139] The CFTC was also responsible for the institution of grand jury proceedings in New York and Chicago.[140] Numerous criminal indictments were

137. Such activities were also conducted in the securities options markets. *See* Exchange Act of 1934, Release No. 14330 (Jan. 3, 1978).

For an illustration of how this can be done, see chart A on page 26 (not based on actual trades or prices).

In this illustration, each of the three brokers traded soybean contracts with January, April and July delivery dates. In the first set of transactions executed on November 1, each of the traders established a two hundred lot straddle position in soybeans. Thereafter, on December 1, each of the traders liquidated one leg of the transaction to establish a loss. At the same time, a new leg was created for each trader to protect the straddle. The traders set prices at levels they had previously agreed to so as to guarantee a uniform loss of minus three for each leg of the transaction. Thereafter, on January 10, the straddles were liquidated at prices that offset the prior losses. It should be noted that this sample is perfectly symmetrical and involves price relationships that are not likely to occur. In an actual transaction, the price differences would likely be much smaller and there could even be small variations that create profit or losses designed to conceal the fictitious nature of the transaction, or to pass profits on to brokers for accommodating the trades. In *In re* Gimbel, 2 Comm. Fut. L. Rep. (CCH) ¶ 24,213, at 35,004 (Apr. 14, 1988), three traders participated in prearranged transactions in which each trader initiated trades with the understanding that it would be matched so that, when the transactions were complete, the traders would have no market position and the net financial position of the group would be zero. *See* Lasker v. Bear Stearns & Co., 757 F.2d 15, 17 (2d Cir. 1985) (customer sued brokerage house for speculative tax benefits); Note, *The Tax Straddle Cases*, 1982 Duke L.J. 114, 116-25 (discussing several tax straddle incidents); Note, *Taxation: Commodity Straddles as an Income Sheltering Device*, 31 Okla. L. Rev. 233, 235-39 (1978) (detailed discussion of commodity tax straddles).

138. *See* United States v. Turkish, 623 F.2d 769, 770-71 (2d Cir. 1980), *cert. denied*, 449 U.S. 1077 (1981).

139. *See* J. Markham, *supra* note 9, at 153-56.

140. Newspaper reports concerning the grand jury in Chicago sound eerily similar to the recent reports on the FBI sting operations. For example, a 1976 Wall Street Journal article said:

		NOV		DEC		TAX		JAN		END	
		TRADE	AMOUNT	TRADE	AMOUNT	POSITION	AMOUNT	TRADE	AMOUNT	POSITION	AMOUNT
Broker A	JAN Soybeans	S200	@ 7-1/2			S200	0	B200	@ 4-1/2	0	+ 3
	APR Soybeans	B200	@ 10-1/2	S300	@ 7-1/2	0	−3			0	− 3
	JUL Soybeans			B200	@ 10-1/2	L200	0	S200	@ 10-1/2	0	+ 0
										0	−00
Broker B	JAN Soybeans			B200	@ 4-1/2	L200	0	S200	@ 4-1/2	0	+ 0
	APR Soybeans	S200	@ 10-1/2			S200	0	B200	@ 7-1/2	0	+ 3
	JUL Soybeans	B200	@ 13-1/2	S200	@ 10-1/2	0	−3			0	− 3
										0	−00
Broker C	JAN Soybeans	B200	@ 7-1/2	S200	@ 4-1/2	0	−3			0	− 3
	APR Soybeans			B200	@ 7-1/2	L200	0	S200	@ 7-1/2	0	00
	JUL Soybeans	S200	@ 13-1/2			S200	0	B200	@ 10-1/2	0	+ 3
										0	+00

Chart A

returned in both cities.[141] Investigators also discovered that the Commodity Exchange Inc. ("Comex") in New York had special trading rules that allowed straddles to be established in after-hours trading at any price that occurred during the trading range of the day, ensuring price fluctuations for tax purposes. The CFTC later prohibited this practice.[142]

In Chicago, grand juries indicted several soybean traders and in New York over forty traders were the subject of enforcement actions, all arising out of passing money, fraudulent trading and tax straddles.[143] In one Chicago case, *United States v. La Mantia*,[144] however, a district court held that the term "fictitious sale" in Section 4c of the Commodity Exchange Act was unconstitutionally vague.[145]

The CFTC's concern about tax straddles resulted in the passage of the

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> The two-month-old federal grand jury investigating soybean trading on the Chicago Board of Trade has found evidence of fictitious, prearranged trading by exchange floor traders and others, sources close to the investigation say. . . . [I]nsiders say that criminal indictments are possible for offenses ranging from income-tax fraud and evasion to violations of the Commodity Exchange Act.
>
> In recent weeks the investigation has widened to trading in other commodities on the Board of Trade and trading on the Chicago Mercantile Exchange. . . .
>
> For one thing, until recently, fictitious trades were relatively easy for floor traders to pull off, insiders say. Trades for their own account aren't time-stamped and immediately reported as are those executed on behalf of brokerage house customers and commercial hedgers. Also commodity exchange ticker tapes report only price changes and not individual trades.
>
> Thus traders operating together can rig an instant trading profit or loss by simultaneously taking a position and reversing it, based on futures prices that actually occurred earlier in the trading day. In contrast to legitimate trades, the transaction is without risk because the traders aren't subject to the vagaries of the market. The traders set in advance both the price at which the trade is made and reversed. Typically such trading is done off the floor for privacy.

Laing, *U.S. Study of Soybean Trading is Seen Leading to Tax-Law, Other Indictments*, Wall St. J., Aug. 9, 1976, at 18, col. 2. *Compare id.* with articles cited *supra* notes 1-5.

141. These indictments were for passing money, fraudulent trading and illegal tax straddles. *See, e.g.*, Sundheimer v. CFTC, 688 F.2d 150, 153 (2d Cir. 1982) (floor brokers indicted for knowingly aiding in preparation of fraudulent tax return), *cert. denied*, 460 U.S. 1022 (1983); United States v. Turkish, 623 F.2d 769, 771 (2d Cir. 1980) (illegal tax straddle), *cert. denied*, 449 U.S. 1077 (1981); United States v. La Mantia, [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,667, at 22,716 (N.D. Ill. Aug. 9, 1978) (defendant indicted for role in fictitious sales and fraudulent tax return preparation); J. Markham, *supra* note 9, at 156 (discussing tax straddle cases).

142. *See* 45 Fed. Reg. 43,820, 43,820-24 (June 30, 1980); 46 Fed. Reg. 23,516, 23,516 (Apr. 27, 1981); 1981 CFTC Ann. Rep. 76; 1980 CFTC Ann. Rep. 119. The Comex unsuccessfully challenged the CFTC's action in court. *See* Commodities Exchange Inc. v. CFTC, 543 F. Supp. 1340 (S.D.N.Y. 1982), *aff'd*, 703 F.2d 682 (2d Cir. 1983); J. Markham, *supra* note 9, at 143.

143. *See In re* Jules Nordlicht, CFTC Doc. No. 79-31 (Jan. 7, 1981); *In re* Ralph J. Hemminger, CFTC Doc. No. 78-6 (Nov. 21, 1977); *In re* Alfred Perlmutter, CFTC Doc. No. 79-33 (Dec. 3, 1979); J. Markham, *supra* note 9, at 155-156.

144. [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,667, at 22,715 (N.D. Ill. 1978).

145. *Id.* at 22,717.

Economic Recovery Tax Act of 1981,[146] which changed the ways in which commodities futures transactions are taxed. Under the Act, tax straddles are now taxed at year-end by being marked to their market price even if the transaction has not been liquidated. If there is an open gain in one leg of a straddle and a realized loss of the closing of the other leg, the gain is taxed as if it had been closed. This eliminates the usefulness of tax straddles as well as the need for wash sales and other trading techniques which sought to reduce trading risks.[147] Nevertheless, much of the law concerning prohibited trading practices is based on cases against traders engaging in tax straddles brought prior to the Economic Recovery Tax Act of 1981.

For example, in *In re Jean Goldwurm*,[148] the Commodity Exchange Authority charged that the respondents had engaged in wash and fictitious sales by executing purchase and sale contracts simultaneously to convert short-term income into long-term capital gains. These transactions were found to be artificial for trading purposes and fictitious because they were simply matched off against each other. The judicial officer determined that the Commodity Exchange Act sought to prohibit such wash sales because they were artificial and not the result of arms-length trading based on supply and demand. The traders, their brokers and the floor brokers who handled the orders were held liable.[149]

A similar case is *In re Thomas Jordan & Co.*,[150] where wash sales were conducted in cotton futures contracts on the New Orleans Cotton Exchange. The orders at issue in *Jordan* were reciprocal purchase and sale transactions that offset each other and washed each other out. The judicial officer ruled that where offsetting purchases and sales are made for the same customer, no change in ownership takes place because the trader is buying and selling to himself. Such transactions were held to be wash sales and fictitious sales.[151] Similarly, in *Peers & Co.*,[152] simultane-

146. Pub. L. No. 97-34, 95 Stat. 172 §§ 501-09 (1981) (codified as amended at 26 U.S.C. § 1256 (1986)).

147. *See generally* 2 T. Russo, Regulation of the Commodity Futures and Options Markets § 15.01, at 15-2 (Economic Recovery Tax Act of 1981 designed to thwart illegal tax avoidance schemes); Lee, *The Taxation of Commodity Straddles Under the Economic Recovery Tax Act of 1981*, 28 Prac. Law. 11, 12-13 (1982) (illustrating tax avoidance opportunities which Act sought to foreclose).

The Economic Recovery Tax Act of 1981 apparently did not stop all futures trading abuses for tax purposes. The CFTC and grand jury probe in New York is apparently focusing on wash trades and possibly other forms of tax motivated illegal transactions. *See, e.g.*, Power & Siconolfi, *Key Traders Face Glare of Inquiry*, Wall St. J., May 8, 1989, at C1, col. 6 (detailing investigation into prearranged trading, frontrunning and wash sales to avoid taxes); Eichenwald, *Commodity Inquiry Said to Have a Second Focus*, N.Y. Times, May 6, 1989, at 43, col. 3 (discussing investigation into frontrunning on New York commodities exchanges); Eichenwald, *New York Commodity Inquiry*, N.Y. Times, May 5, 1989, at D1, col. 6 (reporting investigation of N.Y. brokers and traders).

