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DEFINING THE ROLE OF COMMODITIES REGULATORS

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I. INTRODUCTION

In 1996, a copper scandal involving Sumitomo Corporation exposed glaring vulnerabilities resulting from the quality of the regulation of commodities markets. Yet the Commodity Futures Trading Commission ("CFTC"), which regulates the United States commodities markets, had been criticized for years by other financial regulators as well as by market participants that believe that the CFTC subjects commodities markets to excessive regulation. The Commodities Exchange Act requires Congress to periodically evaluate commodities regulation and reauthorize the CFTC. The current authorization for the CFTC expires at the end of fiscal year 2000. Congress began the process to reauthorize the CFTC beyond 2000 early this year.

This article assesses the current framework for commodities regulation and analyzes arguments for regulatory reform. Part II describes three instances of commodities market manipulation: one instance of manipulation before the commodities markets were regulated and two relatively recent market disruptions. Part III explains the current regulatory debate. Part IV considers the reasons that governments regulate the commodity markets. Part V describes recent efforts to define the scope of the commodities regulators' authority. Finally, Part VI explains the importance of accepting the parameters of today's global markets and the responsibility of Congress to balance market integrity and market growth during the current reauthorization of the CFTC.
II. THREE SCANDALS IN THE COMMODITIES MARKETS

A. United Metals

During the first nine months of 1907, the supply of copper in the United States was unusually tight. Between April and August, the United Metals Selling Corporation usually sold 150 to 200 million pounds of copper, but during that period in 1907, it sold only five million pounds.\(^1\) Then, in October 1907, United Metals sold ninety-three million pounds of copper, and the price of the metal and of copper mining stocks plummeted.\(^2\) Although people suspected that United Metals was manipulating the market, it insisted that its sales activity merely reflected irregular fluctuations in the demand for copper.\(^3\)

One victim of the rapid devaluation of copper mining stocks was F. Augustus Heinze, president of United Copper and Mercantile National Bank.\(^4\) During 1907, Mr. Heinze had acquired a significant interest in United Copper's stock.\(^5\) When United Metals flooded the market with copper in October, Mr. Heinze expected investors to short-sell stock in United Copper in anticipation of a fall in the price of the stock.\(^6\) He ordered his brokers to continue buying the stock, thinking that if he owned enough shares of United Copper, he could force the short sellers to buy from him at an artificially high price when the time came for them to cover their positions.\(^7\) Unfortunately for him, Mr. Heinze overestimated the

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1. See Ellis W. Tallman & Jon R. Moen, Lessons From the Panic of 1907, ECON. REV. (Federal Reserve Bank of Atlanta), May/June 1990, at 5.

2. See id.

3. See id.

4. See id.

5. See id. at 6.

6. A "short sale" occurs when an investor believes that the market price of a stock is overvalued, borrows shares of the stock, and then sells the borrowed shares. The investor expects the value of the shares to fall below the price for which he sold them. If this happens, then the investor will realize a profit when he covers his position by buying shares at the depressed market price. An investor who owns a controlling interest in a shorted stock can "squeeze the shorts" when the time comes for the short sellers to cover their positions if the short sellers cannot find enough shares to cover their obligations without buying from the controlling shareholder. In the case of United Copper, Mr. Heinze attempted to "squeeze the shorts," but there were few shorts to squeeze. See id. at 6. For a detailed explanation of short sales, see BENTON E. GUP, THE BASICS OF INVESTING 167, 339 (5th ed. 1992).

7. See Tallman & Moen, supra note 1, at 5.
volume of short selling in United Copper's stock. When the value of United Copper's stock dropped, Mr. Heinze was unable to force buyers to pay above-market prices for his shares in order to cover their short sales.

As the value of Mr. Heinze's investment deteriorated, the public became concerned about his ties to the New York banking industry. Besides being president of Mercantile National, Mr. Heinze was a director of a number of banks and trust companies, and had influential friends in the industry. Depositors withdrew funds from his bank and from the banks and trust companies of those associated with him. The run on banks and trust companies in New York strained their ability to fund stock market trading. Activity on the New York Stock Exchange nearly came to a halt until J.P. Morgan arranged a fund to support the troubled institutions.

B. Metallgesellschaft

Today, the financial markets and our mechanisms for regulating them are significantly more mature than in 1907. In the United States, the Federal Reserve System and the Comptroller of the Currency ("OCC") share responsibility for the safety and soundness of the banking industry, the Federal Deposit Insurance Corporation ("FDIC") insures the public's retail bank deposits, and the Commodities Futures Exchange Commission ("CFTC") regulates the U.S. commodities markets. Given the roles of the Federal Reserve, the OCC, the FDIC, and the CFTC, it is unlikely that a simple market manipulation could still trigger a widespread bank panic. However, spectacular trading losses can still unnerv the market.

Toward the end of 1993, Germany's Metallgesellschaft learned firsthand that a crisis at one firm can threaten the stability of the commodities markets. In December 1992, Metallgesellschaft signed a security agreement guaranteeing the trading obligations of its U.S. subsidiaries, but according to the CFTC, it did not accurately measure its exposure. During the early nineties, U.S. subsidiaries of Metallgesellschaft purchased substantial amounts of short-term oil futures

8. See id.
9. See id.
10. See id. at 4.
11. See id. at 5.
12. See id. at 4.
13. See id. at 8.
contracts to hedge against long-term supply contracts that they entered into with independent gasoline stations and heating oil distributors.\textsuperscript{15} Approximately one-third of the short-term futures contracts were purchased on the New York Mercantile Exchange ("NYMEX").\textsuperscript{16} The balance were privately negotiated contracts.\textsuperscript{17} All of the long term supply contracts were off-exchange, privately-negotiated contracts.\textsuperscript{18} When oil prices dropped in the fall of 1993, one subsidiary, MG Futures, had open positions\textsuperscript{19} covering 160 million barrels of oil, including 55 million that were traded on the NYMEX.\textsuperscript{20}

In November 1993, oil prices approached their lowest level in three years.\textsuperscript{21} The prices fell below those at which MG Futures was obligated on its futures contracts.\textsuperscript{22} The NYMEX required MG Futures to supply increasing amounts of margin, and MG Futures solicited Metallgesellschaft for funding.\textsuperscript{23} As the margin calls escalated, Metallgesellschaft became reluctant to continue supporting the position of MG Futures.\textsuperscript{24} During the first week of December 1993, Metallgesellschaft sought the aid of the CFTC and the NYMEX in liquidating the contracts.\textsuperscript{25}

The CFTC and the NYMEX knew that timing the liquidation would be critical and proceeded with caution.\textsuperscript{26} When a futures contract is liquidated, the seller, for a price, releases the purchaser from its obligation. A rapid

\begin{enumerate}
\item See id. A futures contract fixes a time period, a price, and a quantity. At the end of the time period the purchaser is obligated to buy the specified quantity at the specified price. See Economic Purposes of Futures Trading, (last modified Jan. 1997) <http://www.cftc.gov/opa/brochures/econpurp.html>.
\item See In re MG Ref. & Mktg., Inc. & MG Futures, Inc., 1995 WL 447455, at *4.
\item See id.
\item See id.
\item An "open position" in this context is an obligation to purchase pursuant to futures contracts.
\item See Jeffrey Taylor & Kenneth H. Bacon, How the Nymex Calmed Crisis Over MG's Oil Trades, WALL ST. J., Apr. 5, 1994, at C1.
\item See id.
\item See id. To mitigate the risk that a trader will not cover a contract that has lost value, exchanges require traders who are "long" (obligated to buy at a pre-determined price) to deposit "margin" (funds representing the difference between the contract price and the market price) when prices drop. See GUP, supra note 5, at 479.
\item See Reerink, supra note 21, at 58.
\item See id.
\item See id.
liquidation would have weakened the "buy" side of the market and could have further depressed oil prices, compounding Metallgesellschaft’s losses, and creating losses for others in the market. However, if Metallgesellschaft voluntarily or involuntarily declared bankruptcy before its positions were liquidated, it would be excused from performing the contracts that were still open. To make matters worse, a number of Metallgesellschaft’s creditors, fearing that the company was no longer viable, demanded loan repayments that would have disrupted an orderly liquidation of the futures contracts.\(^{27}\)

The company delayed paying its creditors and adhered to the scheduled liquidation of the futures contracts.\(^{28}\) As a result of the liquidation, Metallgesellschaft lost more than $1 billion.\(^{29}\) The losses nearly bankrupted the company and reminded creditors, exchanges, and market participants of systemic risk—the fact that the failure of a large international conglomerate might still trigger a chain reaction of losses.

