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I. INTRODUCTION

Every corporate lawyer knows that insider trading in securities is illegal. The Securities and Exchange Commission ("SEC") bans insider trading under section 10(b)[1] of the Securities Exchange Act of 1934[2] ("SEA") and Rule 10b-5 promulgated thereunder.[3] Although section 10(b) and Rule 10b-5 do not specifically mention "insider trading," the Supreme Court has upheld a private cause of action for trading on material, non-public information.[4] What is not well known is that insider trading in commodities may be permissible in some circumstances. Even though the language of section 6b of the Commodity Exchange Act[5] ("CEA") tracks the language of its analogue statute in section 10(b) of the SEA, no similar cause of action for trading on inside information exists. Moreover, although insider trading in commodities is prohibited in some circumstances, the rules governing such trading are too lenient and do not cover all traders.[6]

There are some fundamental differences between securities and commodities that explain, in part, why they are regulated differently. Securities, whether they be stocks or bonds, are often issued by public companies, such as McDonald's or Procter & Gamble. Directors, officers, and other insiders of these companies have time and place advantages in evaluating the company over other members of the public. Given the position of the officers, for example, in implementing corporate policies and managing finances, they know before everyone else whether the company has a strong or weak outlook.

Commodities are fundamentally different than stocks. There is no CEO of oil or pork bellies or interest rates, as there is a CEO of ExxonMobil, for example. The price of a commodity, like oil, is affected by three primary inputs: cash markets, traders, and regulators.[7] Inside information about ExxonMobil's operations may or may not change the price of oil in a predictable direction because there are many other oil companies competing with Exxon that also affect oil prices. Furthermore, the activity of hedge funds and commodity exchange regulators is outside the knowl-

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1. Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j (2006). Section 10(b) states that it shall be unlawful for any person "[t]o use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device . . . ." *Id.*

2. The SEA primarily deals with trading and regulation in the secondary securities markets (as opposed to the Securities Act of 1933 ("1933 Act"), which primarily deals with the initial offer and sale of securities). Both the SEA and the 1933 Act prohibit manipulative and deceptive practices. Marc I. Steinberg, Understanding Securities Law 1 (3d ed. 2001).

3. Employment of Manipulative and Deceptive Devices, 17 C.F.R. § 240.10b-5 (2008). Rule 10b-5 states: "It shall be unlawful for any person . . . [t]o employ any device, scheme, or artifice to defraud . . . ." *Id.*

4. *See* Herman & MacLean v. Huddleston, 459 U.S. 375 (1983).

5. Commodity Exchange Act, 7 U.S.C. § 6b (2006). Section 6b(a)(2)(A) provides that it shall be unlawful "for any person, in or in connection with any order to make . . . any contract of sale of any commodity[,] to cheat or defraud . . . the other person[.]"; *see also* Fraud in Connection with Commodity Transactions, 40 Fed. Reg. 26,504, 26,505 (June 24, 1975) ("The operative language of the anti-fraud provision contained in Section 4b [now 6b] of the Commodity Exchange Act . . . is no less broad than Rule 10b-5 with respect to misrepresentations and deceptive acts and practices.").

6. *See* 17 C.F.R. § 1.59 (2008).

7. *See infra* p. 620 for more information on these inputs.

edge of any single CEO. Similarly, if a hedge fund manager wants to buy a large block of oil contracts, it is extremely difficult to predict whether oil prices will rise because there are many other factors that influence oil prices.

There is one category of market participants, though, that does have time and place advantages with respect to the cash market, trader, and regulator inputs. Governing members of commodities exchanges have information as to what regulators are doing because they are the people passing rules for their exchanges. In addition, governing members, through their auditing of market participants and their surveillance of the futures markets, also have access to trader information and cash market fundamentals.[8] Because of their access to aggregated information, governing members consistently possess material, non-public information not available to other market participants.[9]

Given the privileged position of governing members in the commodity trading scheme, it may seem surprising that they are regulated less vigorously than others in the commodity trading world. This has been the case, however, since 1986, when the CFTC dipped its feet into the regulatory waters of insider trading with the passage of Regulation 1.59.[10]

This note will argue that CFTC Regulation 1.59's existing ban on insider trading is insufficient. Due to its lenient language, Regulation 1.59 is unlikely to deter insider trading by governing members of commodities exchanges. The rules passed by other commodities regulators, such as the National Futures Association ("NFA") and the exchanges (i.e., the Chicago Mercantile Exchange ("CME") and the New York Mercantile Exchange ("NYME")), under the authority of Regulation 1.59, are similarly ineffective. Ineffective insider trading rules harm the commodities markets in two fundamental ways. First, hedgers[11] are favored at the expense of speculators.[12] This is problematic because speculators provide the liquidity necessary for a functional commodities market. Second, insider trading is fundamentally unfair. Unfairness can lead individuals and other market participants to stop trading on the commodities markets. Consequently, this note argues that governing members of

8. The CFTC contrasts the position of a governing member who has access to specific information concerning futures and cash market positions on both an individual and aggregate/market-wide basis with other market participants who have incomplete information. Commodity Futures Trading Comm'n, A Study of the Nature, Extent and Effects of Futures Trading by Persons Possessing Material, Nonpublic Information app. VI, at 20–21 (Sept. 1984) [hereinafter Insider Trading Study]. For example, a broker who makes trades has information specific only to those transactions. In the cash market, individual firms only have complete information about the cash and futures transactions of their own firms. This information cannot become material until aggregated among several other cash market firms. *Id.* at 85–86.

9. *Id.*

10. 17 C.F.R. § 1.59 (2008).

11. Hedgers take a position in a futures market opposite a position held in the cash market in order to reduce the risk from adverse price changes. CFTC Glossary, http://www.cftc.gov/educationcenter/glossary/index.htm (last visited Sept. 25, 2008) [hereinafter CFTC Glossary].

12. A speculator is a person who does not hedge. Rather, he seeks profit through successful anticipation of price movements. *Id.*

commodities exchanges should be banned from trading on the commodities markets.

This note consists of four parts. Part II is separated into two sections. Section A will provide an overview of futures regulation and Section B will provide a summary of the CFTC's approach to insider trading. Part III contains two sections as well. Section A will show how the CFTC's response to insider trading, through Regulation 1.59, falls short, and Section B will discuss why lax insider trading laws are a problem. Part IV proposes that the CFTC redraft Regulation 1.59 to deal more aggressively with insider trading. In particular, the redrafted regulation should ban commodities trading by governing members of commodities exchanges. Part V concludes that the CFTC must also take action to enforce its new rule.