148. 7 Agric. Dec. 265 (1948).

149. *See id.* at 280-81.

150. 7 Agric. Dec. 381 (1948).

151. *See id.* at 384-86.

ous purchase and sale orders for two firms controlled by a single individual were held to be wash sales and fictitious sales.[153]

Later CFTC cases paralleled the Commodity Exchange Authority opinions. For example, in *In re Siegel Trading Co.*,[154] the CFTC charged that fictitious tax straddles were conducted in order to shelter some $500,000 through a butterfly straddle in Mexican peso futures on a Chicago exchange. In a butterfly straddle, the trader is long in one delivery month and short half of the number of long futures in both a prior and a subsequent delivery month; the goal is to reduce risks caused by fluctuations in different delivery months. The butterfly straddle in *Siegel* involved 1,000 contracts. On several occasions parts of the straddle were lifted so that losses could be realized on the losing legs. On each occasion a new leg was established to protect against the deterioration of the offsetting profits on the opposing side of the transaction. In the following year, a 2,000 contract straddle was established. This practice was not uncommon as traders had to increase the size of their straddles each year to carry over the current and previous gains. This straddle was offset six months and one day after it was established.

The CFTC charged that the trades were fictitious and prearranged and not subject to competitive bidding on the floor of the exchange. The Commission found that the broker had offset and taken the opposite side of the customer's orders to carry out the straddle without risk, and that he had bucketed orders. The broker thus became the buyer of the customer's short positions and the seller of the customer's long positions. Wash sale violations were also found based upon the analysis employed in *Goldwurm*.[155] The CFTC found that in lifting and reestablishing the legs of the straddle, the trades were opened and closed at substantially the same price and that the transactions were prearranged and executed in a noncompetitive manner. The Commission found that the parties had engaged in other prohibited practices, including the passing of profits from floor broker accounts to the customer. The CFTC found that passing money was not a legitimate method of trading and held this conduct to be wash and fictitious trading.[156]

2. Prohibited Trading Practices

The CFTC has also pursued floor trading abuses outside the area of

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152. 13 Agric. Dec. 597 (1954).

153. *See id.* at 601-02; *see also In re* John T. Lyons, 26 Agric. Dec. 221 (1967) (brokers buying from and selling to each other the same amount at same price held to be wash sales or fictitious sales).

154. [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,452, at 21,827 (C.F.T.C. July 26, 1977), *proceedings stayed*, [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,862, at 23,532 (C.F.T.C. July 27, 1979).

155. *In re* Jean Goldwurm, 7 Agric. Dec. 265, 276 (1948).

156. *See In re* Siegel Trading Co., [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,452, at 21,849 (C.F.T.C. July 26, 1977).

tax straddles. For example, in *CFTC v. Savage*[157] the CFTC charged that Jack Savage, a broker on the floor of the Mid-American Commodity Exchange in Chicago, had defrauded customers through a series of prearranged transactions in which he bought contracts for customer accounts at a firm that controlled their trading and simultaneously sold futures contracts for the accounts of other customers. The result was that "Savage sustained losses with respect to [some] customers who had deficits in their accounts and enjoyed profits on transactions with [other] customers who had credit balances in their accounts."[158] The net effect of the transactions was that Savage's losses and gains were substantially offset, and customer funds were simply shifted between accounts with deficits and those with credits. These "Robin Hood" transactions were done in order to avoid the need to meet CFTC segregation of fund requirements.[159] In addition, the Commission charged that Savage had engaged in other prearranged trades between himself and the customers of the firm in which he became the buyer with respect to customer sell orders and the seller with respect to customer buy orders in a manner that assured his profits.

The Ninth Circuit reversed in part an order of summary judgment against Savage because the CFTC had not shown that Savage intentionally had violated the anti fraud provisions of Sections 4b[160] and 4c[161] of the Act.[162] The Ninth Circuit held that the CFTC must show, for purposes of Sections 4b and 4c, that the floor broker's acts were done with knowledge of their nature and character. In other words, for purposes of Section 4b the trader must have known that he was cheating, that he was making a false report, that he was deceiving or that he was taking the opposite side of the transaction. The court held that knowledge exists when one acts in careless disregard of whether his acts amount to cheating or fraud.[163] Such knowledge, the court ruled, "cannot be precluded by ignorance brought about by willfully or carelessly ignoring the truth."[164]

The court also addressed the provisions of Section 4c that prohibit wash trading, cross trades, accommodation trading and fictitious sales.[165] The court noted that Congress viewed such transactions as "pure, un-

157. 611 F.2d 270 (9th Cir. 1979).

158. *See id.* at 275.

159. *See id.* at 275 n.5; Commodity Exchange Act § 4b (codified at 7 U.S.C. § 6b (1982 & Supp. V. 1987)) (fund segregation requirements); *see also* 17 C.F.R. § 1.20 (1988) (segregation of customer funds in certain trust accounts).

160. Commodity Exchange Act § 4b (codified as amended at 7 U.S.C. § 6b (1982 & Supp. V 1987)).

161. Commodity Exchange Act § 4c (codified as amended at 7 U.S.C. § 6c (1982 & Supp. V 1987)).

162. *See* CFTC v. Savage, 611 F.2d 270, 283-84 (9th Cir. 1979).

163. *See id.* at 284.

164. *Id.* at 283.

165. *See* Commodity Exchange Act § 4c (codified at 7 U.S.C. § 6c (1982 & Supp. V 1987)).

adulterated fraud"[166] and it cited *Goldwurm*[167] for the proposition that the essential characteristic of a wash sale is the intent not to make a genuine bona fide trade.[168] On the other hand, "one can not have an 'accommodation' sale or a 'fictitious' transaction if one in fact believes he is bargaining faithfully and intends to effect a bona fide trade."[169] Again, however, "the required knowledge [could] not be eliminated by willfully or carelessly induced ignorance."[170]

In another case, *In re Citadel Trading Co.*,[171] the CFTC found wash sales to be a violation of the Commodity Exchange Act.[172] In *Citadel*, two floor brokers had prearranged transactions in customer discretionary accounts of a brokerage firm. The Commission found that the brokers executing these transactions entered orders opposite each other in order to generate commissions.[173] The frequency of the wash result, the relatively short period between the entry and fill of the orders and the inability of other traders to garner even a share of the orders also evidenced that the transactions were prearranged wash sales. Furthermore, the floor broker who figured in the *Savage* case had engaged in transactions with accounts of this brokerage firm so that customers would sustain losses in their discretionary accounts while Savage was assured of profits. The CFTC review board found that Savage returned a portion of these illicit profits in cash to a principal of the brokerage firm.[174] Because money returned in such transactions was often carried in a gym bag, the transactions became known as "bag" trades.[175]

166. CFTC v. Savage, 611 F.2d at 284 (quoting 80 Cong. Rec. 7905 (1936)) (remarks of Sen. Smith).

167. *In re* Jean Goldwurm, 7 Agric. Dec. 265 (1948).

168. *See* CFTC v. Savage, 611 F.2d at 284.

169. *Id.*

170. *Id.*

171. [1980-1982 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,238, at 25,165 (C.F.T.C. Aug. 31, 1981), *aff'd*, [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,082, at 32,182 (May 12, 1986).

172. *See id.* at 25,180.

173. *See id.* at 25,185.

174. *See id.* at 25,185-86.

175. The Chicago Sun Times defined a bag trade as follows:

> [W]hen markets are volatile, with prices moving quickly, traders sometimes arrange schemes in which they fill a customer's order at a price that doesn't reflect the market. In a typical case, a broker may sell a contract for 5,000 bushels of soybeans to a colleague for $4 a bushel while prices are moving up. The other trader then sells the contract at the market price, say $4.05, and pockets the 5 cents-a-bushel profit, for a gain of $250 on the trade. The traders may then either split the profit or return the favor.

Burns & Greising, *Will Probe Outcry Peril Open Outcry?*, Chicago Sun Times, Jan. 22, 1989, at 60, col. 1.

Bag trades and other fictitious trading practices were also the subject of the indictments recently returned in Chicago. One indictment stated that:

> It was further a part of the scheme that the defendants would accommodate one another in illegal, prearranged trades, sometimes called "bagged" trades, at the expense of and to the financial detriment of brokers' customers. Traders who regularly accommodated particular brokers were called "bagmen." The de-

fendants participated in various illegal and prearranged trades to facilitate the theft and misappropriation of customer funds and opportunities as follows:

a. Using their knowledge of a customer's order, defendant brokers would trade ahead of the customer order by arranging with an accommodating trader for the traders to take a market position prior to the filling of the customer's order. When the customer's order was then filled, the previously taken position would be made more profitable. The accommodating trader would then liquidate the profitable position and transfer a portion of the profit back to the broker or the broker's designee.

b. Defendant-brokers would arrange with accommodating traders for the traders to take the opposite side of their customer orders — that is sell to a buying customer and buy from a selling customer — to misappropriate customer profit and opportunity. A portion of the profit would later be transferred back from the accommodating trader to the broker or the broker's designee.

c. Defendant-brokers and accommodating traders would arrange for the traders to take the opposite side of the broker's customer orders in order to protect the broker against personal liability for customer loss caused by the broker's failure to execute the customer orders at the appropriate prices, as well as losses caused by market shifts, out-trades, errors and omissions. The loss incurred by the accommodating trader would often be repaid by the broker through later, illegal prearranged ("allocated"), profitable ("winning") trades at the expense of the broker's other customers.

d. Defendant-brokers and accommodating traders would arrange for the traders to engage in prearranged trades to accept losses for brokers' personal trading activity and other errors which losses the brokers would later repay to the traders by misappropriating customer profit and market opportunity.

e. Defendant-brokers and accommodating traders would arrange for the traders to take the opposite side of customer orders in prearranged trades to help the broker fill the order at a price favorable enough to the customer to allow the broker to maintain the customer order flow, resulting commissions and theft opportunities.

f. Defendant-brokers and accommodating traders would illegally offset customer orders by placing the traders in the middle of the customer "buy" and "sell" orders, with the prearranged trades guaranteeing the accommodating trader a profit, a portion of which would be kicked back to the defendant-brokers by way of other prearranged trades.

g. Defendant-brokers and accommodating traders would arrange for the traders to trade out of positions for themselves and brokers on the curb as long as one hour and fifteen minutes after the close of the market.

h. Defendant-brokers and accommodating traders would arrange for traders to kickback a varying percentage of misappropriated customer funds to the broker by placing money into the broker's personal trading accounts and those designated by the brokers. Those illegal funds would be transferred through illegal prearranged trades, through false out-trade checks, by cash, and by offset between accommodating traders.

i. Defendant-brokers would manipulate and prearrange trades involving "price or limit" or "stop" orders in order to assure a fellow broker or accommodating trader a profitable position while ostensibly filling the order as instructed, thus denying the customer his right to an opportunity for an execution of the order at the best available price.

j. Defendants would engage in illegal prearranged trades to pass money, usually stolen customer money, between personal accounts.