C. Sumitomo Corporation

Not long after Metallgesellschaft’s oil trading losses, signs of a copper trading scandal similar to the 1907 scandal began to surface. In 1994, the London Metal Exchange ("LME") leased a warehouse for copper in Long Beach, California so that U.S. market participants could have easy access to the metal.\(^{30}\) However, very little copper ever left the warehouse.\(^{31}\) The resulting short supply of copper caused its price for immediate delivery (the "cash" or "spot" price) to exceed its price for future delivery.\(^{32}\) For many commodities, cash prices are normally lower than prices for future delivery.\(^{33}\) When cash prices are higher than future prices, market participants call the premium for immediate delivery “backwardation.”\(^{34}\)

An unexplained backwardation may act as a signal that someone is trying to control supplies. On Friday, October 13, 1995, the backwardation difference between spot and 90-day contracts in copper tripled from $20 to

\(^{27}\) See Taylor & Bacon, supra note 20, at C1.
\(^{28}\) See id.
\(^{29}\) See Reerink, supra note 21, at 58.
\(^{31}\) See id.
\(^{32}\) See id.
\(^{34}\) See id.
$60.\textsuperscript{35} In light of this increase, members of the LME and its American counterpart, Commodities Exchange, Inc. ("Comex"), were fairly certain that somebody was manipulating the market.\textsuperscript{36}

The following Monday, the Wall Street Journal reported that Yasuo Hamanaka, a trader at Sumitomo Corporation, may have controlled more than two-thirds of the copper in the Long Beach warehouse.\textsuperscript{37} Like United Metals in 1907,\textsuperscript{38} Hamanaka denied that Sumitomo was manipulating the copper supply.\textsuperscript{39} Over the next several months, the CFTC sought information from the LME to determine who might be in a position to control the copper supply.\textsuperscript{40} The LME was slow to respond to the CFTC’s requests, initially reporting that it did not detect any sign of manipulation.\textsuperscript{41} However, as backwardation continued through the winter, the LME agreed to participate in the CFTC’s investigation.\textsuperscript{42}

While the CFTC and the LME were investigating copper prices in April 1996, a clerk at Sumitomo Corporation received a bank statement that she could not reconcile with Sumitomo’s records.\textsuperscript{43} Sumitomo contacted the bank and learned that Hamanaka had initiated the transactions reflected on the statement.\textsuperscript{44} Apparently, the transactions were related to Hamanaka’s unauthorized trading in copper.\textsuperscript{45} Because of the questions surrounding Hamanaka, Sumitomo removed him from his position as a copper trader.\textsuperscript{46} Several weeks later, Hamanaka confessed to his manager at Sumitomo that he had been secretly trading copper for nearly ten years and that Sumitomo

\textsuperscript{36} See id.
\textsuperscript{37} See id.
\textsuperscript{38} See supra notes 1–13 and accompanying text.
\textsuperscript{39} Behrmann et al., supra note 35, at C1.
\textsuperscript{40} McGee & Frank, supra note 30, at A1.
\textsuperscript{41} See id.
\textsuperscript{42} See id.
\textsuperscript{43} See id. Apparently, that undisclosed foreign bank was Union Bank of Switzerland. See UBS Held 4 Accounts for Sumitomo Copper Trader Hamanaka, \textit{AFX News}, July 7, 1997, available in LEXIS, News Library, AFX News.
\textsuperscript{44} See McGee & Frank, supra note 30, at A1.
\textsuperscript{45} See id.
controlled a substantial portion of the copper in the Long Beach warehouse.\footnote{See McGee & Frank, infra note 30, at A1.}

Hamanaka began his unauthorized trading in 1985 to cover up a $20 million trading loss.\footnote{See Anatomy of a Debacle: How Sumitomo’s Hamanaka Came Undone, AGENCE FRANCE-PRESSE, Feb. 17, 1997, available in 1997 WL 2060745.} Over the next several years, Sumitomo lost increasing amounts of money through Hamanaka’s speculative trading in the copper market.\footnote{See id. For example, in 1994 Hamanaka lost $253 million by writing $150 million of combined put and call options in favor of Morgan Guaranty. This strategy, known as a “top straddle,” was one of the strategies used by Nicholas Leeson when his futures trading bankrupted his employer, Barings, PLC in 1995. Writing a combination of put and call options is risky because the writer gives the other party to the options the right to either sell or buy. Unless the writer hedges its position, the writer will lose money if the price of the underlying commodity either rises or falls beyond a narrow range. For information regarding “top straddles”, see HAL S. SCOTT AND PHILIP A. WELLONS, INTERNATIONAL FINANCE: TRANSACTIONS, POLICY, AND REGULATION 1010-11 (4th ed. 1997).} In late 1993, attempting to recover Sumitomo’s losses, Hamanaka established a relationship with a U.S. copper merchant firm.\footnote{See In re Sumitomo Corporation, 1998 WL 236520, at *4.} Their goal was to purchase vast quantities of copper, artificially inflate the market price of copper, and then liquidate their holdings at a substantial profit.\footnote{See id.} By late 1995, when the CFTC began investigating copper prices, Sumitomo and the U.S. copper merchant owned and controlled up to 100% of LME copper stocks.\footnote{See id.}

Hamanaka’s control of the copper market ended when Sumitomo removed him from his position in May 1996.\footnote{See id.} At the time, he had not yet liquidated most of Sumitomo’s holdings; it still owned a significant amount of copper.\footnote{See id.} The day after Hamanaka confessed, copper prices dropped 10%.\footnote{See id.} Market observers suspect that Sumitomo immediately began to unload its store of copper, driving prices down.\footnote{See id.} Eight days later, Sumitomo publicly disclosed the extent of its holdings and projected losses.\footnote{See Fred Vogelstein & Neil Behrmann, Market Struggles to Sort Out Sumitomo Mess: Copper Traders See Volatility Amid Scandal, WALL ST. J., June 17, 1996, at C1.} Copper prices again fell 10% in a single day.\footnote{See id.} Because of its
large holdings and the rapid decrease in prices, Sumitomo's losses were enormous. In the end, Sumitomo reported a $2.6 billion loss as a result of the copper trading scandal.59

Sumitomo was not the only victim of Hamanaka's fraudulent trading. Many banks and other large market participants that had sold put options to copper producers suffered from the rapid decline in prices.60 In this context, a "put" is an option that a financial intermediary sells to a commodity producer, promising to buy a certain amount of the commodity from the producer at a set price on a future date.61 A dealer that sells a put expects that prices will remain stable or will not fall below the exercise price for the put, in which case the dealer can collect the option fee without having to actually perform on the contract. However, if the market falls below the exercise price, producers that bought puts will exercise their options to sell their products to the dealers at higher prices than the market price. To offset this risk, dealers typically use a "dynamic" hedging strategy in which they sell copper futures contracts or buy call options.62 However, in a rapidly declining market, dealers face losses even if they have hedged their positions because dynamic hedging can be difficult, if not impossible, to achieve in a market that has become illiquid due to an unpredictable fall in prices.63 Dealers that had sold put options on copper in the spring of 1996 faced significant losses after Sumitomo's copper scandal sent the market into a tailspin.64

III. A REGULATORY CROSSROADS

Each of these three commodity trading scandals—United Metals in 1907, Metallgesellschaft in 1993, and Sumitomo in 1996—had a profound impact on financial regulation. After the bank panic that followed the United Metals market manipulation, the Federal Government held hearings which determined that the country needed a central source for assessing the stability of the banking industry.65 The hearings ultimately were influential

62. See Barry, supra note 60, at MW 12.
63. See id.
64. See id.
65. See Tallman & Moen, supra note 1, at 2.
in leading Congress to establish the Federal Reserve System—a first step toward building the supervision of the financial markets that we have today in the United States.\textsuperscript{66}

In response to Metallgesellschaft's 1993 oil contracts trading dilemma, the CFTC fined MG Futures and a second U.S. subsidiary, MG Refining and Marketing, $2.25 million.\textsuperscript{67} Significantly, the CFTC also required them to strengthen their internal controls, and declared their off-exchange supply contracts illegal and void.\textsuperscript{68} The CFTC's regulatory action against Metallgesellschaft was criticized by market participants and legislators alike. Market participants questioned the CFTC's authority to regulate internal controls, but they were primarily concerned with the legality of the off-exchange contracts.\textsuperscript{69} Some observers believed that, by rendering the contracts void, the CFTC was challenging the entire off-exchange interbank swaps market.\textsuperscript{70} The CFTC assured Congress that it did not intend to disrupt the off-exchange market,\textsuperscript{71} but certain members of Congress wanted to rein in its regulatory authority. Early in 1997, Congressman Ewing introduced amendments to the Commodity Exchange Act in the House of Representatives\textsuperscript{72} and Senator Lugar introduced a similar bill in the Senate.\textsuperscript{73} Both bills sought to significantly reduce the CFTC's regulatory authority. Although neither bill became law, together they set the stage for a dramatic dispute regarding commodities regulation.