II. HISTORY

A. Overview of Futures Regulation

The CFTC is a federal regulatory body that regulates the commodities futures industry.[13] Commodities that are traded include: grains, wheat, corn, rubber, sugar, crude oil, natural gas, gold, aluminum, interest rates, and index futures.[14] In 2006, there were 11,859,266,610 futures and options contracts traded worldwide on commodities exchanges.[15] The CME is the largest exchange by volume and alone traded 1,101,712,533 contracts.[16] There are twelve Designated Contract Markets[17]

13. 7 U.S.C. § 2(a)(1)(A) (2006) (granting the CFTC "exclusive jurisdiction . . . with respect to accounts, agreements . . . and transactions involving contracts of sale of a commodity for future delivery").

14. *See* Mary Ann Burns, *May Volume Pushes World Trading Past the 5 Billion Mark*, Futures Industry, Sept./Oct. 2007, at 10. Physical commodities in the agricultural, energy, and metal sectors did well between January and May 2007. There were 48.30 million crude oil futures, 25.85 million corn futures, and 11.60 million soybean futures traded. *Id.* at 13. The interest rate sector, however, attracts much more trading activity, with 242.60 million Eurodollar futures, 134.94 million 10-Year T-Note futures, and 128.75 million E-mini S&P 500 Index futures traded between January and May 2007. *Id.* at 12. Index derivatives attract even more volume than interest rate derivatives, with 787.11 million equity index futures and options traded globally between January and February 2006, representing 41.7% of total global volume during this period. Rebecca Holz, *A Remarkable Start in 2006*, Futures Industry, May/June 2006, at 10, 10–11.

15. Galen Burghardt, *Derivatives Exchange Volume Accelerates in 2006*, Futures Industry, Mar./Apr. 2007, at 16, 16–17. The number of contracts traded worldwide in 2006 grew by more than 30% over the previous year (there were 9,973,823,087 contracts traded in 2005). *Id.* at 16. With global futures and options volume reaching 4.6 billion contracts in the first four months of 2007, Cass Johnson, *Global Futures and Options Volume Reaches 4.6 Billion Contracts in First Four Months of 2007*, Futures Industry, July/Aug. 2007, at 8, 8–11, derivatives trading is on target to break 13 billion contracts for 2007.

16. Burghardt, *supra* note 15, at 28. Remarkably, of the 1.1 billion contracts traded last year on the CME, over 500 million were Eurodollar contracts. *Id.* at 18.

17. DCMs are boards of trade (exchanges) operating under the regulatory oversight of the CFTC. CFTC Website, http://cftc.gov/industryoversight/tradingorganizations/designatedcontractmarkets/index.htm (last visited Sept. 25, 2008). Under 7 U.S.C. § 7 (2006), a board of trade applying to the CFTC for designation as a DCM must meet several criteria, including prevention of market manipulation, establishment of rules for fair and equitable trading, establishment of a trade execution facility, and enforcement of rules through disciplinary procedures.

("DCMs") regulated under the CFTC.[18] The CFTC also has regulatory authority over eleven derivatives clearing organizations[19] ("DCOs").[20] In addition, the CFTC regulates the activities of over 70,000 registrants, including associated persons[21] (54,258), commodity pool operators[22] (1570), commodity trading advisors[23] (2589), floor brokers[24] (8203), floor traders[25] (1512), futures commission merchants[26] (210), and introducing brokers[27] (1741).[28]

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18. Commodity Futures Trading Comm'n, FY 2008 President's Budget and Performance Plan 6 (Feb. 2007) [hereinafter Budget and Performance Plan]. Some of the DCMs regulated by the CFTC include the Chicago Mercantile Exchange Group ("CME Group"), CBOE Futures Exchange, LLL ("CFE"), Kansas City Board of Trade ("KCBT"), Minneapolis Grain Exchange ("MGE"), New York Board of Trade ("NYBOT"), and the New York Mercantile Exchange ("NYMEX"). *Id*.

19. A DCO "is a clearinghouse . . . facility, system, or organization that . . . (i) enables each party to the agreement . . . the credit of the derivatives clearing organization . . . ; (ii) arranges or provides . . . for settlement or netting of obligations . . . ; or (iii) otherwise provides clearing services . . . ." 7 U.S.C. § 1(a) (2006).

20. Budget and Performance Plan, *supra* note 18, at 7. Some of these DCOs include the AE Clearinghouse, EnergyClear, HedgeStreet, CBOT, and NYMEX. *Id.*

21. An associated person ("AP") is a person who acts on behalf of a futures commission merchant ("FCM"), introducing broker ("IB"), commodity trade advisor ("CTA"), commodity pool operator ("CPO"), or an agricultural trade option merchant ("ATOM"). APs solicit or accept orders and discretionary accounts, or participate in commodity pools. APs also supervise individuals involved in these activities. CFTC Glossary, *supra* note 11.

22. A CPO "means any person engaged in a business that is of the nature of an investment trust, syndicate, or similar form of enterprise, and who, in connection therewith, solicits, accepts, or receives from others, funds, securities, or property . . . for the purpose of trading in any commodity." 7 U.S.C. § 1a(5) (2006).

23. A CTA "means any person who for compensation or profit, engages in the business of advising others . . . as to the value of or the advisability of trading in any contract of sale of a commodity." 7 U.S.C. § 1a(6)(A)(i)(I).

24. A floor broker ("FB") means any "person with exchange trading privileges who, in any pit . . . provided by an exchange for the meeting of persons similarly engaged, executes for another person any orders for the purchse or sale of any commodity for future delivery." CFTC Glossary, *supra* note 11.

25. A floor trader ("FT") means any "person with exchange trading privileges who executes his own trades by being personally present in the pit or ring for futures trading." *Id*.

26. A futures commission merchant ("FCM") means"[i]ndividuals, associations, partnerships, corporations, and trusts that solicit or accept orders for the purchase or sale of any commodity for future delivery on or subject to the rules of any exchange and that accept payment from or extend credit to those whose orders are accepted." *Id*.

27. An introducing broker ("IB") is any

> person (other than a person registered as an associated person of a futures commission merchant) who is engaged in soliciting or in accepting orders for the purchase or sale of any commodity for future delivery on an exchange who does not accept any money, securities, or property to margin, guarantee, or secure any trades or contracts that result therefrom.