United States v. Dempsey, No. 89-666, indictment at 18-20 (N.D. Ill. Aug. 2, 1989).

In re Murphy[176] involved so-called "ginzy" trades. In a ginzy trade, traders arrange to take disadvantageous prices on some orders and advantageous prices on others so that they can effectively trade in half tick differences.[177] This practice was common in the T-Bond pit on the Chicago Board of Trade. When a ginzy was done at a disadvantageous price, it was the custom on the floor for the trader experiencing the disadvantageous price to receive a subsequent ginzy at an advantageous price without public outcry. The CFTC held that this was noncompetitive trading in violation of regulation 1.38.[178]

The *Murphy* case signaled a new, tough approach by the CFTC to floor trading abuses. Thereafter, in *In re Collins*,[179] the CFTC held that a trader engaged in illegal wash trades when he entered simultaneous buy and sell transactions in commodity futures contracts for the same commodity with identical delivery dates. The trader made these trades to reposition himself in the delivery line, in which traders holding the oldest positions are given delivery notices first. To avoid this, the trader would close his position and immediately reestablish the same position so that he would receive an earlier date on his trades, thereby delaying receipt of delivery notices. As a result, the trader could stay in the market for a longer period.[180] The Commodity Exchange Authority had ruled previously that such trading was wash trading and the CFTC agreed.[181] The Commission also found that the trades were prearranged and fictitious in violation of the Commodity Exchange Act.[182]

In *In re Collins*, the CFTC also noted that in *United States v. La Man-*

176. [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,798, at 31,339 (C.F.T.C. Sept. 25, 1985).

177. Trading had been conducted previously in half tick differences, but changes in the law made such trading unprofitable. A new innovation, however, has created synthetic half ticks. Ginzy trades take advantage of these synthetic half tick differences. *See* J. Markham, *supra* note 9, at 175.

178. *See In re* Murphy, [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,798, at 31,354 (C.F.T.C. Sept. 25, 1985); *see also* 17 C.F.R. § 1.38(a) (1988) (prohibiting non-competitive trading). The CFTC recently brought another ginzy case. *See In re* John K. Angelo, CFTC Doc. No. 89-5 (filed Apr. 13, 1989). *See generally 22 Traders Face Charges*, N.Y. Times Apr. 12, 1989, at D15, col. 5 (discussing *Angelo*); McMurray, *CFTC Alleges 'Ginzy' Trading by 22 at Board of Trade*, Wall St. J., Apr. 11, 1989, at C1, col. 2 (same).

179. [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,982, at 31,896 (C.F.T.C. Apr. 4, 1986), *modified*, [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,401, at 33,077 (Nov. 26, 1986), *rev'd sub nom.* Stoller v. CFTC, 834 F.2d 262 (2d Cir. 1987).

180. *See id.* at 31,900.

181. *See* Letter from Douglas Bagnell, Deputy Administrator, Commodity Exchange Authority, to exchange supervisors and staff of the Commodity Exchange Authority (November 25, 1955) (discussing trading to delay or avoid delivery) (on file at *Fordham Law Review*); Letter from Alex B. Caldwell, Administrator, Commodity Exchange Authority, to Everette B. Harris, President of the Chicago Mercantile Exchange (Sept. 13, 1971) (discussing Commodity Exchange Authority position on trading to avoid or delay delivery) (on file at *Fordham Law Review*).

182. *See Collins*, [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) at 31,901-03.

tia[183] a district court had held that the term "fictitious sale" was unconstitutionally vague.[184] The CFTC, therefore, believed it was appropriate to provide future guidance as to the meaning of this term. The Commission stated that the central characteristic of a fictitious sale is "the appearance of submitting trades to the open market while negating the risk or price competition incident to such a market."[185] The CFTC held that prearranged trading is a form of fictitious trading.[186] The CFTC also reversed its earlier position, taken in *In re Sundheimer*,[187] that prearranged transactions resulting in actual trades in the pit did not constitute fictitious trading.[188] The CFTC held in *Collins* that the test to determine whether prearranged trading is a fictitious sale is whether information such as price and quantity is determined outside the pit and whether the execution of the transaction in the pit is designed to "shield the private nature of the bargain from public scrutiny."[189] The CFTC asserted that both price competition and market risks were eliminated in such circumstances.[190]

The CFTC did not apply the views on futures trading expressed in *Collins* retroactively to prearranged trading, but it did so with respect to its finding of the wash sales.[191] Subsequently, the Chicago Mercantile Exchange requested clarification of the CFTC's position on wash trading in *Collins*.[192] The CFTC replied that a wash trade took place where the respondent knowingly participated in transactions initiated with the intent to avoid a bona fide market position.[193] The exchange was concerned with the practices of "scalpers" on the floor of the exchange who engage in quick in-and-out trading to obtain small gains and to limit their losses. These traders often engage in "scratch" trades in which

183. [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,667, at 22,715 (N.D. Ill. Aug. 9, 1978).

184. *See In re* Collins, [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,982, at 31,901 (C.F.T.C. Apr. 4, 1986), *modified* [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,401, at 33,077 (Nov. 26, 1986), *rev'd sub nom.* Stoller v. CFTC, 834 F.2d 262 (2d Cir. 1987).

185. *Id.* at 31,902.

186. *See id.* at 31,901-03.

187. [1980-1982 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,245, at 25,219 (C.F.T.C. Sept. 16, 1981), *aff'd* 688 F.2d 150 (2d Cir. 1982), *cert. denied*, 460 U.S. 1022 (1983).

188. *See In re* Collins, [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,982, at 31,903 n.23 (C.F.T.C. Apr. 4, 1986) (prearranged trading resulting in actual trades in pit is fictitious trading), *modified*, [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) at 33,077 (Nov. 26, 1986), *rev'd sub nom.* Stoller v. CFTC, 834 F.2d 262 (2d Cir. 1987).

189. *Id.* at 31,903.

190. *See id.*

191. *See id.* at 31,902.

192. *See In re* Collins, [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,112, at 32,283 (C.F.T.C. June 18, 1986).

193. *See In re* Collins, [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,401, at 33,077 (C.F.T.C. Nov. 26, 1986), *rev'd sub nom.* Stoller v. CFTC, 834 F.2d 262 (2d Cir. 1987).

there is no profit or loss. Traders in the Chicago Mercantile Exchange expressed concern that the CFTC's opinion in *Collins* could preclude that type of trading. The CFTC stated that this was not the case. The CFTC asserted that *Collins* did not prohibit scratch trades as a form of wash trades, but said that wash trades were those that involved techniques that gave the appearance of submitting trades to the open market while eliminating the risk of price competition.[194]

Subsequently, on appeal, the Second Circuit, in *Stoller v. CFTC*,[195] reversed the CFTC on its wash sale holding in *Collins*. The Second Circuit found that the CFTC's clarification at the request of the exchange had not given fair notice of what was a prohibited wash trade and that the Commodity Exchange Authority's views on the type of trading engaged in by Stoller, the trader involved in *Collins*, had not been broadly publicized. The Court also noted that wash trades involved virtually risk-free transactions which were often prearranged and intentionally designed to mislead.[196] The transactions in the *Collins* case were not of that ilk. Although designed to minimize risk, they served a legitimate commercial purpose. The Court stated that the subtle distinctions expressed by the CFTC in its clarifying opinion could not be applied to Stoller.[197]

Undaunted by its setback in *Stoller*, the CFTC subsequently maintained in *In re Gimbel*[198] that it would continue to apply its views as expressed in *Collins*.[199] In *Gimbel*, the CFTC asserted that a prearranged transaction in the pit is a fictitious sale where it appears to be the result of open outcry but where risk and price competition incident to an open outcry market are actually negated.[200] The CFTC also stated that a fictitious transaction need not be structured to negate both market risk and price competition; it is sufficient if the transaction is structured to negate price competition or market risk. Price competition or market risk is negated when it is reduced to a level that has no practical impact on the transaction.[201] In determining whether a prearranged transaction is present, the CFTC will look at the transaction as a whole and not at its constituent parts. In this case, each individual trade was initiated with the understanding that it would be matched. As a result, "when the prearranged transaction was complete, the three traders would have no market position and the net financial position of the group would be zero."[202]

The CFTC's regulatory scheme also prohibits noncompetitive trading.

194. *See id.* at 33,077-78.
195. Stoller v. CFTC, 834 F.2d 262 (2d Cir. 1987).
196. *See id.* at 266.
197. *See id.* at 266-67.
198. 2 Comm. Fut. L. Rep. (CCH) ¶ 24,213, at 35,002 (C.F.T.C. Apr. 14, 1988).
199. *See id.* at 35,003 n.6.
200. *See id.* at 35,003.
201. *See id.* at 35,003 n.7.
202. *Id.* at 35,004.