As Congress considered narrower authority for the CFTC, commodity regulators around the world questioned the adequacy of their regulatory systems in light of the Sumitomo debacle. In November 1996, regulators from seventeen countries met in London to discuss global standards for commodities regulation.\textsuperscript{74} They agreed to develop standards for contract

\begin{itemize}
  \item \textsuperscript{66} See id.
  \item \textsuperscript{67} See In re MG Ref. & Mktg., Inc. & MG Futures, Inc., No. 95-14, 1995 WL 447455, at *4 (C.F.T.C. July 27, 1995).
  \item \textsuperscript{68} See id. In general, a contract for the sale of a commodity for future delivery must be traded on a CFTC-designated contract market unless the CFTC grants an exemption. In 1993, the CFTC exempted swap contracts from the off-exchange prohibition, but only if the contract is privately negotiated between certain types of financially sophisticated parties.
  \item \textsuperscript{70} See Justin Fox, Futures Agency Denies Intention of Regulating OTC Derivatives, AM. BANKER, Jan. 23, 1996, at 2.
  \item \textsuperscript{71} See id.
  \item \textsuperscript{72} H.R. 467, 105th Cong. (1997).
  \item \textsuperscript{73} S. 257, 105th Cong. (1997).
  \item \textsuperscript{74} See Nancy E. Kelly, CFTC's Born Sees a World of Tasks to Tackle, AM. METAL
design, market surveillance, and information sharing.\textsuperscript{75} In October 1997, the regulators reconvened in Tokyo and issued a Communiqué that endorsed a set of best practices for regulatory cooperation, and for overseeing contract development and market activity ("Best Practices").\textsuperscript{76} The regulatory authorities that participated in the conference agreed to share surveillance information about large exposures with each other and to encourage their own governments to remove domestic obstacles to obtaining and sharing such information.\textsuperscript{77}

Despite global efforts to coordinate and strengthen oversight of the commodities markets, many in the U.S. oppose a more active role for the CFTC. In May 1998, the CFTC issued its Concept Release regarding Over-the-Counter (OTC) Derivatives.\textsuperscript{78} The release sought public comment on a number of issues relating to the rapidly expanding off-exchange market for financial derivatives.\textsuperscript{79} The CFTC's regulations presently govern exchange-traded contracts, but off-exchange contracts are generally unregulated.\textsuperscript{80} The CFTC presented its concept release as a neutral request for comments, but to many people—who had already seen the CFTC declare Metallgesellschaft's off exchange contracts void—it implied that the CFTC intended to regulate the off-exchange derivatives market. Afraid that legal uncertainty would drive the OTC derivatives market offshore, the U.S. Treasury Secretary, the Federal Reserve chairman, and the Securities and Exchange Commission (SEC) chairman each petitioned Congress for emergency legislation to prevent the CFTC from regulating the OTC market.\textsuperscript{81}

Throughout the summer of 1998, committees of the U.S. Senate and House of Representatives held hearings about the CFTC's concept release.\textsuperscript{82}

\textsuperscript{75} See id.

\textsuperscript{76} See Commodity Futures Trading Commission, Tokyo Commodity Futures Markets Regulators' Conference 3 (1997) [hereinafter Tokyo Conference].


\textsuperscript{79} Id. at 26,115.

\textsuperscript{80} Id. at 26,114.


\textsuperscript{82} The House of Representatives Committee on Agriculture's Subcommittee on Risk Management and Specialty Crops held a hearing on June 10, 1998. The House of
The CFTC testified that its concept release merely sought public opinions about the OTC markets. The Treasury Department, the Federal Reserve, and the SEC testified that the concept release threatened an already fragile understanding that certain off-exchange contracts are legal and enforceable. Leaders of the U.S. commodity exchanges and industry associations presented divergent views regarding the off-exchange market and the threat, if any, presented by the concept release. In June 1998, following the first round of hearings, Congressman Leach introduced the Financial Derivatives Supervisory Improvement Act of 1998 ("HR 4062") in the House of Representatives. After a second and third round of hearings, Congressman Smith introduced the Financial Markets Reassurance Act of 1998 ("HR 4507"). Both bills sought to restrain the CFTC from proposing any rule regarding the off-exchange market until after the CFTC reauthorization process.

Shortly after the hearings, and while the bills were still before various congressional committees, a financial crisis punctuated the regulatory debate. Long Term Capital Management ("LTCM") is a hedge fund manager that borrowed heavily to invest in both on- and off-exchange contracts. In September 1998, regulators learned that LTCM’s capital had fallen to less than 1% of its securities investments, and they were concerned that LTCM might default on margin calls. To ensure that LTCM would not default, the Federal Reserve Bank of New York orchestrated a $3.6 billion capital contribution from LTCM’s major creditors. The bailout left the regulators contemplating familiar questions regarding off-exchange

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84. See Subcomm. Hearings, supra note 81.
85. Id.
88. See Agric. Comm. Hearings, supra note 82, (statement of Brooksley Born, Chairperson, CFTC).
89. Id.
Ultimately, the four regulators (the Treasury, the Federal Reserve, the SEC, and the CFTC) agreed to conduct a joint study of the off-exchange market, and Congress passed legislation to restrain CFTC regulation of the off-exchange market for several months while the study was being conducted.

The simultaneous efforts to restrain commodities regulation in the United States and to expand it abroad place commodities regulators at a crossroads. In seeking effective regulatory infrastructures, many countries try to emulate the United States because they consider the U.S. markets to be particularly efficient and a universal model. Meanwhile, the United States is trying to recapture market share by emulating the more narrow regulation practiced in other jurisdictions. During the current reauthorization process, Congress may restructure the law governing the U.S. commodity markets. The following sections will analyze the various reasons to regulate commodity markets, assess the performance of existing commodities regulation, and weigh the sometimes competing interests of integrity and growth in the marketplace.

IV. WHY REGULATE THE COMMODITIES MARKETS?

A. Identifying the Participants

The natural purpose of a commodities market is to facilitate trade in commodities. A commodities market has three types of participants: suppliers of commodities, users of commodities, and financial intermediaries. These participants use commodities exchanges to buy and sell commodities, or to trade options or contracts covering commodities. Suppliers use commodity exchanges, in part, to ensure that they can sell their products at a predictable price in the future, while purchasers use the

90. Id.
91. See Agric. Comm. Hearings, supra note 82 (statement of Barbara P. Holum, Commissioner, CFTC).
93. The Commodity Exchange Act broadly defines “commodity” to include a list of agricultural products and “all other goods and articles, except onions... and all services, rights, and interests in which contracts for future delivery are presently or in the future dealt in.” 7 U.S.C. § 1(a)(3) (1994). More generally, commodities include metals, minerals, hydrocarbons, and agricultural, and financial products.
94. See Economic Purposes of Futures Trading, supra note 61.
95. See id.
same exchanges, in part, to ensure predictable prices for the products they need to purchase in the future. Supplied and purchasers will use a commodity exchange if they are confident that the contracts traded on the exchange will be honored and reflect an accurate assessment of market conditions.

As Section II revealed, market participants sometimes attempt to manipulate a market by controlling supplies and maintaining artificially high prices. Mr. Heinze of United Copper (a supplier) tried this technique in 1907, and Mr. Hamanaka of Sumitomo Corporation (a financial intermediary) tried it during the early 1990's.

To complicate matters, the third group of market participants, financial intermediaries, sometimes trade on commodity exchanges not because they need to buy or sell a particular product, but because they believe that, on the basis of their understanding of market conditions, they can take profitable positions in the market. In such cases, they wish to use their understanding to exploit what they perceive to be opportunities to profit in the market, and are said to play the role of speculators.

Speculators can stabilize a market. For example, a speculator who buys a particular commodity believing that its supply will drop in the future, may intend to withhold the commodity from current consumption when the supply is adequate and sell it in the future when the supply is inadequate. The practice of withholding a commodity which is abundant in order to sell it when it is scarce stabilizes the market for the commodity. However, when a speculator's predictions turn out to be wrong, the resulting losses sometimes disrupt the market. During 1993, U.S. subsidiaries of Metallgesellschaft wrongly predicted that oil prices would rise, and their substantial obligations on oil contracts nearly caused a financial crisis when oil prices dropped.

A market disruption can cause participants to question whether their contracts accurately reflect market conditions, or whether the contracts reflect some activity that is distorting the true state of the market. A shock to market confidence can affect trading volume. For example, after Sumitomo announced its massive copper trading losses in 1996, the volume of copper futures trading on both the LME and the New York Mercantile

96. See id.
97. See id.
98. See supra note 1 and accompanying text.
99. See supra note 46 and accompanying text.
100. See GuP, supra note 6, at 469.
101. See In re MG Ref. & Mktg., Inc. & MG Futures, Inc., supra note 14, at *2.
Exchange declined. Trading remained slow into the summer of 1997. In May 1997, metals analyst Alan Williamson of Deutsche Morgan Grenfell in London commented that "[c]ertainly, the speculative community (i.e., position-taking intermediaries) hasn’t wanted to play the copper market." Since unstable markets can adversely affect commerce and economic conditions in general, governments tend to believe that a stable commodities market serves the public interest. They regulate their commodity exchanges so that they can play a role in instilling confidence in the markets. As the commodity markets evolve in various jurisdictions, governments adjust their regulatory frameworks, but the proper scope and source of regulation are a source of enduring controversy.

\textbf{B. Protecting Sophisticated Investors—The Need to Assure Market Confidence for Individual Firms, Local Markets, and Global Markets}

One long-standing principle of financial regulation is that professional market participants do not require as much regulatory protection as do less sophisticated individual investors. For example, when the United States first established its deposit insurance system for commercial banks in 1933, the insurance limit was set at $2,500. This low ceiling was intended to protect consumer deposits and prevent runs on banks. It recognized that large depositors, who in many cases are large corporations or other banks, are better able to assess the condition of their banks than the average consumer. In the commodities markets, rules designed to protect a farmer who sells a put option on wheat may not be necessary to protect a sophisticated dealer that trades financial contracts. In fact, the idea behind current proposals to modify commodities regulation in the United States is that transactions between sophisticated traders should be exempt from most CFTC regulations.

\begin{itemize}
  \item 103. See id.
  \item 104. Id.
  \item 106. See \textsc{Carter H. Golembe and David S. Holland}, \textit{Federal Regulation of Banking} 117 (1986). The limit is currently $100,000. See id.
  \item 108. See id.
\end{itemize}
There are however, limits on the ability of private parties to uncover fraud. Large corporations and sophisticated traders lack the regulatory and investigative powers of a government agency. And, notwithstanding their size, they are vulnerable to the turbulence that may affect markets when large frauds are uncovered. While consumer protection is a significant objective of financial regulation, market confidence is an even more fundamental goal of regulation that reaches beyond consumer-orientated markets. The drop in the volume of copper futures trading following the Sumitomo scandal\textsuperscript{109} illustrates the need for market confidence. As discussed, market participants trade futures contracts in part to stabilize the prices they will pay or receive in the future. But after a market shock that causes participants to question the basis for the contracts, many of those participants may take their chances on future prices rather than enter into contracts that they perceive to be unreliable.