Id.

28. Budget and Performance Plan, *supra* note 18, at 4.

As of 2003, there were an estimated 500 actively traded futures[29] and options[30] contracts over the 15 DCMs.[31] Moreover, the diversity of contracts traded over the commodities exchanges is vast. Some of the products include U.S. Treasury Notes (five year), live cattle, black tiger shrimp, cheddar cheese, Goldman Sachs Commodity Index, and the LIBOR.[32] Despite the large variety of products traded over the commodities exchanges, trading in the commodities market is concentrated primarily in interest rates and equity prices. According to the Futures Industry Association ("FIA"), "90% of all trading in exchange-traded derivatives is tied to interest rates or equity prices."[33]

Federal regulation of derivatives began with the passage of the Future Trading Act of 1921[34] ("the Act").[35] The Act sought to prevent price manipulation, such as excessive speculation in grain prices.[36] To this end, it imposed a prohibitive tax on the trading of grain futures not undertaken through an authorized exchange designated by the secretary of agriculture, termed a "board of trade."[37] In order to qualify

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29. A "futures contract" is

> an agreement to purchase or sell a commodity for delivery in the future: (1) at a price that is determined at initiation of the contract; (2) that obligates each party to the contract to fulfill the contract at the specified price; (3) that is used to assume or shift price risk; and (4) that may be satisfied by delivery or offset.

CFTC Glossary, *supra* note 11.

30. Under 7 U.S.C. § 1a(26), an option means "an agreement, contract, or transaction that is of the character of, or is commonly known to the trade as, an 'option.'" The online CFTC glossary provides a more helpful definition: "A contract that gives the buyer the right, but not the obligation, to buy or sell a specified quantity of a commodity or other instrument at a specific price within a specified period of time, regardless of the market price of that instrument." CFTC Glossary, *supra* note 11.

31. Budget and Performance Plan, *supra* note 18, at 6. The number of registered boards of trade fluctuates from year to year. For example, there were fourteen DCMs in 2001 and eighteen DCMs in 2004. In 2003, there were fifteen DCMs. *Id.*

32. Futures and Options Contracts Designated by the Commodity Futures Trading Comm'n, Div. of Econ. Analysis (1999). LIBOR is an abbreviation for London Interbank Offered Rate. The CFTC glossary defines LIBOR as "[t]he rate of interest at which banks borrow funds from other banks, in marketable size, in the London interbank market. LIBOR rates are disseminated by the British Bankers Association." CFTC Glossary, *supra* note 11.

33. Burghardt, *supra* note 15, at 16. A derivative is a

> financial instrument, traded on or off an exchange, the price of which is directly dependent upon . . . the value of one or more underlying . . . commodities . . . . Derivatives involve the trading of rights or obligations based on the underlying product, but do not directly transfer property. Derivatives include futures, options, and swaps.

CFTC Glossary, *supra* note 11.

34. Future Trading Act of 1921, Pub. L. No. 67-66, ch. 86, 42 Stat. 187, *invalidated by* Hill v. Wallace, 259 U.S. 44 (1922) (holding that the act could not be sustained under Congress' taxing power).

35. *See* Roberta Romano, *The Political Dynamics of Derivative Securities Regulation*, 14 Yale J. on Reg. 279, 285 (1997).

36. Salomon Forex, Inc. v. Tauber, 8 F.3d 966, 970 (4th Cir. 1993).

37. Future Trading Act of 1921, Pub. L. No. 67-66, §§ 4–5; *see also* 7 U.S.C. § 1(a)(2) (2006) ("The term 'board of trade' means any organized exchange or other trading facility.").

for authorization, the board of trade had to comply with several statutory conditions, including transaction record-keeping, preventing price manipulation, and maintaining a recognized, official weighing, and inspection service.[38]

The Future Trading Act of 1921 proved to be short-lived. The Act was declared unconstitutional in *Hill v. Wallace* as an improper exercise of the taxing power.[39] The Act imposed a tax of 20 cents per bushel on all contracts for the sale of grain for future delivery if the sales were not made through a designated board of trade.[40]

With the passage of the Grain Futures Act of 1922,[41] Congress achieved its goal of preventing market manipulation by utilizing the Commerce Clause, as opposed to its taxing power.[42] As the successor to the Future Trading Act of 1921, the 1922 Act was substantially similar.[43] Section 5 still provided that boards of trade had to meet certain qualifications, and the secretary of agriculture had the power to designate boards of trade as contract markets.[44] However, instead of indirectly preventing futures trading on unregulated contract markets with a prohibitive tax, the 1922 Act explicitly banned such trading.[45]

Following the 1921 and 1922 Acts, the next major congressional initiative regulating derivatives was the Commodity Exchange Act of 1936 ("CEA").[46] The CEA overhauled the 1922 Act by adding several new sections.[47] The new Act expanded upon the 1921 Act by increasing the secretary of agriculture's authority. The Act now made it unlawful to engage in commodity brokering without first registering with the secretary.[48] The secretary also had the power to revoke a board of trade's designation as a contract market.[49] In order to prevent sudden fluctuations in commodity prices, the Commodity Exchange Commission[50] could set speculative

38. Future Trading Act of 1921, Pub. L. No. 67-66, § 5 (a)–(d).

39. *Hill*, 259 U.S. at 68. The case was a suit brought by eight members of the Board of Trade in Chicago against Henry Wallace, the Secretary of Agriculture. *Id.* at 45; *see also* 7 U.S.C. § 1 (2006) (mentioning in the notes that "The Futures [sic] Trading Act" was declared unconstitutional, at least in part, in *Hill v. Wallace*); *Salomon Forex*, 8 F.3d at 970.

40. Future Trading Act, Pub. L. No. 67-66, § 4; *Hill*, 259 U.S. at 63.

41. Grain Futures Act of 1922, ch. 369, 42 Stat. 998, *amended by* Commodity Exchange Act, 49 Stat. 1491 (current version at 7 U.S.C. § 1 (2006)).

42. *See In re* Grain Land Coop, No. 97-1, 1998 CFTC LEXIS 270, at *59–63 (Nov. 6, 1998).

43. *See* Grain Futures Act, ch. 369, 42 Stat. 998.

44. *See id.* at 1000.

45. Grain Futures Act, § 4. The constitutionality of the Grain Futures Act was upheld in Chi. Bd. of Trade v. Olsen, 262 U.S. 1 (1923).