Indeed, Regulation 1.38,[203] adopted by the CFTC's predecessor, is a central element of the federal regulatory efforts. This regulation requires that all purchases and sales of futures contracts be "executed openly and competitively by open outcry or posting of bids and offers or by other equally open and competitive methods, in the trading pit or ring or similar place provided by the contract market, during the regular hours prescribed by the contract market for trading" futures contracts.[204]

For example, in *In re Laiken*,[205] the CEA held that Regulation 1.38 was violated where a floor broker received a customer order and handed it to another floor broker for execution. As soon as the floor broker offered the order, the broker who initially had received the order accepted it for his own account. Although offered by open outcry, it was found that the transaction was a sham because no one else had a realistic opportunity to participate in the transaction.[206] The Second Circuit upheld the decision in *Laiken v. United States Department of Agriculture*.[207]

Regulation 1.38 embodies a concept critical to the conduct of commodity futures trading: trades must be competitive.[208] Unfortunately, the CFTC has apparently equated this desirable goal with a requirement that there be no discussion or "shopping" of orders before their entry into the pit.[209] The CFTC's narrow view of competition guarantees that the only competition allowed is that of floor brokers, many of whom are trading for their own account and enjoying the time and place advantage of a position on the floor where all trades are executed. Those advantages, coupled with dual trading and the lack of an adequate audit trail to uncover misconduct, foster abuses, reduce competition and give floor traders significant control over orders flowing into the pits.[210]

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203. 17 C.F.R. § 1.38 (1988).

204. *Id.*

205. 23 Agric. Dec. 1193 (1964), *aff'd*, 345 F.2d 784 (2d Cir. 1965).

206. *See id.* at 1201.

207. 345 F.2d 784 (2d Cir. 1965). The Commodity Exchange Authority found similar conduct in *In re* Marks. 20 Agric. Dec. 457 (1961).

208. *See* 17 C.F.R. § 1.38 (1988).

209. *See In re* Collins, [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,982, at 31,903 (C.F.T.C. Apr. 4, 1986), *modified*, [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,401, at 33,078 (Nov. 26, 1986), *rev'd sub nom.* Stoller v. CFTC, 834 F.2d 262 (2d Cir. 1987).

210. The term prearranged trading is not contained in the Commodity Exchange Act. Instead, the statute prohibits "fictitious" trades. *See* 7 U.S.C. § 6c (1980). The CFTC, however, has equated prearranged trading with fictitious trading. *See Collins*, [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) at 31,903. This expansive view of prearranged trading does not square with common understanding. As noted in a Chicago Sun Times article:

> Prearranged trading. Traders sometimes illegally meet outside the trading pit to plan the price or size of trades. By arranging such noncompetitive trades, they can try to manipulate the price of the trade, or steer business to each other, freezing out other traders.

Burns & Greising, *Will Probe Outcry Peril Open Outcry?*, Chicago Sun Times, Jan. 22, 1989, at 60, col. 4. Thus, the key objection to prearranged trading is that it is an effort to exclude other traders and reduce or eliminate competition. If, however, the trade is exe-

Large block trades are an area of particular concern in this regard.[211] Block trades are large orders entered by institutions that may have an undue effect on market prices if entered in the trading pit without being previously positioned with an opposite buyer or seller.[212] A large block trade may drive down prices disproportionately, particularly in illiquid markets where prior placement may be the only method of execution.[213] Realizing that block trades can have such effects, the securities exchanges have long allowed traders to arrange and negotiate large block trades off the exchange floors.[214] The CFTC, however, has not allowed such block trading to occur because of its concern that such transactions are by their very nature prearranged.[215]

The result is that a block trader who prearranges a trade in securities is considered to be undertaking the beneficial task of ensuring sufficient liquidity in the marketplace and the best possible price is being obtained for the block trader, as well as precluding an undue effect upon prices caused by a large block transaction. In contrast, the CFTC deems the same broker providing the same service to a customer in the commodities industry to be in violation of a federal law.[216]

There is no basis for this distinction between securities and commodities.[217] Indeed, as a result of the stock market crash of 1987, the SEC recommended that this disparity in regulation be examined, because large stock index futures trades could have an adverse effect on securities

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cuted competitively in the pit and all traders are allowed to participate, prior negotiations concerning order size or price would not result in a noncompetitive trade. On the contrary, price negotiations could bring additional liquidity into the pit and enhance competition. *See* Committee on Futures Regulation of the Association of the Bar of the City of New York, Large Order Execution in the Futures Markets 19-20 (Jan. 30, 1989) (hereinafter *City Bar Association Report*); SEC, Recommendations Regarding the October 1987 Market Break 16 (Feb. 3, 1988); *cf.* Petacque & Greising, *'Charades' Played in Pits,* Chicago Sun Times, Jan. 27, 1989, at 3, col. 1 (report on allegations that hundreds of trades faked after being secretly rigged ahead of time).

The indictments in Chicago alleged a broad array of rigged trading devices, including "curb" trades arranged before or after the close of trading. *See, e.g.,* United States v. Dempsey, No. 89-666, indictment at 20-21 (N.D. Ill. Aug. 2, 1989).

211. *See generally* Report of the Special Study of the Options Markets to The Securities and Exchange Commission, 96th Cong., 1st Sess., Comm. Print 96-IFC 3 at 159 (Dec. 22, 1978) (discussion of block trades); M. Mayer, Markets 282 (1988) (same).

212. Block trades may also have an undue effect on market prices if institutions are not informed that these orders will be entered on the floor. *See City Bar Association Report, supra* note 210, at 7-8; *see also* Seifert & Turnbull, *Institutional Trading Mechanisms in Futures and Securities,* FIA Rev. July-Aug. 1988, at 12, 14.

213. *See City Bar Association Report, supra* note 210, at 3-6.

214. *See id.*

215. *See id.* at 10.

216. *See In re* Collins [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,982, at 31,903 (C.F.T.C. Apr. 4, 1986), *modified,* [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) at 33,077 (Nov. 26, 1986), *rev'd sub nom.* Stoller v. CFTC, 834 F.2d 262 (2d Cir. 1987).

217. *See* Norris, *Marketplace: Block Trading in Commodities,* N.Y. Times, Feb. 14, 1989, at D8, col. 3.

prices.[218]

A recent report issued by the Committee on Futures Regulation of the Association of the Bar of the City of New York examined block trading at length.[219] The report noted that the CFTC had considered a form of "sunshine trading" where orders would be announced prior to their entry on the floor so that traders could contact customers and seek their participation in the trade before the order is entered for execution in the pit.[220] The Bar Committee concluded the proposed sunshine trading would not undermine the purposes of competitive execution.[221] The Bar Committee suggested that the CFTC regulate such trading in a manner similar to the securities industry, permitting the practice as long as:

> 1. The size of order eligible for such procedures should be such that: (a) in view of the liquidity of the particular market, there is a reasonable probability that the order could not be effected without itself causing a substantial effect on price; and (b) the order is of a size typically used by commercial participants;
> 2. The transaction should have to be bid or offered on the contract market, by open outcry or other competitive method, with adequate opportunity for public participation; and
> 3. Any portion of the transaction that is not promptly taken up at the ring may be crossed, with the floor broker and/or the FCM [brokerage firm] taking the opposite side (with the consent of the customer), but only at the price bid or offered on the contract market.[222]

The Bar Committee noted, however, that the decision on whether a brokerage firm should permit the execution of commodity futures orders in blocks should be made by the contract market.[223] The exchanges object strongly to block trading. They contend that the practice will ultimately divert liquidity from the exchanges and that its proponents are large brokerage firms who stand to profit from such large scale trading.[224] This is not inconsistent; typically industry representatives are strong proponents of block trades, and the exchanges oppose these transactions. Recently, however, an advisory committee to the Chicago Mercantile Exchange recommended that the Exchange take steps to facilitate large block orders[225] and the Exchange Board of Governors approved such a rule to do

218. *See* Markham & Stephanz, *The Stock Market Crash of 1987—The United States Looks at New Recommendations,* 76 Geo. L.J. 1993, 2041 (1988) (citing SEC, Recommendations Regarding the October 1987 Market Break 13 (Feb. 3, 1988)).

219. *See City Bar Association Report, supra* note 210. *See generally* Power, *Futures Exchanges Urged To Allow Block Trading,* Wall St. J., Mar. 3, 1989, at C15, col. 4 (discussing *City Bar Associaiton Report* and block trading).

220. *See City Bar Association Report, supra* note 210, at 39-44.

221. *See id.* at 50.

222. *Id.* at 50-51.

223. *See id.* at 51-52.

224. *See* Letter from Jerrold E. Salzman to the author (Mar. 29, 1989) (on file at *Fordham Law Review*).

225. *See* Crawford & Gaines, *Merc Moves Would Go to Core of Trading,* Chicago Trib-

so.[226]

There are other incongruities and uncertainties in the regulation of floor trading practices. For example, another prohibition contained in the Commodity Exchange Act concerns "accommodation" trading.[227] Historically this type of trading involved transactions between two clearing firms in which one house was net long while the other was net short. As a result, both firms had to post margin funds with the clearing house to secure their exposed net long or short positions. To avoid such payment, the firm that was net long sold sufficient futures contracts to the firm that was net short to place each firm in an even or nearly even position. This reduced or eliminated the need to put up margin with the clearing house. Later, another transaction was entered to unwind the first transaction. In the meantime, each house had the use of the margin money.[228]

After the passage of the Commodity Exchange Act in 1936, the CEA sought to expand the definition of accommodation trading to include "wash trading entered into by one broker to assist another broker to make cross trades, wash trades, etc."[229] The CFTC has also sought to expand accommodation trading to include instances where floor brokers assist other floor brokers in noncompetitive transactions and in transactions that allow brokers to trade indirectly against their customers.[230]

The cross trade is another type of transaction prohibited under the

une, Apr. 21, 1989, § 3, at 1, col. 2; McMurray, *Chicago Merc Panel Unveils Tighter Rules*, Wall St. J., Apr. 20, 1989, C1, at C12, col. 6. Members of the key exchanges have criticized some of the committee's proposals. *See* McMurray, *Chicago Merc Plans Trading Outside Pits*, Wall St. J., Sept. 22, 1989, at C1, col. 3; McMurray, *Many Chicago Merc Members Criticize a Proposed Package of Tougher Rules*, Wall St. J., Apr. 28, 1989, at C15, col. 1.