The so-called "Japanese premium"\textsuperscript{110} illustrates the costs of sacrificing market confidence. In late 1995, following a string of rescues and scandals involving Japanese banks, most notably Daiwa's bond trading scandal in New York, lenders in the international funds markets lost confidence in the Japanese banking industry and charged Japanese banks a premium for funds (both yen and U.S. dollars) above the rates charged to non-Japanese banks.\textsuperscript{111} The premium hurt an already ailing Japanese banking market, causing many Japanese banks to scale down their international business, and causing some of their customers to use foreign banks for financing.\textsuperscript{112}

Efforts by emerging market countries to adopt global standards for bank regulation demonstrate that many countries recognize the value of market confidence. The Basle Committee on Bank Supervision is a committee of banking supervisory authorities.\textsuperscript{113} In September 1997, it issued Core Principles for Effective Banking Supervision ("Core

\begin{thebibliography}{9}
\bibitem{109} See Vogelstein & Behrmann, supra note 57, at C1.
\bibitem{111} See Steiner, supra note 110.
\bibitem{112} For example, Sumitomo Corporation turned to foreign banks, including American banks, for financing when the so-called Japanese Premium made it difficult for Japanese banks to offer competitive financing. See \textit{The Sumitomo Copper Trading Scandal: The Japanese Context: Hearing Before the House Banking Comm.}, 104th Cong. (1996) (statement of Douglas Ostrom, Senior Economist, Japan Economic Institute of America).
\bibitem{113} The committee currently consists of senior representatives of banking supervisory authorities and central banks from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, Netherlands, Sweden, Switzerland, United Kingdom, and the United States.
\end{thebibliography}
Principles") which set forth twenty-five basic concepts for establishing and maintaining a stable banking market.\textsuperscript{114} The premise of the Core Principles is that by adopting a regulatory framework that meets certain global standards, bank supervisors can create a basis for global confidence in the banks that they supervise.\textsuperscript{115} In addition to the twelve states that are members of the Basle Committee, sixteen non-member countries participated in developing the Core Principles, and supervisory authorities around the world have been invited to adopt them.\textsuperscript{116}

The recent expansion of the Organization for Economic Cooperation and Development ("OECD") also illustrates the emphasis that certain emerging market countries place on market confidence. The OECD exists to promote compatible economic and social policies among its member countries in order to foster economic growth and financial stability.\textsuperscript{117} To be eligible for OECD membership, a country must develop policies and regulations that are consistent with the OECD goals of growth and stability. Several countries have recently been admitted to, applied to, or expressed an interest in the OECD. South Korea, Poland, and Hungary are the countries most recently admitted to the OECD.\textsuperscript{118} Status as an OECD-member could enhance a country's investment, finance, and trade opportunities because of enhanced market confidence in that country.

Given the separate goals of consumer protection and market confidence, an evaluation of the appropriate scope of regulation for the commodities markets must first identify the market's participants, its risks, and the potential victims if those risks materialize. In a September 1996 editorial, \textit{The Wall Street Journal} pointed out that Sumitomo is a Japanese company, Yasuo Hamanaka was based in Tokyo, and his trading was largely conducted on the LME in London rather than on a U.S. exchange.\textsuperscript{119} The editorial asserted that the Sumitomo incident had no American victims

\begin{footnotes}
\item[115] \textit{See Core Principals, supra} note 114.
\item[116] \textit{See id.}
\end{footnotes}
because the author could not identify an American consumer who had lost money as a direct result of Sumitomo's trading scandal. Therefore, the Journal argued, the scandal should not cause concern in America. A lead story in The Financial Times in March 1997 made a similar argument, stating that retail investors require some protection, but market professionals do not. However, this line of reasoning fails to consider adverse effects of the trading scandal on copper market participants worldwide due to the loss of confidence in the copper futures markets.

In fact, the Sumitomo copper trading scandal imposed significant costs on commodity exchanges and on those that rely on them. First, there is evidence that the scandal undermined confidence in both the LME and the Comex with respect to copper and brought about decreased trading volume on those exchanges. Second, financial intermediaries such as Banker's Trust, J.P. Morgan, and American International Group that had sold put options to copper producers in ignorance of Sumitomo's fraudulent activity faced extraordinary losses if copper producers exercised their put options. Third, any copper producer that had not purchased enough put options to cover its inventories may have been forced to sell, at deflated market prices, the portion of its inventories that was not covered. Fourth, the increased volatility of copper prices resulting from the scandal is likely to have caused the premium charged for put options to rise, thereby costing copper producers more to protect the value of their copper inventories.

Finally, banks that had arranged creative financing for Sumitomo's copper trading were exposed to losses when the trading scandal surfaced. For example, J.P. Morgan & Co. had originally loaned Sumitomo $400

120. The story argued that "there is general agreement that retail investors need protection. But there is no case for protecting market professionals who are capable of looking after themselves." A Slim CFTC, FINANCIAL TIMES, Mar. 11, 1997, at 19.

121. Despite the perception of market participants that the Sumitomo incident caused a decline in trading volume (see, e.g., Lucchetti, supra note 102) and figures cited by NYMEX chairman Daniel Rappaport that tend to show that such a decline did occur, LME chairman David King claimed in May 1997 that the Sumitomo incident did not cause a decline in trading volume. Mr. Rappaport contends that the "LME has illusory numbers that inflate the volume." Mr. Rappaport's comments were directed at copper trading in particular, while Mr. King's comments were in reference to trading volume generally. See Stephen Coplan, Nymex Chief Cites Copper Gain over LME, AM. METAL MARKET, Sept. 10, 1997, at 8, available in 1997 WL 8678741 and Michele Peel, LME Chief to Report Increased Volume, FIN. TIMES, May 21, 1997, at 42, available in 1997 WL 11029548.


123. See id.

million to finance copper trading, but apparently had restructured the loan by turning it into a security based on the payment stream expected from the copper trading.125 On April 2, 1997, the Federal Reserve and the New York State Banking Department reprimanded J.P. Morgan & Co. for "careless management and control in its base metals business" following an investigation into its relationship with Sumitomo.126 Although reports in the press did not provide details of the transaction, it seems that J.P. Morgan initially issued a loan to Sumitomo that it later forgave in exchange for rights to a payment stream linked to Sumitomo's copper trading.127 The bank might not have been affected by the scandal if the financing had remained a traditional bank loan to Sumitomo Corporation, which was supported by Sumitomo Bank and Sumitomo Trust.128 However, if J.P. Morgan had linked its right to receive payments to the performance of Sumitomo's copper trading, it was exposed to a significantly lower level of payments when prices fell after the copper trading scandal surfaced.129

Sophisticated traders may require less protection than small investors, but they require a significant level of protection. All participants in professional trading markets need to be protected from systemic risk (i.e., activity that threatens the integrity of the markets). When a trading scandal caused by one market participant imposes costs on suppliers, end-users, and financial intermediaries that were not responsible for the scandal, the sophisticated nature of their business neither reduces their losses, nor protects against systemic risk.130 Decreased trading volume following a


126. See id. The reason for the reprimand was not disclosed in the press. By issuing a reprimand rather than taking regulatory action, state and federal authorities implied that the business was not fraudulent and that any loss Morgan suffered as a result of its relationship with Sumitomo was caused by market disruptions brought about by Sumitomo's market manipulation, not by fraudulent activity by its own employees. See id.

127. See id.


129. As a creditor, J.P. Morgan would have been entitled to repayment regardless of Sumitomo's copper trading losses, and could have expected repayment even if the losses threatened the solvency of Sumitomo because the Sumitomo banks promised to support the trading corporation. However, as a counterparty to a financial contract, J.P. Morgan's right to a payment stream would have been susceptible to market distortions caused by Sumitomo's manipulative trading.

130. For example, see the testimony before Congress of John G. Gaine, of the Managed Futures Association on April 17, 1997. Addressing proposed amendments to the Commodity Exchange Act, Mr. Gaine stated "because our membership also bears the cost
scandal suggests that participants are not using the markets to mitigate pricing risks to the extent that they used the markets prior to the scandal. When parties not associated with a scandal bear significant losses because of it, their subsequent reluctance to use the markets indicates that the markets and the authorities that regulate them are not effectively serving their purpose, which is to facilitate trade.

V. THE SCOPE OF AUTHORITY OF COMMODITIES REGULATORS

Although governments and the regulators of the commodities markets may seek to tighten their supervision of the markets after a scandal causes catastrophic losses, they must carefully avoid over-regulating the markets. To facilitate trade, regulators must allow markets to be efficient, and that requires balancing regulatory principles that focus on market confidence with deregulatory principles that focus on market efficiency. To a large extent, legislators balance regulatory interests by creating regulatory powers and the courts participate in this balancing by interpreting those powers. But regulators, exchanges, and market participants also play important roles in defining the scope of authority of commodities regulators.