46. Commodity Exchange Act of 1936, ch. 545, 49 Stat. 1491 (1936) (codified as amended at 7 U.S.C. § 1 (2006)).

47. *See* CEA §§ 5, 7, 9, 49 Stat. at 1492–1500 (adding sections 4a–i, 5a–b, 6a–b).

48. CEA § 5, 49 Stat. at 1492–97.

49. CEA § 7, 49 Stat. at 1498.

50. The Commodity Exchange Commission was the successor to the Grain Futures Commission. *See* U.S. Nat. Archives & Records Admin., Records of the Commodity Futures Trading Comm'n, http://www.

position limits on trading.[51] In addition, the CEA extended regulatory coverage of commodities beyond grain to include cotton, rice, corn, oats, barley, rye, flaxseed, grain sorghums, mill feeds, butter, eggs, and Irish potatoes.[52]

The Commodity Futures Trading Commission Act of 1974 ("CFTCA") established the Commodity Futures Trading Commission ("CFTC"), which was granted exclusive authority to regulate futures contracts.[53] The CFTC is now an independent agency separate from the Department of Agriculture.[54] Regulation of U.S. financial markets was divided between the Securities and Exchange Commission ("SEC"), with authority over securities, and the CFTC, with authority over futures.[55] The CFTCA gave powers to the CFTC that the SEC[56] did not have at the time. For example, "the CFTC could impose civil penalties of up to $100,000 per violation, bar violators from trading on contract markets, and grant reparations to investors injured by [CEA violators]."[57]

The 1974 CFTCA also authorized the creation of "registered futures associations."[58] This legislation led to the establishment of the National Futures Association ("NFA"), a nationwide self-regulatory organization[59] ("SRO"), for the futures industry, in 1982.[60] Under CFTC oversight, the NFA passes rules,[61] performs audits and examinations to ensure compliance with the rules, takes disciplinary actions against firms and individuals who violate the rules, and provides a forum for arbitration and mediation of disputes.[62] Membership with the NFA is mandatory for those who wish to conduct business on U.S. futures exchanges.[63]

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archives.gov/research/guide-fed-records/groups/180.html (last visited Sept. 26, 2008).

51. CEA § 5, 49 Stat. at 1492.

52. CEA § 3(a), 49 Stat. at 1941.

53. Commodity Futures Trading Commission Act of 1974, 7 U.S.C. § 2(a)(2) (2006).

54. Commodity Futures Trading Commission Act of 1974, Pub. L. No. 93-463, 88 Stat. 1389, 1414.

55. *Id.* at 1395 (stating the CFTC will not supersede any SEC authorities or duties unless it is necessary to carry out its authority as it pertains to futures).

56. The SEC, created in 1934, is a federal agency charged with the administration and enforcement of federal securities law. Steinberg, *supra* note 2, at 2.

57. Jerry W. Markham, *Super Regulator: A Comparative Analysis of Securities and Derivatives Regulation in the United States, the United Kingdom, and Japan*, 28 Brook. J. Int'l L. 319, 348–49 (2003) (citing to 7 U.S.C. §§ 9, 9, & 18, respectively).

58. 7 U.S.C. § 21 (2006); *see also* National Futures Association Website, http://www.nfa.futures.org/aboutnfa/indexAbout.asp (last visited Sept. 26, 2008) [hereinafter NFA Website].

59. The online CFTC glossary defines SROs as "[e]xchanges and registered futures associations that enforce financial and sales practice requirements for their members." CFTC Glossary, *supra* note 11.

60. NFA Website, *supra* note 58.

61. NFA rules cover areas such as advertising, risk disclosure, discretionary trading, disclosure of fees, minimum capital requirements, and reporting and proficiency testing. *Id.*

62. *Id.*

63. *Id.* The CFTC has delegated its power to register commodity market participants to the NFA. There are more than 4200 firms and 55,000 associates registered with the NFA. *Id.*

The futures exchanges, such as the CME and the NYMEX, along with the NFA, have the most direct responsibility for regulating market participants.[64] However, the CFTC retains oversight of the rule enforcement programs of the futures exchanges and the NFA.[65] Each year, the CFTC publishes Rule Enforcement Reviews of Designated Contract Markets (e.g., futures exchanges) where the CFTC examines trade practices and offers conclusions and recommendations.[66] For example, in 2006, the CFTC reviewed the CME and the Kansas City Board of Trade ("KCBT"), and in 2005, the CFTC reviewed the New York Board of Trade ("NYBOT"), the Chicago Board of Trade ("CBOT"), and OneChicago.[67]

B. Overview of the CFTC's Approach to Insider Trading

In its mission statement, the CFTC describes its main purposes as preventing fraud and promoting competition: "The CFTC's mission is to protect market users and the public from fraud, manipulation, and abusive practices related to the sale of commodity and financial futures and options, and to foster open, competitive, and financially sound futures and option markets."[68]

In the 1970s and 1980s, there were a number of incidents involving commodities trading that were perceived as insider trading[69] abuses.[70] One event that concerned

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64. *See* Susan C. Ervin, OTC Derivative Markets and Their Regulation: Working Paper on Commodity Futures Trading Comm'n Regulatory Framework, Report of the Commodity Futures Trading Comm'n (Oct. 1993).

65. *Id.*

66. *See* U.S. Commodities Futures Trading Comm'n, Rule Enforcement Reviews of Designated Contract Markets, http://www.cftc.gov/industryoversight/tradingorganizations/designatedcontractmarkets/dcmruleenf.html (last visited Sept. 4, 2008).

67. *Id.* In 2006, the CFTC's Division of Market Oversight conducted a rule enforcement review of the CME. In a fifty-nine page report, Market Oversight summarized its findings and made recommendations. It audited four areas: audit trail, trade practice surveillance, disciplinary program, and dispute resolution program. The CFTC found that all of these areas were adequate and offered no recommendations. CFTC, Div. of Mkt. Oversight, Rule Enforcement Review of the Chicago Mercantile Exchange 3, 3–5 (2006), http://www.cftc.gov/files/tm/tmrer-cme102606.pdf [hereinafter Div. of Mkt. Oversight]. In contrast, the Division of Market Oversight's 2006 Rule Enforcement Review of KCBT found some inadequacies with the KCBT's audit trail. One suggestion by Market Oversight was to encrypt the trade data back-up tapes taken off-site each night or alternatively deposit the trade data back-up tapes in a secure off-site location. CFTC, Div. of Mkt. Oversight, Rule Enforcement Review of the Kansas City Board of Trade (2006), http://www.cftc.gov/files/tm/tmrer-kcbt061606-14final.pdf.