226. The proposal approved by the Board of Governors would allow orders of 300 or more futures contracts to be executed through solicitation outside the pit or by having the executing broker become the contra party. "The rule is comparable to the block facilitation rules on major U.S. securities exchanges." Chicago Mercantile Exchange, Special Executive Report S-2159 (Sept. 21, 1989); *see* Berg, *Chicago Merc to Allow Some Trading Off Floor*, N.Y. Times, Sept. 22, 1989, at D1, col. 4.

227. *See* 7 U.S.C. § 6c (1982); *see also* 80 Cong. Rec. 8088 (1936) (for a definition of accommodation trades).

228. *See* 5 Federal Trade Commission, Report on the Grain Trade 248 (1920); 80 Cong. Rec. 8089 (1936).

229. Letter from Alex C. Caldwell, Administrator of Commodity Exchange Authority, to Deputy Administrator of Division and Region Directors (May 25, 1966) (defining various trade practices prohibited by the Commodity Exchange Act) (on file at *Fordham Law Review*).

230. *See* CFTC, Glossary of Some Terms Commonly Used in the Futures Trading Industries 1 (Aug. 1978). In *In re* Sundheimer, [1980-1982 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,245 (C.F.T.C. Sept. 16, 1981), *aff'd*, Sundheimer v. CFTC, 688 F.2d 150 (2d Cir. 1982), *cert. denied*, 460 U.S. 1022 (1983), the CFTC stated that, where prearranged transactions allowed an oil company to utilize a commodity futures market for extrinsic advantage without exposure to market risk, the transactions were tantamount to accommodation trades prohibited by Section 4c of the Commodity Exchange Act. *See id.* at 25,219 & n.8; Commodity Exchange Act § 4c (codified at 7 U.S.C. § 6c (1982 & Supp. V 1987)). *See generally In re* Buckwalter, [1984-1986 Transfer Binder]

Commodity Exchange Act.[231] Certain cross trades are permitted, as where a broker has in hand an order to buy and an order to sell from different customers. The orders can be matched against each other at the market prices or at the limit prices upon open outcry pursuant to exchange rules.[232] Some exchange rules permit this practice but require approval of an exchange official, indicating that the trade was done by open outcry. Other exchanges prohibit the practice entirely.[233]

The CFTC prohibited a type of cross trading that involves the direct or indirect offsetting of customer orders. These transactions allow a floor broker to profit by offsetting transactions in his own or a competing floor broker's account.[234] The legislative history of the Commodity Exchange Act notes that such cross trades are fictitious trades recorded as real trades and used

> by pit brokers [as devices] for becoming buyers in respect to selling orders of customers and vice versa. They take the form of a recorded double purchase and sale between two brokers. Each broker is recorded as having both bought from and sold to the other the same quantity of the same futures at the same price.[235]

Comm. Fut. L. Rep. (CCH) ¶ 22,782, at 31,277 (C.F.T.C. Sept. 27, 1985) (accommodation trades involve cooperation by one trader with another in an unlawful manner).

The recent indictments in Chicago also charge accommodation trading: "It was further a part of the scheme that the defendants would accommodate one another in illegal, prearranged trades." United States v. Dempsey, No. 89-666, indictment at 18 (N.D. Ill. Aug. 2, 1989).

231. *See* 7 U.S.C. § 6c (1982 & Supp. V 1987).

232. CFTC Regulation 1.39 permits such cross-trades conducted in accordance with exchange rules. *See* 17 C.F.R. § 1.39(a) (1987).

233. *Compare* Coffee, Sugar & Cocoa Exchange, Floor Trading Rule No. 3.13 (certain cross trades permitted if verified by Exchange employee) *and* Chicago Mercantile Exchange, Floor Privileges—Trading Qualifications and Practices Rule No. 533 (procedure allowed with approval of Exchange official) *with* Chicago Board of Trade, Floor Practices Rule No. 332.00 (trader forbidden from acting as agent for both buyer and seller, either directly or indirectly).

234. *See* 7 U.S.C. § 6b(D) (1982 & Supp. V 1987). Offsetting is permitted with the prior consent of the customer. *See id. See generally* CFTC Interpretive Letter No. 83-7, [1982-1984 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,907, at 27,929 (Oct. 25, 1983) (futures commission merchants may knowingly take other side of customer's order only with proper authorization contained in document separate and distinct from customer agreement); CFTC, Interpretive Statement and Specification of Terms and Conditions for Certain Exemptions, [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,441, at 21,797 (July 7, 1977) (floor broker must have prior consent of customer before taking other side of customer order).

235. 80 Cong. Rec. 8089 (1936). The following example was given:

> Broker A is put down as seller to broker B of 5,000 bushels of May wheat at $1 per bushel and is also put down as buyer from B of 5,000 bushels at $1 per bushel. The transaction appears to be without purpose and without effect. But A, having made an actual sale of 5,000 bushels of May wheat for a customer at, say, $1.01 reports to his commission firm that the customer's order has been executed at $1. Thereupon, he switches the sold side of his own $1 cross trade for the actual $1.01 sale for the customer and takes a profit for himself of the 1-cent difference, which should have been added to the sale price for the customer. In this example, of course, it is assumed that there is a 1-cent fluctuation

The attempt to prohibit cross trades thus seems to be directed at the specific practice of indirectly trading against customer orders to the detriment of the customer and to the profit of the floor brokers.

II. Reforms in the Commodity Futures Markets

A. *Dual Trading And Time Stamps*

The greatest area of concern in the commodity futures markets involves dual trading. It is a practice that has been deeply ingrained in the industry, and is often strongly defended. The CFTC has permitted dual trading, principally on the grounds that it does not have sufficient data to determine whether the practice is harmful. The adoption of time-stamping requirements for the execution of trades, however, would eliminate that obstacle and allow the CFTC to make such a determination. But whatever the outcome of a review of the effects of dual trading, the public perception will persist that commodity futures trading provides advantages to dual traders trading on the floor.[236] This perception is due in part to the time and place advantages enjoyed by the floor trader and the inherent conflicts of dual trading. The public will likely suspect that a floor broker will protect his own rather than his customers' trading interest and that there is a strong temptation to cheat. For these reasons, Congress is considering banning dual trading, at least in active trading pits.[237]

> in price while the customer's order is in the hands of the pit broker and before he reports execution.

Id.

236. *See generally* Petacque & Greising, *'Charades' Played in Pits*, Chicago Sun Times, Jan. 27, 1989, at 3, col. 1 (dual trading in Chicago criticized in press by Governor of Illinois).

237. *See* Ricks, *Senators Propose Tougher Rules in Futures Markets*, Wall St. J., Mar. 10, 1989, at C13, col. 5; *CFTC Asks Funds, Gets Talking-To*, Chicago Tribune, Apr. 7, 1989, § 3, at 1, col. 2. One initial congressional proposal would curb dual trading in any pit where an exchange audit trail could not demonstrate a one minute accuracy rate of 90% or better and where liquidity is adequate to fill customers' orders efficiently. *See* Letter from Senator Patrick Leahy to John Damgard, President of the Futures Industry Association (Mar. 16, 1989) (on file at *Fordham Law Review*). A bill passed by the House of Representatives would set a threshold level of trading whereby traders in pits with average daily trading volume in excess of 7,000 contracts would be barred from dual trading, absent unusual circumstances. *See* H.R. Rep. No. 236, 101st Cong., 1st Sess. 2 (1989).

The CFTC has directed the exchanges to determine whether dual trading should be curtailed or eliminated as a result of the FBI sting operation. *See* McMurray, *Exchanges Told to Look Into Dual Trading*, Wall St. J., Mar. 9, 1989, at C13, col. 1; Letter from Andrea M. Corcoran, Director of CFTC Division of Trading and Markets, to Thomas R. Donovan, President of CBOT (Feb. 7, 1989) (discussing issues to explore in self-regulatory review, including whether to curtail or eliminate dual trading) (on file at *Fordham Law Review*). The Chicago exchanges have also considered prohibiting or restricting dual trading themselves, although the Chicago Board of Trade seems to have retreated from such a position. *See* McMurray, *Board of Trade Affirms Support of Dual Trading*, Wall St. J., May 2, 1989, at C14, col. 6; Crawford & Gaines, *Merc Moves Would Go to Core of Trading*, Chicago Tribune, Apr. 21, 1989, § 3, at 1, col. 2; Berg, *Merc Panel Issues Pro-*

A prohibition against dual trading would serve to curtail the appearance of a conflict of interest. It would not, however, stop all abuses or appear to do so. For example, a prohibition against dual trading would not preclude bag trades and other fraudulent transactions, as where a trader dealing for his own account is allowed to take advantage of a customer order and then share profits either directly or indirectly with the other trader. Such activities are fraudulent per se and prohibited under any standard applied to the Commodity Exchange Act. Consequently, it is doubtful whether new regulations, including a prohibition on dual trading, would be any more effective in stopping such transactions. Instead, more sophisticated surveillance data is needed to uncover and deter such violations.

Specifically, automated timing procedures for order execution and computerized market surveillance to detect trades that occur away from the market would be the most effective way to stop these types of fraud. For example, if every transaction was required to have an automated time sequence in order to obtain entry into the exchange's computer system, the timing of the trade would be known and the time of the transaction could be compared with other transactions on the exchange. Where it appears that the trade was away from the market, then further investigation would be warranted.[238]

The CFTC and the major exchanges, such as the Chicago Board of

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posals to Combat Trading Abuses, N.Y. Times, Apr. 20, 1989, at D1, col. 1; McMurray, *Chicago Merc to Seek Tougher Trading Rules*, Wall St. J., Apr. 18, 1989, at C1, col. 5; Burns, *Merc May Push Revamp of Dual Trading*, Chicago Sun Times, Feb. 13, 1989, at 41, col. 1; Crawford & Gaines, *CBOT Officials Stand Behind Dual Trading*, Chicago Sun Times, Feb. 10, 1989, at 1, col. 3; Norris, *Marketplace: The Pits Hang on to Dual Trading*, N.Y. Times, Feb. 9, 1989, at D8, col. 3; Neikirk & Jouzaitis, *Dual Trade Tactic Likely on Way Out*, Chicago Tribune, Feb. 3, 1989, § 3, at 1, col. 2. The Chicago Mercantile Exchange did adopt a regulation pursuant to which traders in its Standard & Poor's 500 stock index futures pit must decide before every trading session whether they are trading for their own account or for customers. The CFTC has also announced that it plans to restrict dual trading in some form, although the exact nature of its restrictions has not yet been published. *See* Salwen, *CFTC Plans Curbs on Dual Trading in Commodities*, Wall St. J., Oct. 18, 1989, at C1, col. 6.