A. Global Coordination Following the Sumitomo Incident

On October 31, 1997, regulators of commodities markets in seventeen jurisdictions demonstrated that they intend to help shape the scope of their own authority by issuing the *Tokyo Commodity Futures Markets Regulators' Conference*, which establishes regulatory “best practices.” The topics if markets lack integrity or are inefficient, we believe deregulation should be approached knowledgeably. . . . The wave of incidents outside the United States, such as Barings and Sumitomo, reminds us of the importance of some of the features of our regulatory structure.” Revision of Commodity Market Regulation: Hearings on H.R. 467 Before the Subcomm. on Risk Management and Specialty Crops of the House Comm. on Agric., 105th Cong. (1997) (statement of John G. Gaine, Managed Futures Association).

131. The seventeen adherents to the *Tokyo Communiqué* are: Australian Securities Commission (Australia), Comissao de Valores Mobiliarios (Brazil), Canadian Grain Commission (Canada), Commission des Operations de Bourse (France), Bundesaufsichtsampt fur den Wertpapierhandel (Germany), Securities and Futures Commission (Hong Kong), Hungarian Banking and Capital Market Supervision (Hungary), Commissione Nazionale per le Societa e la Borsa (Italy), Ministry of International Trade and Industry, Ministry of Agriculture, Forestry, and Fisheries (Japan), Ministry of Finance and Economy (Korea), Securities Commission (Malaysia), Securities Board of the Netherlands (Netherlands), Singapore Trade Development Board (Singapore), Financial Services Board (South Africa), Financial Services Authority (United Kingdom), Commodity Futures Trading Commission (United States of America). See TOKYO CONFERENCE, *supra*
covered by the *Tokyo Conference*—contract design, market surveillance, and information sharing—are all legitimate concerns of the regulators. However, implementing the best practices may require them to amend their own policies. In other instances market regulators may request that their governments broaden their regulatory authority or even modify national policies.

1. Contract Design

With respect to contract design, the *Tokyo Conference* encourages regulators to review exchange-traded contracts to ensure that they are designed to minimize their "susceptibility . . . to abusive conduct." Such a review, while useful, implies that regulators will require more time to approve new contracts. However, in 1997 the CFTC, under pressure to provide efficient supervision, introduced a "fast-track" process to approve new exchange-traded contracts. Under the fast-track process, exchanges may obtain the CFTC's approval to trade certain new types of futures contracts within ten days of the application date. When the CFTC proposed the fast-track rules, the exchanges generally commented that they "did not go far enough to relieve the exchanges from the perceived competitive burden which they argued the approval process entails." In particular, the Chicago Board of Trade argued that the CFTC should not review contract design at all because the exchanges should be trusted to review new contracts. Meanwhile, the Futures Industry Association, whose members "effect [sic] more than eighty percent of all customer transactions executed on United States contract markets," supported the CFTC's review process, but expressed concern that fast-track approval would inhibit public comment on proposed contracts.

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132. *Id.* at 7.
133. *Id.* at 34.
135. *Id.* at 10,434.
136. *Id.* at 10,435.
137. *See id.* at 10,435.
138. *Id.* at 10,438.
139. *See id.* Applications had previously been subject to a thirty day comment period.
The CFTC did not accede to the suggestions of the exchanges, and promulgated the fast-track rules essentially as proposed.\textsuperscript{140} However, the exchanges continued to press for less regulatory oversight, citing competitive pressures from foreign exchanges and the off-exchange markets.\textsuperscript{141} Responding to the exchanges' concerns, in July 1999 the CFTC proposed a rule that allows the exchanges to list certain contracts for trading prior to receiving CFTC approval.\textsuperscript{142} In the Federal Register notice that introduced the proposed rule, the CFTC referred to its 1994 study on global competition.\textsuperscript{143} The 1994 study found "no evidence that disparities in the regulatory frameworks of various jurisdictions, including particularly disparities in procedures for listing new contracts, were a major force explaining the success of various exchanges in the global market."\textsuperscript{144} The CFTC noted that "the trend among foreign authorities has been to strengthen their regulatory regimes."\textsuperscript{145} However, the CFTC also recognized that its own rules "must be responsive to changes in the marketplace if U.S. markets are to remain competitively robust."\textsuperscript{146}

The proposed rules for listing contracts prior to approval seek to balance competitive pressures with the public interest. Under the proposal, exchanges must notify the CFTC of their intent to list a contract prior to approval the day before the contract is listed.\textsuperscript{147} The notice must describe the contract's terms and conditions.\textsuperscript{148} The CFTC noted that it will require an exchange to amend a contract if it does not satisfy the CFTC's regulations, and that amending an actively traded contract might require the exchange to take emergency action with respect to open positions.\textsuperscript{149} Therefore, the CFTC commented that listing contracts prior to approval should be reserved for contracts that "clearly raise no legal or practical impediments to trading."\textsuperscript{150} By allowing exchanges to list routine contracts

\textsuperscript{140} See id.
\textsuperscript{142} See id.
\textsuperscript{143} See id.
\textsuperscript{144} Id.
\textsuperscript{145} Id.
\textsuperscript{146} Id.
\textsuperscript{147} See id. at 40,532.
\textsuperscript{148} See id.
\textsuperscript{149} See id.
\textsuperscript{150} Id.
prior to approval while warning them against listing complex contracts without approval, the CFTC's proposal attempts to balance competitive pressures and the public interest.

Although fast-track approval and listing contracts prior to approval are arguably consistent with the public interest, they may be inconsistent with the global best practices. Fast-track approval forces the CFTC to approve contracts more quickly, and with less time for public comment, than it did before it endorsed the Tokyo Conference. Listing prior to approval would allow contracts to be traded before any public comment. However, the exchanges generally contend that they already review their own contracts to "minimize their susceptibility to abusive conduct,"\textsuperscript{151} and that any CFTC review is redundant.\textsuperscript{152} Fast-track approval and listing prior to approval both demonstrate the tension between the U.S. market's trend toward efficiency and the global market's trend toward caution.

2. Market Surveillance

With respect to market surveillance, the Tokyo Conference encourages regulators to adopt rules that will help them to monitor market activity and to detect and investigate conduct that may be abusive or may otherwise impair market stability.\textsuperscript{153} In particular, the Tokyo Conference suggests that regulators should develop systems to identify large exposures, including over-the-counter positions that are related to large exchange positions.\textsuperscript{154} Such information provides a market with transparency.

A transparent market is one in which market participants have access to information about pricing and the size of holdings.\textsuperscript{155} Lack of transparency played a central role in the 1907 United Metals market manipulation and the panic that followed it. First, because the copper market was not transparent, United Metals was able to control the U.S. copper supply during much of 1907 without regulatory intervention.\textsuperscript{156} Second, when United Metals dumped its copper on the market in October 1907, Mr. Heinze guessed that market participants were short-selling stock in United Copper but he did not have access to information that would

\begin{itemize}
  \item \textsuperscript{151} See \emph{Tokyo Conference}, supra note 76, at 34.
  \item \textsuperscript{152} See generally \emph{Revised Procedures II}, supra note 141.
  \item \textsuperscript{153} See \emph{Tokyo Conference}, supra note 76, at 34.
  \item \textsuperscript{154} See id.
  \item \textsuperscript{155} See Richard W. Jennings et al., \emph{Securities Regulation: Cases and Materials} 9 (7th ed. 1992).
  \item \textsuperscript{156} See Tallman & Moen, supra note 1, at 5.
\end{itemize}
confirm his suspicions. Consequently, Heinze pursued a "short-squeeze" strategy in a market where there were few short-sellers. In a transparent securities market, Heinze would have known the volume of short-selling and probably would not have attempted to squeeze the short-sellers. Third, after Heinze lost a fortune through his United Copper transactions, the public became concerned about the solvency of the banks with which he was associated. But because the banking market was not transparent, neither the public nor the government had ready access to information that could clarify which banks could remain solvent, and a bank panic ensued. These events exposed simultaneously the dangers of a lack of transparency in the commodities, securities, and banking markets.

With respect to commodities, the CFTC now requires traders with large positions on U.S. commodity exchanges to report their exchange positions each week. The CFTC compiles the information in its Commitments of Traders in Futures reports, which are publicly available on the Internet. The large trader reports add transparency to the U.S. commodities markets where, in the past, companies like United Metals were able to manipulate the markets with a good degree of anonymity.