68. CFTC, About the CFTC, http://www.cftc.gov/aboutthecftc/index.htm (last visited Sept. 26, 2008) [hereinafter About the CFTC].

69. The term "insider trading" will be used in this paper for brevity's sake. The CFTC, however, refers to insider trading as trading on material, non-public information. *See, e.g.*, Insider Trading Study, *supra* note 8, at 1.

70. *See, e.g.*, *id.* at 32–38 (analyzing the 1972 sale of wheat to the Soviet Union, trading in live cattle futures, and events in the silver markets in 1979–80 as potential abuses of material, non-public information).

Congress was the 1972 sale of wheat to the Soviet Union.[71] In April 1972, representatives of the U.S. State Department visited the U.S.S.R. to discuss possible grain sales.[72] In July 1972, the U.S. government entered into an agreement to export "roughly 434 million bushels of wheat and at least 291 million bushels of feed grains and soybeans to the U.S.S.R."[73] As a result of this deal's "size and commercial importance," the wheat futures market was dramatically affected.[74] In the wake of the State Department meeting there was a dramatic increase in wheat futures, which led to a general concern that certain government officials privy to this information (in this case, State Department officials) traded on wheat futures.[75]

As a result of similar events during the 1970s and 1980s,[76] the industry became concerned with abusive trading practices in the commodities markets. In 1982, Congress mandated the CFTC to do a detailed study into the "nature, extent, and effects" of insider trading.[77] In September 1984, the CFTC issued its report on insider trading to the Committee on Agriculture of the House of Representatives and the Committee on Agriculture, Nutrition, and Forestry of the Senate.[78] The CFTC identified four types of traders who may potentially engage in insider trading: government employees who obtain information from their workplace,[79] employees of

71. *Id.* at 32–34.

72. *Id.* at 33.

73. *Id.*

74. *Id.* For example, "the July 1972 trading volume of wheat futures trading on the [KCBT] was more than triple that of June 1972 and nearly double that of July 1971." *Id.* "[T]he Kansas City cash price of hard red winter wheat rose from $1.44¼ per bushel on June 27, 1972, to $2.26½ per bushel on September 25, 1972." *Id.* at 34.

75. *See id.* at 32. The Insider Trading Report noted that there was no actual evidence of insider trading in wheat futures. *Id.*

76. As noted above, there were concerns about potential insider trading in live cattle futures. U.S. Congressman Neal Smith stated at a February 27, 1981 press conference that the market for live cattle futures was open to trading abuses. Representative Smith stated that "the market is very thin and therefore a few insiders, by trading on their knowledge of their firms' trades, could affect the live cattle futures' prices." *Id.* at 35–36.

77. *Id.* at 1. The CFTC noted that the insider trading study was prompted by concerns regarding instances such as the 1972 sale of wheat to the Soviet Union. *Id.* at 32.

78. *See id.* at cover page.

79. By government employees, the CFTC is referring to employees of information generators and market regulators. *Id.* at 89.

futures SROs,[80] individuals who trade as agents,[81] and employees of cash and futures firms.[82]

The CFTC made several additional findings. First, although futures transactions, unlike securities transactions, are generally not firm-specific, there is still information in the market that may be material and non-public.[83] With respect to government employees, the CFTC concluded that existing laws were sufficient to deter insider trading.[84] For employees of futures SROs,[85] the CFTC noted that many futures SROs had already adopted restrictions in this type of trading.[86] The CFTC, nonetheless, stated that it intended to pass its own rule requiring futures SROs to adopt insider trading rules that met basic, specified standards.[87] For floor brokers and other fiduciaries (i.e., those trading as agents), the CFTC noted deficiencies in the current laws and stated that it intended to propose a new rule.[88] Lastly,

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80. By SROs, the CFTC was referring to employees of "exchanges, clearinghouses, and any industry-wide organizations, that have quasi-governmental functions." *Id.* at 88. The CFTC noted: "It is common for employees of futures self-regulatory organizations to be exposed to confidential information of a market-sensitive nature in the course of their official responsibilities." *Id.* at 94.

81. Broadly classified as market professionals, this group of people includes floor brokers and "others in the trading chain" who have a fiduciary duty to the customer. *Id.* at 102.

82. *Id.* at 2.

83. *Id.* at 7.

84. *Id.* at 8. The CFTC noted that the high ethical standards expected of government employees forbidding them from personally profiting from the conduct of their official duties amounted to strict liability restrictions. *Id.* at 88. The CFTC noted several statutes that preclude government employees from insider trading, including: 18 U.S.C. § 1905, a criminal statute, 5 U.S.C. § 7301, from the Code of Ethics for Government Service, and 18 U.S.C. § 1902, a specific prohibition on the release of crop reports. *Id.* at 90–91 nn. 2–4.

85. The CFTC gave several examples of employees. On a commodities exchange, there are

> members of the compliance and audit staffs [who] are privy at times to [financial data about] individual firms; market surveillance staffs [who often] possess information about the market position of large traders; staff associated with the Board of Governors or Business Conduct Committee [who] at times know about [non-public] exchange decisions; and clerks and typists [who often] handle documents [with] sensitive [market information].

Id. at 94.

86. *Id.* at 8–9. Some of the restrictions that many commodities exchanges had adopted included prohibitions against various forms of employee trading. *See, e.g.*, CFTC Notice, 47 Fed. Reg. 7300 (Feb. 18, 1982) (discussing a proposed rule that would have barred insider trading by employees).