Most exchanges based in New York have opposed prohibitions on dual trading. *See Four Exchanges in New York Support Brokers' Dual Trading*, Wall St. J., May 4, 1989, at C13, col. 3. For a discussion of the merits of dual trading, see T. Hieronymus, Economics of Futures Trading 342-343 (2d ed. 1977).

238. According to a CFTC internal review, the Chicago Mercantile Exchange seems to provide much of the needed data. *See supra* notes 95-96 and accompanying text. The exchange surveillance system has resulted in an increased number of disciplinary actions. *See* Burns, *Merc Punishes Eight Members*, Chicago Sun Times, Apr. 5, 1989, at 57, col. 5; *Merc Fines or Warns 8 Traders in Broker Association Cases*, Chicago Tribune, Apr. 5, 1989, § 3, at 3, col. 1; *Chicago Merc Disciplines 8*, N.Y. Times, Apr. 5, 1989, at D19, col. 3. The Chicago Board of Trade's CTR system, although found by the CFTC staff to be insufficient, *see supra* notes 92-93 and accompanying text, has also brought an increased number of disciplinary actions. *See* Berg, *Commodity Exchanges See Threat*, N.Y. Times, Mar. 13, 1989, at D1, col. 6 ("Disciplinary actions have more than tripled at both [brokerage] exchanges since 1984—to 207 at the Merc and to 879 at the Board of Trade.").

Trade, are seeking to create more certainty in execution times by requiring broker tickets to be picked up more frequently and by reducing bracket periods. These and other steps are designed to minimize the opportunities for floor traders to victimize customers by entering fraudulent and fictitious trades during periods of price fluctuations. That effort may be successful, but it will require constant monitoring to eliminate all opportunity for fraud. It may also be superseded by events, as Congress may require the timing of executions within one minute, and later within 30 seconds.[239]

Without doubt, the most effective method for ensuring an accurate audit trail is to record automatically the entry time and eliminate the opportunity to change paperwork that is submitted to the exchange. This would, however, require a sophisticated computerized order entry mechanism in the trading pit itself. It is unclear whether current technology could produce such a sophisticated system.[240] Such a system would guarantee that transactions are properly timed and would eliminate most post-fact order changes, but would still be imperfect. The floor broker holding a deck of customer orders would have the additional burden of handling a computer, which would be awkward in the pit.[241] Although

239. *See* H.R. Rep. No. 236, 101st Cong., 1st Sess. 4-5 (1989). The House bill was passed by a vote of 420-0. *See* Salwen, *Commodities Oversight Bill Clears House,* Wall St. J., Sept. 14, 1989, at C14, col. 6. The bill does not appear to require time-stamping of executions. Rather, it appears to still allow a CTR system such as that used by the Chicago Board of Trade. *See* H.R. Rep. No. 236, 101st Cong., 1st Sess. 4-5 (1989). Prior to the passage of the House bill, the CFTC has proposed requiring collection of broker's trading cards every thirty minutes in order to increase the integrity of the audit trail. *See* 54 Fed. Reg. 37117 (1989). But the General Accounting Office concluded that these and other CFTC proposals for preventing the conduct discovered in Chicago were inadequate. *See* Salwen, *CFTC Plan to Curb Trading Abuses is Weak, GAO Says,* Wall St. J., Sept. 8, 1989, at C13, col. 1.

240. In 1984 the CFTC was of the view that technology was sufficient to permit time-stamping. *See* Trade Time-Sequencing Standards and Exchange Audit Trail Systems, [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,450, at 29,973-74 (Dec. 27, 1984). The CFTC was later convinced that the technology was not available for precise trade timing standards. Eventually, the CFTC conceded that technological advances would allow improved trade timing, although time-stamping machines were still clearly "inappropriate" for higher transactions pits. *See* CFTC Division of Trading and Markets, Memoranda: Audit Trail Enhancements: Proposed Amendments to Commission Regulation 1.35, at 105-06 (Jan. 14, 1986).

The Chicago Board of Trade and the Chicago Mercantile Exchange have announced plans to develop a hand held electronic terminal that will time trades as they are executed in the pit. *See Moneyline: Futures Plan,* USA Today, Aug. 17, 1989, at B1, col. 1. The Commodity Exchange, Inc. has announced that it too is developing a computerized order entry device for its floor traders. The hand held computer would provide tamper-proof time-stamping of trades. *See New Computerized Order-Entry Device Unveiled by Comex,* Wall St. J., Sept. 28, 1989, at C16, col. 6.

241. The deck is a stack of orders that are to be executed away from the current price. Some are to buy and some are to sell as the price rises while others are to buy and sell as the price declines. Some are at specific prices while others are for immediate execution as soon as a price is reached, and some involve a scale of quantities and prices. The orders are typically on pieces of paper about five by seven inches. The broker arranges them in the order of execution that will

the computer could be used to call up orders, this would require a display panel so that the broker would know at a glance what orders he was holding in his deck. But that display would increase the size of the computer and would also expose those orders to other traders in the pit. These and other practical problems abound.

It should also be noted that there is substantial resistance on the part of the exchanges to a completely automatic order process. First, the exchanges are concerned that technology would slow trading and thereby impair the functioning of the pits. An attorney for the Chicago Board of Trade asserted that time-stamping could, in fact, cause trading to be shifted from the United States to exchanges abroad that do not have the CFTC's audit trial concerns.[242] This argument should be taken seriously. The exchange pits are, indeed, efficient mechanisms for executing trades. This was demonstrated as recently as the market crash of 1987 when the efficiency of the futures pits matched or exceeded that of the New York Stock Exchange.[243] This efficiency should not be threatened unless absolutely necessary.

Nevertheless, advocates of an audit trail process have contended that a "black box" system is needed for the exchanges.[244] A black box involves computerized trading conducted through computer terminals rather than in a pit on the floor of an exchange. Under such a system, floor traders would not be clustered on the floor but would operate through computer terminals. It is thought that this impersonalization of the market would prevent rigged trading because the traders would have neither advance knowledge nor time and place advantages over other traders. Instead, customer orders would be entered into the system and all traders would have an equal opportunity to trade against them.[245]

> take place as the price moves up or down. He then folds them lengthwise for concealment and puts them in his pocket so that his hands will be free to handle his trading card and pencil, and to signal with. Occasionally, the decks are as much as an inch thick and require great memory skill and anticipatory planning.

T. Hieronymus, Economics of Futures Trading 53 (2d ed. 1977). The New York Stock Exchange already has miniature computerized "electronic display books" for holding customer limit orders. *See* Melloan, *Is the Big Board All Dressed Up with Nowhere to Go,* Wall St. J., Oct. 3, 1989, at A23, col. 3.

242. Letter from John H. Stassen to the author (Mar. 8, 1989) (on file at *Fordham Law Review*).

243. *See* Markham & Stephanz, *The Stock Market Crash of 1987—The United States Looks at New Recommendations,* 76 Geo. L.J. 1993, 2027-28 (1988).

244. *See generally* Jouzaitis & Widder, *Probe Forces Reform Issue on Exchanges,* Chicago Tribune, Jan. 22, 1989, § 7, at 1, col. 5 (discussing effect of FBI probe on open outcry procedure).

245. *See generally The World's Traders Get Off the Floor,* Euromoney, May 1985, at 154 (discussing computerized trading systems in London, Sydney, Tokyo, Toronto and Zurich); Morris, *Trading Automation: Easier Said Than Done,* American Banker, July 9, 1982, at 3 (discussing benefits and disadvantages of computerized trading); *100-Million-Share Days?,* Forbes, Nov. 12, 1979, at 18 (discussing results of Merrill Lynch's use of electronic stock trading on a day of heavy trading); *Watchpoodle?,* The Economist, Apr. 7, 1979, at 114 (SEC urges exchanges to implement "black-box" trading); *Which Way to*

Opponents of black box trading contend that it will reduce liquidity by limiting an atmosphere on the floor that encourages floor traders to trade for their own accounts and thereby add liquidity to the market. That is, floor traders become caught up in the excitement, rumors and frenzy on the floor and trade more than they would sitting in the more cold and calculating environment of their office. Moreover, floor traders may not be willing to risk as much of their capital absent the frenzy or information available on the trading floor.[246]

Notwithstanding such claims, the Chicago Mercantile Exchange is developing a system called Globex, which allows after-hours trading of commodity futures contracts. Globex is a computerized system that allows trades to be executed and entered after trading ceases on the floor of the exchange in Chicago.[247] The Chicago Board of Trade has also developed a system called Aurora.[248] Like Globex, Aurora allows trading of contracts when Chicago markets are closed. The Board of Trade's Aurora system, however, uses computer graphics to simulate a futures pit,

a National Securities Market?, The Economist, Apr. 29, 1978, at 105 (discussing SEC proposals for a national market system); Hershman, *Here Comes the New Stock Market*, Dun's Review, Apr. 1978, at 65 (electronic markets would aid investor at expense of specialist); *New York Stock Exchange; Black Box Blackballed*, The Economist, July 10, 1976, at 105 (specialists have most to lose if exchanges adopt the "black-box").

246. *See* Melamed, *The Mechanics of a Commodity Futures Exchange: A Critique of Automation of the Transaction Process*, 6 Hofstra L. Rev. 149 (1977); Whitehouse, *LIFFE Could Adopt Automated Trading by Next Year*, Reuters Release, Apr. 14, 1988. The Administrator of the Commodity Exchange Authority noted during the hearings on the CFTC Act of 1974 that he favored computerizing floor trading on the contract markets. *See* H.R. Rep. 975, 93rd Cong., 2d Sess. 49 (1974). The CFTC Act of 1974 included a provision permitting the CFTC to consider computerized trading. Section 18 of the Commodity Exchange Act states that:

> The Commission shall establish and maintain, as part of its ongoing operations, research and information programs to (1) determine the feasibility of trading by computer, and the expanded use of modern information system technology, electronic data processing, and modern communication systems by commodity exchanges, boards of trade, and by the Commission itself for purposes of improving, strengthening, facilitating, or regulating futures trading operations; (2) assist in the development of educational and other informational materials regarding futures trading for dissemination and use among producers, market users, and the general public; and (3) carry out the general purposes of this chapter.
>
> (b) The Commission shall include in its annual reports to Congress plans and findings with respect to implementing this section.