In contrast to the CFTC's mandatory reporting, in 1996 the LME permitted brokers to voluntarily report positions of their large clients, and traders on the London International Financial Futures and Options Exchange ("LIFFE") did not report their positions at all. Professor Christopher Gilbert, a "U.K. academic noted as an expert on commodity futures markets," recommended that the U.K. authorities should use the CFTC's large trader reports as a model for monitoring market activity. Professor

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157. See id. at 6.
158. See id.
159. See id. at 4.
160. See id. at 8.
165. See Gilbert, supra note 163, at 14.
Gilbert also proposed that the LME should take the extra measure of requiring reports of physical positions (i.e., ownership of stock in LME warehouses). 166 Professor Gilbert suggested that the U.K. authorities might have detected Sumitomo's market manipulation much sooner if they had required such large-trader reports. 167 Professor Gilbert's suggestions were consistent with the market surveillance best practices that were endorsed by the world's commodity markets supervisors, including the U.K.'s Financial Services Authority ("FSA"). 168

Despite global recognition that market surveillance is important, and the recognition of the CFTC's Commitments of Traders in Futures reports as a model for market surveillance, some U.S. exchanges would like to discontinue large-trader reporting. For example, former chairman of the Chicago Board of Trade ("CBOT") Patrick Arbor favored eliminating the reports. 169 During a 1997 interview with Futures magazine, Mr. Arbor stated that the large-trader reports cost the CBOT business because professional customers who want anonymity choose to trade "in Europe over the United States to avoid the reports." 170

Daniel Rappaport, chairman of the New York Mercantile Exchange ("NYMEX"), can point to Sumitomo Corporation as one customer that NYMEX lost because of position reporting. 171 Yasuo Hamanaka stopped trading directly on the New York exchange three years before his market manipulation surfaced. 172 At the time, Hamanaka complained about "onerous position reporting requirements imposed by the CFTC." 173 While testifying before Congress on H.R. 467, Mr. Rappaport recognized that position reporting prevented Sumitomo's market manipulation from taking

166. See id.
167. See id. at 17.
170. Id.
172. See id.
place directly on the NYMEX, and supported the use of position reporting for market surveillance.\textsuperscript{174}

Both of the bills concerning commodities regulation that Congress considered during 1997 would have allowed exchanges to eliminate much large-trader reporting. As discussed below, both bills (H.R. 467 and S. 257) contained a professional market exemption that would have allowed certain market participants to trade on and off U.S. exchanges without being subject to many of the CFTC's regulatory protections.\textsuperscript{175} To the extent that the bills would have allowed exchanges to dismantle the CFTC's system for market surveillance\textsuperscript{176} they were inconsistent with the recently adopted global best practices. Although neither bill was enacted, Congress is revisiting the issues that they raised during the current CFTC reauthorization process. If Congress amends the Commodities Exchange Act, it should carefully consider the market surveillance best practices when assessing the benefits and risks of a professional market exemption.

3. Information Sharing

With respect to information sharing, the global best practices encourage regulators to share "relevant information concerning the supervision of their respective markets, both on a routine basis and as needed, and to promote communication among relevant personnel."\textsuperscript{177} The Sumitomo affair exposed a need for enhanced cooperation among regulatory authorities in different jurisdictions. During the CFTC's fall 1995 investigation into copper backwardation, the LME was reluctant to share information.\textsuperscript{178} In fact, one senior CFTC official told the Wall Street Journal that "we [the CFTC] wanted to know much more about what was going on at the LME than either the LME or British regulators were willing to tell us. The LME stonewalled us."\textsuperscript{179}

Since the Sumitomo incident, regulatory authorities in the U.S. and U.K. have signed a Memorandum of Understanding ("MOU") in which they agreed to cooperate with each other and share supervisory

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\textsuperscript{174} See Rappaport Testimony, supra note 171.
\textsuperscript{177} TOKYO CONFERENCE, supra note 76, at 34.
\textsuperscript{178} See McGee & Frank, supra note 30, at A1.
\textsuperscript{179} Id.
information. The MOU is intended to "address potentially significant market events experienced by US or UK securities or banking firms." Had the MOU been in place during the CFTC's fall 1995 copper investigation, the LME might have been more forthcoming with information about Sumitomo's market position. However, the value of an agreement to share information depends on the quality and compatibility of information possessed by the parties to the agreement. Regulators and exchanges can only share as much information as they have. As discussed, the LME relied on voluntary reporting of large market positions, while the CFTC had a system of mandatory reporting. Perhaps the LME "stonewalled" the CFTC because it did not possess the information sought by the CFTC.

The Tokyo Conference encourages a parity of market surveillance and information sharing among the jurisdictions of its seventeen endorsing supervisors. The supervisors cannot attain such a parity on their own. The CFTC is promoting enhanced market surveillance while the exchanges that it regulates and the legislators that give it power are exploring methods to make such surveillance less intrusive. The FSA has agreed to share information with U.S. supervisors that U.K. exchanges may not be readily able to provide. In other jurisdictions whose regulators endorsed the Tokyo Conference, the principles of market surveillance and information sharing may conflict with national policies regarding privacy. Therefore, the success of the global best practices depends on whether the authorities that endorsed them will be allowed by their governments to develop and maintain meaningful and compatible systems for market surveillance and information sharing.


181. Id.

182. See Gilbert, supra note 163, at 23.


184. See TOKYO CONFERENCE, supra note 76, at 5.

185. Laws which restrict information sharing are sometimes stricter in other countries than in the U.S. Although such laws are usually designed to protect the privacy of individuals, they could create an environment that is wary of sharing information about participants in the financial markets. See generally Scott Barancik, Foreign Privacy Laws Hinder U.S. Oversight, GAO Warns, AMERICAN BANKER, Aug. 4, 1998, at 4. See also Cavaletti, supra note 169, at 1 (quoting Chicago Board of Trade Chairman Patrick Arbor regarding large trader reports: "[Professional market participants] want anonymity–they deserve anonymity. They feel [large trader reporting] is an invasion of their privacy, and they subject themselves to all kinds of statutory liabilities if they do not do it right."
B. Efforts by the Judiciary and Congress to Define the Scope of Commodities Regulation

While the CFTC uses the global stage to help shape the scope of its authority in the United States, U.S. courts try to ensure that the CFTC operates within its legislated boundaries and Congress tries to ensure that those boundaries are appropriate.

1. The Over-the-Counter Market Exemption: Antifraud and the Banker's Trust Cases

The Commodity Exchange Act ("CEA") generally grants the CFTC exclusive jurisdiction over "accounts, agreements . . . and transactions involving contracts of sale of a commodity for future delivery, traded or executed" on CFTC-designated contract markets. To strengthen the CFTC's jurisdiction, the CEA makes any off-exchange dealings in such accounts, agreements, or transactions unlawful unless exempted by the CFTC. In 1993, the CFTC exempted transactions commonly known as swaps from the off-exchange prohibition, but retained any antifraud jurisdiction that it may have had over such transactions. To be exempt, a swap agreement must be a privately negotiated transaction between "eligible swap participants."

The swaps exemption does not specifically require a principal-to-principal relationship. Instead, it requires off-exchange swap contracts to be between "financially sophisticated persons or institutions." "Eligible swap participant" is defined by the regulation, and generally includes financial institutions, large corporations or other business organizations, and any natural person with assets greater than $10,000,000. The CFTC's swap exemption is based on the characteristics of each party, rather than on the relationship between the parties to a particular contract.

189. Id.
191. See Exemption for Certain Swap Agreements, supra note 188, at 5588.
In crafting the swap exemption, the CFTC retained antifraud jurisdiction contained in CEA section 6(b) and 6(o). Unlike the swap exemption itself, the CFTC's antifraud caveat to the exemption is based on the relationship between the parties to the swap contract. Section 6(b) of the CEA makes unlawful certain fraudulent conduct in connection with a covered commodities contract made "for or on behalf of any other person..." Section 6(o) of the CEA prohibits a "commodity trading advisor" from engaging in "any transaction, practice, or course of business which operates as a fraud or deceit upon any client or participant or prospective client or participant." With respect to any particular interest rate swap agreement, one party would be a "commodity trading advisor" if it advised the other party "for compensation or profit... as to the value of or the advisability of" the agreement.

The antifraud provisions of CEA sections 6(b) and 6(o) both require a relationship that is something more than a principal-to-principal relationship. In a pure principal-to-principal relationship, neither party would act "for or on behalf of" the other, and neither party would act as an advisor to the other. Therefore, such a relationship would never be subject to the antifraud provisions of CEA section 6(b) or section 6(o).

Shortly after the swap exemption became effective, it was tested by two cases involving Bankers Trust ("BT"). Taken together, the cases demonstrate that it is important, but sometimes difficult, to consistently distinguish principal-to-principal relationships from advisory relationships.

In 1994, Gibson Greetings ("Gibson") suffered losses under off-exchange interest rate swap contracts that it had entered into with BT. Gibson qualified as an "eligible swap participant" under the CFTC regulation, and the CFTC did not declare the contracts null and void as it had done in the Metalgesellschaft case. Nevertheless, the CFTC determined that BT had acted in an advisory capacity with respect to

192. See id. at 5589.
198. Id.
Gibson, and ultimately fined BT $10 million for violating antifraud provisions of the CEA. In a similar 1996 case, Procter and Gamble ("P&G") sued BT over losses caused by off-exchange interest rate swaps. However, U.S. District Court Judge Feikens held that the antifraud provisions of the CEA did not apply to the swap agreements between P&G and BT.

Both the Gibson case and the P&G case involved off-exchange interest rate swaps with the same bank. The different outcomes reflect the sometimes difficult task of defining the relationship between parties to such transactions. In April 1994, BT had advertised in *The Economist* that it had "devised a complex long-range structure which will wash price risk right out of [an] Asian stock market" for its "client." The advertisement continued: "Our whole business is built on managing global risk like this." BT appeared to suggest that it considered itself to be an advisor to companies that sought to manage their financial risks.

At the time when they entered into their respective contracts with BT, Gibson and P&G both sought to reduce their sensitivity to interest rate risk. Gibson had made a large debt offering and was obliged to make interest payments under the offering. Gibson entered into the swap contracts to reduce its interest payments in the event that interest rates fell below the rate that it was paying on its debt. Although not stated in the court's opinion, P&G probably entered into interest-rate swaps with BT for similar reasons. In the Gibson case, the CFTC found that BT had acted as an advisor to Gibson because BT's managing director for the Gibson account had told his supervisor in February 1994 that Gibson "really put themselves in our hands like 96% . . . [a]nd we have known that from day one."