87. Insider Trading Study, *supra* note 8, at 9.

88. *Id.* at 9–10. The CFTC noted that floor brokers or other fiduciaries may engage in dual trading, a practice where a floor broker or other fiduciary trades on his own account while having concurrent knowledge of the customer orders they are filling. *Id.* The CFTC noted that although "Commission and exchange rules require . . . floor brokers [to] execute customers' orders before trading for their own accounts, many exchanges ha[d] deficiencies in their trade reconstruction systems that [made it difficult for exchanges to enforce these rules]. *Id.*

although the CFTC noted that trading by directors, officers, and employees of cash and futures firms could lead to abuses, no change to the law was recommended.[89]

This note will focus on the CFTC's actions following the release of the insider trading study with regard to the second class of traders, namely, employees of futures SROs. Employees include members of the compliance and audit staffs, market surveillance staff, staff associated with the Board of Governors or Business Conduct Committee, and clerks and typists.[90]

Following the insider trading study, in 1986 the CFTC adopted Regulation 1.59 to tackle the problem of SRO employees engaging in insider trading. Regulation 1.59, titled "Activities of self-regulatory organization employees, governing board members, committee members, and consultants," prohibits these classes of people from trading on material, non-public information.[91] The regulation defines material information as "information which, if such information were publicly known, would be considered important by a reasonable person in deciding whether to trade a particular commodity."[92] Non-public information is defined as "information which has not been disseminated in a manner which makes it generally available to the public."[93] While a cursory glance at section 1.59(a) leads to the conclusion that it unequivocally prohibits insider trading (i.e., no trading on material, non-public information by any employee), a reading of the whole regulation shows that by dividing commodities exchange employees into two classes the CFTC has left a loophole.

III. PROBLEM

A. Regulation 1.59 Fails to Adequately Regulate Harmful Insider Trading

Regulation 1.59 fails to prohibit harmful insider trading for several reasons. First, the rules restricting insider trading are ambiguous. Regulation 1.59 creates two classes of potential traders: (1) governing board members,[94] which include com-

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89. *Id.* at 10. The CFTC decided not to recommend any legislative changes to Congress based on the research of the insider trading study and the lack of evidence regarding this type of insider trading. *Id.* Specifically, the CFTC found that information available to cash and futures firms concerning aggregate supply and demand was normally incomplete. *Id.* at 86. Individual firms typically have specific cash and futures information about transactions of their own firms. *Id.* This information, however, does not become material unless it is aggregated with the cash and futures information of several other cash and futures firms. *Id.*

90. *See id.* at 94.

91. 17 C.F.R. § 1.59 (2008).

92. *Id.* § 1.59(a)(5). The regulation provides examples of "material information" as including "information relating to present or anticipated cash, futures, or options positions, trading strategies, the financial condition of members of self-regulatory organizations . . . or their customers . . . or the regulatory actions or proposed regulatory actions of a self-regulatory organization." *Id.*

93. *Id.* § 1.59(a)(6).

94. "Governing board member means a member, or functional equivalent thereof, of the board of governors of a self-regulatory organization." *Id.* § 1.59(a)(2). The CME has a board of directors consisting of thirty-one members. CME Website, http://investor.cmegroup.com/directors.cfm (last visited Sept. 27, 2008) [hereinafter CME Website]. The management team of the CME consists of eleven members

mittee members[95] and consultants,[96] and (2) employees.[97] Governing members[98] must meet less stringent requirements than employees to avoid restrictions on insider trading.[99] This bifurcation signals to governing members that the real targets of the insider trading regulations are the lower level exchange employees, not themselves. This belief is reinforced by CFTC Releases regarding Regulation 1.59, which manifest a clear intent to maintain a less restrictive insider trading standard for governing members.[100] From a policy perspective, this rule seems backwards. Prohibiting the appearance of impropriety seems like an objective that should start from the top down, not the other way around.

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including a CEO, president, managing director, general counsel and corporate secretary, managing director and chief corporate development officer. *Id.* It is unclear from the language of Regulation 1.59(a)(2) whether the eleven members of the management team are considered "governing board members." The only person of the eleven member management team who is also on the board of directors is Craig S. Donohue, the CEO. *Id.* Clearly, he is considered a governing board member. It is unclear, however, whether the other ten members of the management team are also considered governing board members. The titles of the officers suggest that they indeed are the equivalent of board members. Except for the CEO and the president, the titles of the other eight officers are proceeded by the name managing director (e.g., managing director and chief financial officer). *Id.*

95. "Committee member means a member, or functional equivalent thereof, of any committee of a self-regulatory organization." 17 C.F.R. § 1.59(a)(3). The CME has nine committees: an Audit Committee, Compensation Committee, Executive Committee, Finance Committee, Governance Committee, Market Regulation Oversight Committee, Market & Public Relations Advisory Committee, Nominating Committee, and a Strategic Steering Committee. CME Website, *supra* note 94.

96. The term "consultant" is undefined in the regulation. The CFTC noted that Barron's Business Guides define consultant as an "individual or organization providing professional advice to an organization for a fee[;] [a] consultant is an independent contractor." Final Rules Concerning Amendments to Insider Trading Regulation, 65 Fed. Reg. 47,843 n.11 (Aug. 4, 2000) (to be codified at 17 C.F.R. pt. 1) (quoting Barron's Dictionary of Business Terms 120 (2d ed. 1994)). Noting that the terms consultant and employee can be difficult to distinguish, the CFTC stated that it is the obligation of the futures SRO to decide who is an "employee" and who is a "consultant." *Id.* at 47,846. The CFTC stated that consultants should be held to the more narrow standard of governing members (rather than the absolute ban on trading in any commodity interest on the contracting futures SRO) because most consultants do not gain access to insider information. The CFTC reasoned that in contrast to employees, the relationship between consultants and their futures SROs is generally attenuated. *Id.*

97. "Employee means any person hired or otherwise employed on a salaried or contract basis by a self-regulatory organization, but does not include: (i) Any governing board member . . . ; (ii) Any committee member . . . ; or (iii) Any consultant . . . ." 17 C.F.R. § 1.59(a)(4). Positions for employees of a futures SRO include administrative and support services, business development and strategy, clearing, finance/accounting/internal audit, human resources, legal/market regulation, marketing/PR/communications, operations, products and services/sales, and technology. *See, e.g.*, CME Website, Job Openings, http://www.cme.com/about/careers/index.html (last visited Sept. 27, 2008).

98. Hereinafter, the term "governing members," will include board members, committee members, and consultants.

99. *See infra* pp. 613–14.

100. *See generally* 17 C.F.R. § 1.59. Following the initial passage of Regulation 1.59, there have been three interpretive releases: on Dec. 29, 1987, 52 Fed. Reg. 48,977, on Oct. 25, 1993, 58 Fed. Reg. 54,973, and on Aug. 4, 2000, 65 Fed. Reg. 47,847.