7 U.S.C. § 22 (1982). In 1977, the CFTC conducted an industry conference on automation at which various economists, finance professors and technological experts debated the issues associated with automation in the futures industry. *See* Melamed, *supra*, at 151. The CFTC has also reported on the program of computerized trading in its annual reports. *See, e.g.*, 1988 CFTC Ann. Rep. 116 (discussing technological innovations implemented at the various exchanges).

247. *See* Chicago Mercantile Exchange, Globex (1989); Berg, *2 Big Futures Exchanges in a Race*, N.Y. Times, Apr. 11, 1989, at D2, col. 1.

248. *See* Chicago Board of Trade, Aurora/Eos: The Dawn of a New Age in International Trading (1989); Campbell, *CBOT Takes Wraps Off Aurora and Eos Systems*, Fin. Times, Mar. 17, 1989; Shellenbarger, *CBOT, in a Sign of the Times, May Finally Join Electronic Age*, Wall St. J., Feb. 6, 1989, § 3, at 1, col. 3.

while Globex simply matches buy and sell orders. With the Aurora system the floor trader is identified on the computer screen and a bid or offer may be made to a particular trader.[249]

Whatever their relative merits to traders, these two systems may indicate how effective computerized trading would be in preventing abuses and whether the atmosphere of the floor is a significant factor in trading volume.[250] Unfortunately, there is still some doubt whether a computerized system will provide a definitive answer to the question of the effectiveness of computerized trading because after-hours trading in other environments, such as links with foreign exchanges, has not proved to be as successful as trading conducted during the regular hours of the exchanges.[251]

In any event, it would not seem necessary for trading on the floor of the exchanges to be eliminated entirely in favor of a computer environment. To date, the exchanges have been efficient in developing new products and providing liquidity to many financial instruments which, though previously not traded, have become a necessary part of large portfolio management.[252] It would not seem appropriate to rule out exchange trading simply because abuses have been occurring on the floors. Rather, the CFTC should concentrate on eliminating those abuses through more

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249. *See* Berg, *2 Big Futures Exchanges in a Race*, N.Y. Times, Apr. 11, 1989, at D2, col. 1; Campbell, *Technology Wars Ravage Chicago*, Fin. Times, Mar. 21, 1989.

250. The Chicago Board of Trade has charged that the Globex system is susceptible to manipulation, prearranged trading and other abuses. *See Board of Trade Opposes Merc's Electronic Trading System*, Associated Press Release, Sept. 12, 1988; *The CBOT Has Capitulated. Has Automated Trading Come of Age?*, Fin. Times, Mar. 8, 1989; Burns, *Probe May Complicate Merc's Computer Move*, Chicago Sun Times, Jan. 26, 1989, at 63, col. 1. Nevertheless, automation is making inroads into exchange trading systems and the Chicago Board of Trade and Chicago Mercantile Exchange have apparently decided to bury the hatchet over the relative merits of their proposed trading systems. Instead, they have agreed to act jointly in developing such a system. *See* McMurray, *Exchanges Link Trades After-Hours*, Wall St. J., May 30, 1989, at C1, col. 6; Gaines, *Traders Trained by Computer*, Chicago Tribune, Apr. 5, 1989, § 3, at 7, col. 6; Towie, *PC Option Makes Impact at Futures Exchange*, The Australian, Mar. 28, 1989; *see also* Seifert, Selected Computerized Trading Issues, Address Before the Futures Industry Association Division of Law and Compliance (May 11, 1989) (discussing and proposing resolutions to computerized trading issues).

251. *See* Wolman, *Singapore 5; From a Slow Start to Soaring Trading Volumes*, Financial Times, Nov. 13, 1987, at V; Skinner, *Commodities Traders Try to Find the Best Way to Trade 24 Hours*, Reuters Business Report, Aug. 6, 1987; *Exchanges Continue to Forge Trading Links Despite Slow Volume to Date*, Securities Week, July 6, 1987, at 1. The FBI investigation has not hampered efforts to develop the Globex trading system. *See Electronic Trading Plan Wins Easily*, Chicago Tribune, Feb. 3, 1989, at 1, col. 6.

252. These new products traditionally have been important to the agricultural industries. The number of futures contracts traded per year has increased dramatically in recent years. In 1976, some 37 million futures contracts were traded. *See* Futures Industry Association, Volume of Futures Trading 1960-1986 (1986). By 1986 the number of futures contracts traded in the United States exceeded 183,000,000. *See* 1986 CFTC Ann. Rep. 3. In 1988, the volume expanded to 290.7 million futures and options contracts. *See* 1988 CFTC Ann. Rep. 13. Indeed, in 1988 the Chicago Board of Trade alone traded some 143 million contracts. *See* Hargreaves, *Tighter Regulation Feared*, Financial Times, Apr. 10, 1989. *See generally* B. Carroll, Financial Futures Trading 41-44 (1989).

effective enforcement.[253]

There also seem to be alternatives and compromises that can be made. Most commodity futures trading could be subjected to an audit trail process and dual trading limitations which would address many of the concerns which provoked the FBI investigation. In pits with low trading volume it would seem that, just as in the case of the CBOE (which actually has several high volume pits), time-stamping could be permitted and should be required. In pits where there is massive trading volume that could be affected by delays in time-stamping, there needs to be increased automation.[254] But not all months of the pit trade as actively. Time-stamping could be required in back months immediately. In more active months where the busier brokers trade, the exchange could assign additional officials to report execution size, price and to quickly gather and remove paperwork from the pit.[255] Further, these traders could be prohibited from engaging in dual trading; they can hardly claim that dual trading is necessary for liquidity while claiming that liquidity is so great that they do not have the time to time-stamp orders. Once these reforms are in place, more careful scrutiny can be given to the establishment of more certain audit trails for these active pits.[256]

B. *Trade Practice Prohibitions*

Regulation is impaired by the uncertainty of what constitutes a prohibited fictitious sale, wash trade, accommodation transaction, and cross trade as well as by uncertainty as to what is meant by a prearranged fictitious transaction.[257] More precise definitions are needed of terms which concern questionable, and potentially prohibited, trading prac-

253. While it is not known whether computerized trading would be effective in the prevention of trading abuses, many believe that a computer environment could, in fact, reduce market efficiency. *See supra* note 246 and accompanying text. Efforts to automate exchanges in some areas have not been completely successful. For example, the Cincinnati Stock Exchange is automated, but has not had large trading volumes. A recent effort to automate exchange trading in London resulted in large losses. An effort to create an automated futures exchange in Bermuda also failed. *See* Miller & Winkler, *Computerized Trading Starts to Make Inroads at Financial Exchanges*, Wall St. J., Apr. 24, 1989, at 1, col. 6. The Hong Kong Stock Exchange might be the model for future computerized exchanges. *See* Smithsonian, Apr. 1989, at 50. Unfortunately, however, the Hong Kong Exchange has not met with success. *See, e.g.*, Prest, *Hong Kong Set For Financial Revival*, Canberra Times, Mar. 27, 1989 (discussing the after-effects of the 1987 market crash and closure of the Hong Kong Futures Exchange).

254. Trading volumes vary widely in the various commodity futures pits, ranging from 0 to 70 million contracts. *See* 1988 CFTC Ann. Rep. 96-101.

255. *See* Sing, *Reforms to Alter Way U.S. Trades in Futures*, L.A. Times, Jan. 29, 1989, Pt. 4, at 1, col. 5. "Dual trading . . . already is forbidden among brokers who occupy the top step of the CME's huge Standard & Poor's 500 stock index futures pit." *Merc Eyes Limits on Dual Trading*, United Press International Release, Feb. 13, 1989.

256. In fact, the trading pits targeted by the FBI stings were some of the most liquid pits in the commodity futures industry. *See* O'Connor & Marx, *Trading Pits Not for the Faint of Heart . . . or Body*, Chicago Tribune, Feb. 5, 1989, § 1, at 20, col. 1; Gunset & Winter, *Customer Outcry Hard to Hear*, Chicago Tribune, Jan. 25, 1989, § 1, at 1, col. 4.

257. *See supra* notes 148-202 and accompanying text.

tices. Although Congress could provide such clarification by amending the Commodity Exchange Act, history has shown that markets change and such new definitions will become outdated quickly. Congress simply cannot keep up with the commodity futures industry, which changes constantly and rapidly. As a result, it would seem to be more practical for the CFTC to be given authority to adopt regulations defining specific prohibited practices.[258] The Commission has already done this through Regulation 155.2[259] which requires the exchanges to adopt prohibitions against various practices. This requirement, however, should be supplemented by CFTC regulations that would detail the conditions under which a broker can execute orders. Such regulations should include practices which are permitted as well as those that are prohibited so that traders can function in a safe harbor without concern as to liability. This authority could also be used to define manipulative practices and other trading concerns that have plagued the CFTC for years.[260]

To illustrate, if the CFTC were given authority by Congress to promulgate specific prohibitions, it could prohibit certain transactions and define the banned transactions as follows:[261]

> The following trade practices constitute fraudulent and manipulative conduct in violation of the Commodity Exchange Act when done knowingly and willfully:
>
> (a) Wash Sales. Wash sales are buy and sell transactions for the same commodity in the same delivery month that are entered by the same traders, or traders acting in concert, with the intent that the orders will offset each other. Wash sales do not include simultaneous buy and sell transactions entered into for the purpose of changing a trader's position in the exchange's line for delivery notices and do not include scalping transactions that result in a "scratch" trade that does not have a gain or loss, provided the transaction was entered into for the purpose of making a profit or for other bona fide commercial reasons.
>
> (b) Accommodation Trades. Accommodation trades are any transactions in which a floor broker allows any other trader to profit from a customer order held by the floor broker through any arrangement other than by an open and competitive outcry on the floor of the exchange or other transaction permit-

258. The opportunity for Congressional action is already present. The CFTC is conducting hearings to determine whether it should be reauthorized and whether additional legislation is needed. *See* Wayne, *With Futures Under Fire, a Watchdog Feels the Heat*, N.Y. Times, Mar. 26, 1989, § 3, at 1, col. 3. The House of Representatives has already passed a bill that would prohibit certain forms of "insider" trading. *See* H.R. Rep. No. 236, 101st Cong., 1st Sess. 11 (1989).