In the P&G case, the court recognized that BT representatives had "conversations with P&G regarding market conditions, past performance of

202. See id. at 1274.
204. Id.
207. Id. at 5.
Treasury notes and bonds, prognostications for the future, and the like.\textsuperscript{208} The court further acknowledged that BT representatives "gave P\&G a sales pitch regarding the potential benefits of their product."\textsuperscript{209} However, because the BT representatives also discussed P\&G's view of interest rates, the court concluded that P\&G used "[its] own independent knowledge of market conditions . . . not based on commodity trading advice . . . in forming [its] own expectation as to what the market would do . . . ."\textsuperscript{210} Thus, by discussing P\&G's views of interest rates, BT representatives transformed an advisory relationship into a principal-to-principal relationship. After determining that P\&G was a counterparty rather than a client of BT, the court dismissed the claims that P\&G brought against BT under the CEA's anti-fraud provisions.\textsuperscript{211}

Despite the conflict between regulators and the judiciary regarding the relationship between parties to swap agreements, neither reform bill considered by Congress in 1997 proposed to amend the CEA's antifraud provisions.\textsuperscript{212} Many market participants agree that protection against fraud is important. The CFTC, the End-Users Derivatives Association (EUDA), and a speaker representing ten exchanges and self regulatory organizations (SROs) testified during the 1997 hearings that they favored the CEA's antifraud jurisdiction over swaps.\textsuperscript{213} The International Swaps and Derivatives Association ("ISDA") presented a contrary opinion by asserting

\textsuperscript{208} Procter and Gamble, 925 F.Supp. at 1287.
\textsuperscript{209} Id.
\textsuperscript{210} Id.
\textsuperscript{211} See id. at 1286.
that swaps should be entirely outside the scope of the CEA. ISDA represents over 300 large institutions that deal in privately negotiated derivatives, such as swaps. During the 1997 hearings, it suggested that swap agreements should be exempt from the CEA’s antifraud provisions regardless of whether one party to any particular agreement acted in an advisory capacity.

The conflicting interpretations of the CFTC’s antifraud jurisdiction demonstrate that the 1997 proposals to amend the CEA were inadequate. By retaining antifraud jurisdiction in a context where it is not consistently applied, the proposals considered by Congress would have perpetuated the disagreement regarding the CFTC’s jurisdiction. Some action is necessary to clarify the nature of the relationship between swap participants and the scope of the CEA’s antifraud provisions. Congress should consider such action during the current CFTC reauthorization process.

2. The Professional Market Exemption

In addition to the off-exchange exemption, during the 1997 hearings Congress considered a “professional market exemption” for the on-exchange activity of sophisticated market participants. The exemption would have allowed an exchange to establish a professional market exchange comprising institutional participants whose trading would run parallel to the existing exchange, but outside the CFTC’s jurisdiction. Exchanges estimate that under either proposal approximately 90% of commodity exchange trading would qualify for the professional market. In such an environment, the Chicago Board of Trade (“CBOT”), the world’s largest exchange, could eliminate the CFTC’s large-trader reporting requirements and its review of contract design. Removing the CFTC’s authority over market surveillance and contract design with respect to 90%

215. See id.
216. See id.
218. See Born Statement, supra note 213.
219. See id.
of commodity exchange trading would significantly impair the CFTC’s ability to satisfy the global best practices that it recently endorsed.

During the 1997 hearings on H.R. 467, the CFTC opposed the so-called “pro-market” exemption.\textsuperscript{221} It claimed that the exemption was based on a false notion that trading on commodity exchanges has evolved from a retail market into one that is dominated by institutional traders, thereby eliminating the need for regulatory protection.\textsuperscript{222} The CFTC asserted that commodity exchange trading was largely a wholesale market when Congress established the CFTC in 1974 to oversee the market, and that Congress intended the CEA to protect institutional traders.\textsuperscript{223} In effect, the CFTC argued that institutional participants require a certain degree of regulatory protection to maintain their confidence in the markets in which they trade.

During the 1997 Congressional hearings, Brooksley Born, then chairperson of the CFTC, emphasized the heightened need to regulate on-exchange (as opposed to off-exchange) trading.\textsuperscript{224} First, exchange transactions are cleared centrally by the exchange, whereas off-exchange transactions are generally cleared between the counterparties themselves.\textsuperscript{225} As evidenced by the Metallgesellschaft case, centralized clearing spreads the risk of a large default by one counterparty throughout the entire exchange. In contrast, default risk in an off-exchange contract is generally confined to the counterparties to the particular contract.\textsuperscript{226}

Second, exchange-traded contracts are more transparent and anonymous than privately negotiated off-exchange contracts.\textsuperscript{227} Transparency provides exchanges with a price-discovery mechanism not present in the off-exchange market.\textsuperscript{228} Anonymity prevents market participants from determining the identity or the creditworthiness of their counter-parties.\textsuperscript{229} The CFTC asserted that its contract design and market surveillance regulations shield price-discovery from distortions caused by market manipulations, and help

\begin{footnotesize}
\textsuperscript{221} See Born Statement, supra note 213.
\textsuperscript{222} See id.
\textsuperscript{223} See id.
\textsuperscript{224} See id.
\textsuperscript{225} See id.
\textsuperscript{226} See id.
\textsuperscript{227} See id.
\textsuperscript{228} See id.
\textsuperscript{229} See id.
\end{footnotesize}
to ensure the integrity of anonymous market participants.\textsuperscript{230} Such measures can be helpful to both retail and professional market participants.\textsuperscript{231} The SEC and many stock exchanges and SROs opposed the professional market exemption as it relates to equity derivatives.\textsuperscript{232} An example of an equity product governed by the CFTC is an index participation whose value is based on a stock market index.\textsuperscript{233} The SEC noted that the 1987 market break demonstrated that the commodity markets are closely linked to the securities markets, and that a calamity in one market is likely to have repercussions in the other.\textsuperscript{234} Currently, CEA section 2(a)(1)B defines the CFTC's jurisdiction with respect to contracts that involve securities.\textsuperscript{235} This section is commonly referred to as the Shad-Johnson accord.\textsuperscript{236} It was enacted by Congress after the SEC and the CFTC carefully negotiated the fine line that separates some commodities from securities. According to the testimony on behalf of the stock exchanges, the Shad-Johnson accord generally placed equity derivatives under the CFTC's jurisdiction.\textsuperscript{237} The stock exchanges were concerned that unregulated trading in equity derivatives could present great potential dangers to the nation's regulated securities markets and proposed that such products be excluded from the professional market exemption.\textsuperscript{238}

The National Grain and Feed Association ("NGFA"), which represents a retail aspect of the market, also opposed the professional market exemption.\textsuperscript{239} The NGFA believed that a rule which removes 90% of market participants from regulation would impair liquidity on the side of the market that remains subject to regulation.\textsuperscript{240} The NGFA was also skeptical

\textsuperscript{230} See id.  
\textsuperscript{231} See id.  
\textsuperscript{232} See id. See also Brodsky Statement, supra note 214.  
\textsuperscript{233} For details on index participations see Chicago Mercantile Exch. v. SEC, 883 F.2d 537 (7th Cir. 1989).  
\textsuperscript{234} See Born Statement, supra note 213. For a detailed discussion on the "One Market" theory, see Division of Market Regulation, U.S. Sec. & Exch. Comm'n, The October 1987 Market Break (1988).  
\textsuperscript{236} For details on the Shad-Johnson accord, see Chicago Mercantile Exch. v. SEC, 883 F.2d 537.  
\textsuperscript{237} See Brodsky Statement, supra note 214.  
\textsuperscript{238} See id.  
\textsuperscript{240} See id.
that self-regulation by the exchanges would adequately replace CFTC regulation.\textsuperscript{241} The NGFA concern about self-regulation echoed reflections by the House Committee on Agriculture at the time that it created the CFTC: "self-regulation cannot be viewed in this and later decades as an argument against greater Federal regulation. . . . [S]elf-regulation cannot be permitted to be a barrier against public policy and the interests of the American public."\textsuperscript{242} Despite these warnings, a professional markets exemption would allow commodity exchanges to regulate themselves with respect to a significant portion of their activities without federal oversight.

In contrast to the views of federal regulators, stock exchanges, and retail market participants, the CBOT favored the professional market exemption.\textsuperscript{243} However, its views on the professional markets manifested the concerns of those who are suspicious of stand-alone self-regulation. During the 1997 hearing, the CBOT testified that "All professional market participants should be treated alike. If 'professionals only' OTC markets are exempt from regulation, then 'professionals only' exchange markets should be exempt too."\textsuperscript{244} If a professional markets exemption is created, the exchanges could use it to eliminate much large-trader reporting and CFTC review of proposed exchange-traded contracts. To support the exemption, the CBOT argued that "regulatory arbitrage is driving our business away" and that without such regulatory relief, "our markets will disappear."\textsuperscript{245}

The argument for the professional market exemption blurs important distinctions between the exchanges and the OTC market, downplays the success of U.S. commodity exchanges in recent years, and ignores the public interest in the commodity exchanges. While the CFTC recognizes the systemic risk that accompanies exchange trading, and the SEC recognizes the connection between commodity exchanges and stock exchanges,\textsuperscript{246} during the 1997 hearings the CBOT dismissed the significance of the role of the exchanges by stating that sophisticated parties should be

\textsuperscript{241} See id.

\textsuperscript{242} H.R. REP. No. 93-975, at 48 (1974).


\textsuperscript{244} Id.

\textsuperscript{245} Id.