The second reason Regulation 1.59 is insufficient in preventing harmful insider trading is that it has not effectively been implemented by the NFA and commodities exchanges and clearing organizations, as Regulation 1.59 requires.[101] The NFA does not have enough direct authority over governing members to prevent insider trading.[102] Consequently, the commodities exchanges are primarily responsible for enforcing the CFTC's insider trading regulation. However, the CME and NYMEX, two key futures exchanges, do not adequately implement Regulation 1.59 either. The CME only broadly prohibits insider trading in its employee handbook, not in its rulebook. This means that the maximum punishment for an employee who breaches insider trading laws is termination of employment. Similarly, the NYMEX rule implements only the minimum requirements of Regulation 1.59 which, as explained above, creates a dual standard of conduct between governing members and employees.

B. The Scope of Regulation 1.59 Is Too Narrow

In the 1984 insider trading report, the CFTC noted that it could fix the ineffectiveness of section 6b, the general anti-fraud provision of the CEA, by passing a regulation specifically prohibiting insider trading.[103] Two years after the 1984 insider trading report was issued, the CFTC indeed did pass an insider trading regulation targeting employees of futures SROs.[104] However, as a result of the CFTC's intention to maintain a less restrictive insider trading standard for governing members than employees, Regulation 1.59 left open the potential for insider trading by governing members.[105]

Regulation 1.59 differentiates between two groups of insiders under sections 1.59(b) and 1.59(c).[106] Section 1.59(b) applies to employees of futures SROs, and section 1.59(c) applies to governing members.[107] While section 1.59(d), titled "Prohibited conduct," provides a blanket prohibition on insider trading that applies to all industry participants (i.e., employees of futures SROs and the governing mem-

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101. The commodities exchanges act as both exchanges and clearing organizations. *See* Robert J. Aalberts & Percy S. Poon, *Derivatives and the Modern Prudent Investor Rule: Too Risky or Too Necessary?*, 67 Ohio St. L.J. 525, 548 (2006). Consequently, hereinafter the term "exchanges" will refer to both the exchanges and the clearing organizations.

102. *See infra* pp. 615–16 for more information about the NFA's powers.

103. *See supra* p. 600.

104. 17 C.F.R. § 1.59.

105. *See id*.

106. *Id.*

107. *Id.*

bers of futures SROs),[108] section 1.59(c) provides less stringent restrictions on insider trading for governing members than section 1.59(b) provides for employees.[109]

Specifically, section 1.59(c) provides that no governing member "shall use or disclose—for any purpose other than the performance of official duties . . . material, non-public information obtained as a result of such person's official duties."[110] In contrast, sections 1.59(b)(1)(i)(A) and (B), which govern employee conduct, provide that each futures SRO must maintain, in effect, rules that prohibit employees of the futures SRO from "[t]rading, directly or indirectly, in any commodity interest traded on or cleared by the employing contract market . . . in any related commodity interest."[111] Section 1.59(b)(1)(i)(C) goes further, stating that the employee cannot even trade on another commodities exchange.[112] The regulation states that futures SROs should have these rules in place "at a minimum."[113]

In the CFTC's 2000 Amendment to Regulation 1.59,[114] the CFTC explicitly states that the employee ban on trading is absolute: "Specifically, employees are absolutely prohibited in trading in any commodity interest . . . ."[115] In the same release, the CFTC explained that governing members are subject to less stringent standards because the CFTC values their expertise and does not want to discourage their service.[116]

108. Section 1.59(d)(1)(i) provides that no employee, governing board member, committee member, or consultant shall trade for his own account on the basis of material, non-public information. Section 1.59(d)(1)(ii) provides that these participants shall not disclose any material, non-public information for any purpose inconsistent with their duties. Finally, section 1.59(d)(2) disallows any person who has received material, non-public information from an industry participant in breach of their fiduciary duties from trading on the commodity.

109. 17 C.F.R. § 1.59.

110. *Id.* § 1.59(c).

111. *Id.* § 1.59(b)(1)(i)(A) and (B).

112. *Id.* § 1.59(b)(i)(C). This rule means that an employee of the CME cannot trade any commodities on the NYMEX (an exchange that is not regulated by the CME) if he has access to material, non-public information on NYMEX commodities (e.g., natural gas, heating oil, or light sweet crude oil).

113. *Id.* § 1.59(b)(1).

114. The CFTC passed this amendment to clarify that governing board members, committee members, and consultants are not employees. Final Rules Concerning Amendments to Insider Trading Regulation, 65 Fed. Reg. 47,843, 47,844 (to be codified at 17 C.F.R. pt. 1).

115. *Id.*

116. *Id.* It is surprising that a commodities exchange like the CME would have difficulty attracting talent if governing members were more restricted in their trading capabilities. According to Chicago Mercantile Exchange Holdings Inc., Definitive Proxy Statement (Form DEF14A) 36, 43 (Mar. 10, 2006), *available at* http://investor.cmegroup.com/investor-relations/secfiling.cfm?filingID=1193125-06-51032, the 2005 compensation for Craig S. Donohue, the CEO of the CME, was a $700,000 salary and a $951,510 bonus, totaling $1,651,510 for the year. This 1.65 million dollar figure does not include Donohue's $327,535 restricted stock compensation or his additional $193,254 compensation to his 401(k), pension, supplemental plan, and SERP contribution. It should additionally be noted that Mr. Donohue and the other directors and executive officers of the CME (totaling thirty-one people as a group) collectively own 481,251 (or 1.38%) of the Class A shares and thirty-three (or 1.94%) of the Class B shares. At a closing price of $210.60 on May 25, 2005, for Class A shares, thirty-one people owned $101,351,460.60

This position is consistent with the 1986 release adopting section 1.59,[117] in which the CFTC deleted the portion of the regulation that restricted trading by governing members until further comments could be raised and addressed.[118] The CFTC took notice of several criticisms of the proposal based on letters from various industry groups.[119] These groups argued, among other things, that the regulation prohibits more trading than is necessary to maintain the integrity of the market, that it would be difficult to enforce, and that governing members should be given the opportunity to excuse themselves from discussions that could affect the market.[120]

While asserting that its goal in regulating governing members is to "detect and deter violations," the CFTC has continued to maintain its lax position toward governing members, citing its desire to hold on to talented employees in these important positions.[121] In the 2000 release, the CFTC stated that "[t]he possession of material, non-public information . . . does not bar these individuals [governing members] from trading commodity interests."[122] This statement specifically gives to governing members that which it forbids to employees—namely, the right to trade commodity interests on another futures SRO or a linked commodities exchange.[123]

The language and CFTC interpretation of Regulation 1.59 are both ambiguous. On one hand, the language seems absolute with respect to governing members (i.e., trading is prohibited on their own account or for or on behalf of any account). On the other hand, the CFTC explicitly states that governing members are not absolutely barred from trading, as is the case with employees. This ambiguity is even more disturbing in light of the fact that the futures SROs have neither passed stringent rules of their own nor enforced their own rules to restrict insider trading.