259. *See* 17 C.F.R. § 155.2 (1988).

260. *See* Markham, *"Front-Running"—Insider Trading Under the Commodity Exchange Act*, 38 Cath. U.L. Rev. 69, 123-24 (1988).

261. The following terms have been defined by the author unless otherwise noted. The definitions reflect current market practices and trading abuse procedures.

ted by exchange rules. Accommodation trades include but are not limited to:

(1) the undoing or "busting" of a customer's already executed order in order to allow another trader to execute an order at the price of the customer's order or at some other price.

(2) entering into an order with another trader at a pre-determined price in order to allow that trader or any other trader to profit from a customer order.

(3) splitting or adjusting prices during opening or closing rotations except that adjustments for bona fide reporting errors may be corrected in accordance with exchange out-trade procedures.

(4) entering into or executing any futures transactions after the close of trading.

(5) executing a customer limit order through noncompetitive arrangements with any other broker or brokers.

(6) engaging three-cornered or similar deals where three or some other number of traders engage in noncompetitive trades in order to take advantage of customer orders.

(7) entering into "ginzy" trades or other noncompetitive trading for purposes of split tick trading or for other purposes.

(8) "cuffing" trades by delaying the filling of customer orders to benefit another trader.[262]

(9) engaging in any activity during trade checking or out-trade procedures in order to wrongfully deprive a customer of profits.[263]

(c) Cross Trades. Cross trades are prohibited unless conducted in conformance with Regulation 1.39 of the Commodity Exchange Act. Cross trades are any transaction in which a floor broker crosses for execution in the pit a buy and sell order of two different customers. Such orders are to be independently

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262. A variety of trade practice abuses, which can occur in the open outcry commodities markets, were identified and discussed before the Senate Committee on Agriculture, Nutrition and Forestry. *See* Commodity Futures Trading Commission and the Chicago Futures Exchanges' Detection of Trade Practice Abuses Before the Committee on Agriculture, Nutrition and Forestry of the United States Senate, 101st Cong., 1st Sess. 4-5 (1989) (statement of Richard L. Fogel, Assistant Comptroller General, General Government Programs).

263. The commodity markets require all trades to be matched at the clearinghouse with the opposing broker. Because of the confusion that occurs during active trading, errors frequently occur as to the size of the order, the price or the identity of the executing broker. When the trades do not match they are called "out-trades" and the parties have to settle their differences before trading begins the next day. *See* P. Johnson and T. Hazen, I Commodities Regulation § 1.31, at 115 (2d ed. 1989). It was charged in the Chicago indictments that out-trades were used as a mechanism for misappropriating customer funds and orders. *See* United States v. Bailin, No. 89-668, indictment at 11, 22 (N.D. Ill. Aug. 2, 1989). The CFTC has also acted to tighten out-trade procedures. *See* 54 Fed. Reg. 37004 (1989). The Chicago Board of Trade has also acted to tighten its out-trade procedures in the wake of the Chicago indictments. *See CBT Board Approves New Outtrade Rules and Delays Fee Hike Vote,* Securities Week, Sept. 25, 1989, at 1.

and separately handled by different brokers unless otherwise permitted by exchange rules.

(d) Fictitious Sales. A fictitious sale is any transaction that is not executed openly and competitively on the floor of the exchange as required by Regulation 1.38.

(e) Prearranged Trades. Prearranged trades are any trades that are arranged prior to their execution in a manner that excludes or impairs the open and competitive execution required by Regulation 1.38. A prearranged trade does not include negotiations and indications of interest for block trades prior to their execution on the floor of the exchange provided that the following conditions are met:

(1) the size of order eligible for such procedures is such that: (a) in view of the liquidity of the particular market, there is a reasonable probability that the order could not be effective without itself causing a substantial effect on price; and (b) the order is of a size typically used by commercial participants;

(2) the transactions must be bid or offered on the contract market, by open outcry or other competitive method, with adequate opportunity for public participation; and

(3) any person of the transaction that has not promptly taken up at the ring may be crossed, with the floor broker and/or the futures commission merchant taking the opposite side (with the consent of the customer), but only at the price bid or offered on the contract market.

(f) Frontrunning. Frontrunning is the practice of trading in commodity futures or options contracts with advance knowledge of material non-public information about the cash, options, or futures market activities of any dealer, processor, user or consumer of a commodity or customer of the acting party where such activities could reasonably be foreseen to affect market prices and where the information is obtained by the acting party through employment with such persons or through any confidential, fiduciary or any other such special relationship with such persons.[264]

264. *See* Markham, *"Front-Running"—Insider Trading Under the Commodity Exchange Act*, 38 Cath. U.L. Rev. 69, 124 (1988). The House has already approved legislation on frontrunning "insider" trading. *See* H.R. Rep. No. 236, 101st Cong., 1st Sess. 11 (1989). The bill, however, does not contain an explicit prohibition against trading ahead of customer orders, because the Department of Justice informed Congress that such conduct is adequately addressed under existing law. *See id.* at 46; Doyle, *House Panel Approves CFTC Reauthorization*, Associated Press Release, Aug. 3, 1989; *see also* H.R. Rep. 603, 101st. Cong., 1st Sess. 1 (Jan. 20, 1989) (bill introduced by Congressman Smith of Iowa). *See generally* Burns & Greising, *Will Probe Outcry Peril Open Outcry*, Chicago Sun Times, Jan. 22, 1989, at 60, col. 1 (discussing possible legislation to limit open outcry system). Congress has also addressed the concern that associations of brokers were using their relationships to defraud customers in the execution of their orders. A bill passed by the House would restrict brokers in an association from trading with each other in executing customer orders where a member of the association would be trading for his own account. *See* H.R. Rep. No. 236, 101st Cong., 1st Sess. 3-4 (1989).

(1) Nonpublic information is information that has not been disseminated in a manner which makes it generally available to the trading public through recognized channels of distribution.[265]

(2) Material information is information which, if publicly known, would be considered important by a reasonable person in deciding whether to trade a particular commodity interest on a contract market. As used in this section, material information includes, but is not limited to, information relating to present or anticipated cash, futures or option positions or trading strategies.[266]

These definitions are by no means exhaustive or exclusive. Rather, they could be supplemented or restricted as markets develop or particular abuses are discovered. What the definitions do provide is a safe harbor for market participants, while more clearly defining what conduct is prohibited.

CONCLUSION

The commodity futures exchanges have become a key part of the financial services system of the United States. There is, however, serious concern, whether based on perception or fact, that the order execution system on the floors of the exchanges is chaotic, unfair and possibly invites serious fraud. That perception must be corrected in order to protect the markets' integrity and the public's confidence. The most effective way to guard the markets' integrity would be to ban dual trading in the active trading pits and require automated data and timing information upon which serious and substantial surveillance could be maintained. In addition, the CFTC needs greater flexibility to attack abusive floor practices. First, off-exchange negotiations should be expanded to allow price competition with the floor. This would assure that prices and traders on the floor are kept honest by competing price discovery.[267]

Another necessary reform is to allow the CFTC broad authority to prohibit manipulative and fraudulent practices. The CFTC regulations should include floor rules which prohibit specific trading practices. The rules should be simple and few, but should be detailed enough to give the traders guidance. Such rules would include standards under which block orders may be exposed to others.

Another needed reform is to professionalize the CFTC. Most of its members are not lawyers and, with a few notable exceptions, virtually all

265. Markham, *"Front-Running"—Insider Trading Under the Commodity Exchange Act*, 38 Cath. U.L. Rev. 69, 124 (1988).

266. *Id.*

267. *See generally* J. Markham, *supra* note 9, at 150-153 (discussing the CFTC's efforts to curb trading abuses); Markham & Gilberg, *Stock and Commodity Options—Two Regulatory Approaches and Their Conflicts*, 47 Alb. L. Rev. 741 (1983) (discussing SEC and CFTC regulatory efforts aimed at trading abuses).

of its members have had little or no background in futures trading.[268] The result has been uncertainty and delay in adopting needed regulations. The CFTC has also been ill-equipped to counter the political strength of the commodity exchanges whose contributions to and lobbying efforts before Congress and the CFTC have delayed regulations and efforts to automate the audit trail process.[269] Congress should require that the CFTC members be knowledgeable in commodity regulation, and that a majority of exchange board members be representatives of the public so as to ensure that exchange lobbying efforts are carried forward in the public interest.[270]

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268. *See* J. Markham, *supra* note 9, at 117-123.

269. *See* Vise, *Why Won't Wild Swings in Markets Just Go Away?*, Wash. Post, Oct. 18, 1989, at F1, col. 2; Drew & Cohen, *Tradeoff in Futures Industry: Customer Safeguards Sacrificed to Growth, Critics Say*, Chicago Tribune, Aug. 6, 1989, at 1, col. 3.

270. A bill recently approved by the House would require 20% representation of outside members on exchange boards. *See* H.R. Rep. No. 236, 101st Cong., 1st Sess 6 (1989). *See generally* J. Markham, *supra* note 9, at 140-41 (discussing concern that general public representation on CFTC is inadequate); Russo & Glickman, *Business Forum: Look Beyond the "Pits" for Directors*, N.Y. Times, Oct. 28, 1984, § 3, at 3, col. 1 (same). A recent amendment has also been proposed that would require future CFTC commissioners to have demonstrated knowledge in futures trading or its regulations. *See* Salwen, *Commodities Oversight Bill Clears House*, Wall St. J., Sept. 14, 1989, at C14, col. 6.