\textsuperscript{246} Regarding the relevant views of the CFTC and the SEC, see generally Born Statement, supra note 214.
unregulated regardless of where they trade.  Although trading volume on the CBOT rose by 130% between 1986 and 1996, and its 1996 profits were 26% higher than its 1995 profits, the CBOT expressed concern that the U.S. commodity exchanges will disappear because the volume of OTC trading is growing more rapidly than exchange trading. Finally, while the CEA explicitly recognizes the public interest in the price discovery role of the commodity exchanges, the chairman of CBOT, in his 1997 Congressional testimony on CEA reform, did not mention the public interest at all, and stated that “no one has more at stake in the integrity of our markets than we [the CBOT] do.” Such testimony demonstrates that some exchanges would represent their own self-interest rather than the public interest if federal oversight is removed.

VI. CONCLUSION

A. Accepting the Parameters of Today’s Global Marketplace

When Congress created the CFTC in 1974, domestic commodity exchanges generally dominated the U.S. commodities markets. The exchanges faced little competition from off-exchange activity because such activity was generally illegal. They faced little competition from foreign exchanges because those exchanges generally concentrated on local products. In this environment, the CFTC developed a set of rules to ensure that contracts traded on the exchanges were carefully designed and subject to adequate surveillance.

During the years after the CFTC was created, financial institutions found themselves facing competition from new sources. For example, corporations more frequently issued debt in place of bank loans, thereby reducing a significant source of bank assets. The trend away from traditional banking products became known as “disintermediation.”

247. See Arbor Statement, supra note 243.
248. See id.
249. Id.
250. See generally Born Statement, supra note 213.
251. See generally ISDA Statement, supra note 214.
252. See generally Revised Procedures II, supra note 141.
254. See id.
one response to disintermediation, financial institutions began to develop products that were arguably illegal in the U.S. unless traded on a CFTC-designated exchange.\textsuperscript{255} One simple example of such a product is an interest-rate swap, in which two parties agree to swap the payment streams of different interest rates based on a common notional amount. To protect products such as interest rate swaps, financial institutions sought an exemption from the U.S. off-exchange prohibition, and also sought to develop the products in foreign jurisdictions that did not prohibit such off-exchange activity.\textsuperscript{256} After the CFTC created the swaps exemption in 1993, U.S. exchanges began to feel the strain of off-exchange competition.\textsuperscript{257}

If foreign exchanges were located in jurisdictions that allowed off-exchange activity, then they likely felt the strain of off-exchange competition sooner than U.S. exchanges. Some foreign exchanges were able to counter the off-exchange threat by offering products with few regulatory impediments.\textsuperscript{258} As foreign exchanges attracted new business by providing less supervision, U.S. commodities exchanges began to argue that CFTC supervision prevented them from competing with the foreign exchanges and the off-exchange market.\textsuperscript{259} In 1999, they continue to argue that CFTC supervision will destroy the U.S. commodity exchanges by driving business either offshore or off-exchange, unless such supervision is dramatically reduced.\textsuperscript{260}

At the same time that the U.S. commodity exchanges argue for regulatory relief, many U.S. financial institutions argue that the swap exemption is not strong enough to protect the U.S. off-exchange market.\textsuperscript{261} Evidence that the swap exemption is not an airtight guarantee against CFTC intervention includes the Metallgesellschaft case in which the CFTC declared Metallgesellschaft's contracts illegal,\textsuperscript{262} the Gibson Greetings case,

\begin{itemize}
  \item \textsuperscript{255} See generally Exemption for Certain Swap Agreements, supra note 188.
  \item \textsuperscript{256} Id.
  \item \textsuperscript{257} See generally Rappaport Testimony, supra note 171.
  \item \textsuperscript{258} See id.
  \item \textsuperscript{259} See Arbor Statement, supra note 234.
  \item \textsuperscript{261} See generally Reauthorization of the Commodity Futures Trading Commission, Hearings Before the Subcomm. on Risk Management, Research, and Specialty Crops of the House Comm. On Agric., 106\textsuperscript{th} Cong. (1999) (statement of a Coalition of Investment and Commercial Banks) [hereinafter Coalition Statement].
  \item \textsuperscript{262} See In re MG Ref. & Mktg., Inc. & MG Futures, Inc., No. 95-14, 1995 WL
\end{itemize}
in which the CFTC found that the contracts were legal, but that Bankers Trust had committed fraud, and finally, the CFTC's 1998 Concept Release in which the CFTC solicited opinions about regulating off-exchange derivatives. Like the commodity exchanges, the financial institutions argue that their business will go offshore unless they receive regulatory relief.

Foreign exchanges and off-exchange contracts add new dimensions to the commodities markets. The new environment requires market participants and their regulators first to accept the new dimensions, and then to reassess their own role in the multi-dimensional marketplace. Rather than reassessing their roles, many market participants reassess their market share, which becomes diluted as the market expands. For example, the commodities exchanges have focused on the growth of foreign exchanges and off-exchange contracts, although their own trading activity and profitability has steadily increased. An important lesson to be learned is that market share may not be an accurate measure of sustainable success in today's global market.

B. Balancing Integrity and Growth in the Marketplace

Commodities market participants have been reluctant to accept the concept of shared success. In their quest for market share, exchanges like the CBOT and the LME seem willing to sacrifice many of the protections that give market participants the confidence to trade on the exchanges. The volume of metals trading on the LME rose eightfold between 1988 and 1996, but scandals such as the Sumitomo affair marred that growth period and subjected the LME to allegations of lax supervision by regulators of and participants in the commodities markets.

The LME's growth was probably fueled in part by regulatory arbitrage, as the Chicago Board of Trade suggests. However, an exchange that sacrifices its integrity to enhance its growth does not create a valid argument for widespread deregulation. Such an approach would discount to zero the value of market confidence, which is the lynchpin that holds financial

264. See Over-the-Counter Derivatives, supra note 78.
265. See generally Born Statement, supra note 213.
266. See McGee & Frank, supra note 30, at A1.
267. See Arbor Statement, supra note 243.
markets together and is inseparable from the integrity of a market's participants.

Like the commodity exchanges, financial institutions that trade financial derivative contracts over the counter see relaxed supervision as a key to growth. Such institutions may feel threatened when the CFTC declares that a party to a swap contract is not an eligible swap participant, or that a party to a swap contract has committed fraud. To protect the "legal certainty" of swap contracts, they argue, the CFTC should have no authority to intervene.\(^{268}\) Although such "legal certainty" may protect a particular contract if it is challenged in court, it does little to protect confidence in the integrity of the markets. A more appropriate goal might be certainty that legitimate off-exchange activity is not tainted by contracts with ineligible participants or by fraud among eligible participants.

To respond to a growth strategy based on lax supervision, regulators should reduce opportunities for regulatory arbitrage through coordinated regulation. With respect to the commodity exchanges, regulators have sought coordination by endorsing global best practices. With respect to off-exchange contracts, some degree of coordinated regulation is necessary to protect market confidence, however rules that are appropriate for the exchanges may not be appropriate for off-exchange contracts. Nevertheless, regulatory authorities cannot allow reduced supervision to be used as an advantage in competing for business that should be conducted on an exchange. Therefore, the law must clearly distinguish the types of contracts that must be traded on exchanges from those that are suitable for off-exchange trading.\(^{269}\)

Finally, as Congress evaluates commodities regulation, it must remember that the United States is a world leader in financial security and innovation. Even with global best practices, some regulatory disparity will always exist. The lowest degree of supervision may initially attract significant business, but market confidence tends to shift the balance toward properly supervised markets.\(^{270}\) The current CFTC reauthorization marks

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268. See Coalition Statement, supra note 261.

269. See, e.g., Reauthorization of the Commodity Futures Trading Commission, Hearings Before the Subcomm. on Risk Management, Research, and Specialty Crops of the House Comm. On Agric., 106th Cong. 190 (1999) (testimony of Daniel Rappaport, Chairman, New York Mercantile Exchange). Mr. Rappaport testified that the "marketplace has evolved into a situation where 90 percent of the trades that are taking place in the energy OTC market are exchange look-a-like contracts, basically the exact same contract that [NYMEX is] trading, just taking place between very sophisticated players with very high or relatively high credit ratings that are willing to assume each other's counterparty credit risk." Id.

270. See e.g, Rappaport Testimony, supra note 171, at 93. Daniel Rappaport, Chairman
a critical time for U.S. financial regulation. Congress must balance the sometimes competing interests of integrity and growth in the marketplace. In doing so, it should carefully consider the coordinated approach endorsed by the world’s commodities regulators, evaluate the role that commodities exchanges play in today’s business environment, and question the value of self-regulation absent meaningful federal oversight.

of the New York Mercantile Exchange said during the H.R. 467 hearings: “In terms of Sumitomo, the market activity on COMEX actually increased after all the market manipulative activity occurred around the LME and over-the-counter. None actually occurred on COMEX.” *Id.* See also Reauthorization of the Commodity Futures Trading Commission, Hearings Before the Subcomm. on Risk Management, Research, and Specialty Crops of the House Comm. On Agric., 106th Cong. 217, 218 (1999) (testimony of Ronald Hersch, Chairman, Futures Industry Association). Ronald Hersch, Chairman of the Futures Industry Association said during the May 1999 CFTC Reauthorization Hearings: “I don’t believe that you can ever expect the United States to enact regulations to the lowest common denominator. . . . When institutional customers transact business on certain exchanges, they are aware that the risks of trading on those exchanges and transacting business on those exchanges is not the same as it would be on the U.S. exchanges.” *Id.*