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worth of stock. Donohue, with 94,390 Class A shares, owned $19,878,534 of CME stock as of May 25, 2005. *Id.* at 18, 24–26. Class B shares confer certain voting powers. *Id.* at 28, 34.

117. Activities of Self-Regulatory Organization Employees Who Possess Material, Nonpublic Information, 51 Fed. Reg. 44,866 (Dec. 12, 1986) (to be codified at 17 C.F.R. pt. 1) [hereinafter Activities of SRO Employees].

118. *Id.* at 44,866.

119. *Id.*

120. *Id.* at 44,868.

121. In the 1986 release, the CFTC stated that, in consideration of opposition by governing members to further restricting their trading capabilities, it "has determined that the proposal restricting the activities of governing members merits further deliberation and possible amendment." *Id.* In the 2000 release, the CFTC completely ignored its pledge to deliberate on regulating governing members. The 2000 release, instead of discussing further prohibitions on insider trading by governing members, is silent on this issue. Rather, the release makes clear that governing members are not to be considered "employees" (if governing members were considered "employees," they would be subject to more stringent insider trading prohibitions). Final Rules Concerning Amendments to Insider Trading Regulation, 65 Fed. Reg. at 47,844.

122. *Id.* at 47,844.

123. 17 C.F.R. § 1.59.

C. *Regulation 1.59 Has Not Been Implemented by the NFA, Commodities Exchanges, and Clearing Organizations As Regulation 1.59 Requires*

Regulation 1.59(b), which applies to employees of futures SROs, and Regulation 1.59(c), which applies to governing members, state that each futures SRO must maintain rules against insider trading.[124] The CFTC, with its limited budget and resources, delegates a great degree of regulatory authority to the futures SROs in this area.[125] Consequently, this means that if the futures SROs are not regulating or enforcing rules against insider trading, then insider trading will go unpunished.

The rulebooks of the NFA, the CME, and NYMEX[126] lack sufficient prohibitions against insider trading. Under NFA Rule 2-2, titled "Fraud and Related Matters," the NFA provides that "[n]o Member or Associate shall cheat, defraud or deceive, or attempt to cheat, defraud or deceive, any commodity futures customer."[127] This general rule is strikingly similar to the language of section 6b of the CEA, which provides that:

> It shall be unlawful for [any member of a registered entity] . . . for or on behalf of any other person . . . in or in connection with an order to make . . . any contract of sale of any commodity . . . to cheat or defraud or attempt to cheat or defraud such other person[.][128]

Because NFA Rule 2-2 states that it is unlawful to cheat a customer, rather than the market as a whole, the NFA's prohibition on insider trading does not accomplish the goals of Regulation 1.59.[129]

NFA Rule 3-1, titled "Department of Compliance," provides a better solution than NFA Rule 2-2. This compliance rule specifically prohibits insider trading, as opposed to NFA Rule 2-2, which is a general anti-fraud provision. Also, NFA Rule 3-1, unlike the CFTC's Regulation 1.59, is not limited to different categories of market participants. In fact, NFA officers and employees are banned from insider trading. NFA Rule 3-1(b) provides that, "[e]xcept with the President's approval, the Compliance Director and any employee of the Compliance Department shall not trade, directly or indirectly, any commodity interest."[130] The inclusion of the compliance director in the same sentence as "any employee" implies that the ban on insider

124. *Id.*

125. CFTC, FY 2008 President's Budget and Performance Plan 43, at 58 (2007). The CFTC's 2008 fiscal year budget estimate is $116 million. *Id.* Of this figure, only $30,262,000 goes to the Division of Enforcement. *Id.*

126. The CME and the NYMEX are both commodities exchanges and derivative clearing organizations (DCOs). *See supra* text accompanying note 19.

127. NFA Compliance Rules, 2-2, *available at* http://nfa.futures.org/nfaManual/manualCompliance.asp#2-2.

128. CEA, 7 U.S.C. § 6b(a) (2006).

129. *See supra* Part III (explaining why section 6b does not work to prohibit insider trading by governing members).

130. NFA Compliance Rules, 3-1, *available at* http://www.nfa.futures.org/printerFriendly.asp?tag=3-1b.

trading applies equally to both groups. Furthermore, the CFTC noted in its insider trading study (published before Regulation 1.59 was adopted) that the NFA already had rules in place that prohibit NFA officers and employees from insider trading without proper approval of a superior.[131]

The NFA, because of its enforcement authority, certainly has the capacity to deter insider trading. For example, in an NFA regulatory action against Calvary Financial Group, the agency charged the company with several violations of NFA Compliance Rules, including such violations as churning customers' accounts, placing unauthorized trades in customers' accounts, and making deceptive, misleading, and high-pressured sales solicitations.[132] As a result of these violations, Calvary was banned from ever again re-applying for NFA membership or CFTC registration in any capacity.[133] The NFA, in addition to its powers to deny, revoke, suspend, restrict, or condition any market participant's registration, can also fine up to $250,000 per violation.[134] Moreover, the NFA often collaborates with the CFTC and the FBI when bringing charges against firms or individuals.[135]

The problem with NFA Rule 3-1(b) is that it is not enforced. The NFA online database of regulatory actions, dating back to 1996, shows that the NFA has enforced many of its rules, including Compliance Rules 2-4, 2-5, 2-6, 2-8, 2-29, 2-30, and 2-38. Compliance Rule 3-1, however, does not appear in the NFA database of regulatory actions.[136] In fact, the NFA has never brought any kind of action under this rule against one of its members.[137]

Although the NFA can bring a disciplinary action against one of its members, the NFA cannot enforce its insider trading laws against commodities exchange participants. The NFA's Articles of Incorporation, Article III, section 2(a) provides: "No NFA requirement shall purport to govern or otherwise regulate the specific conduct of a Member or Association if such conduct is governed or regulated by the requirements of a contract market and such Member or Associate is subject to the contract market's disciplinary jurisdiction for such conduct."[138] Section 2(b) further specifically provides that the NFA cannot regulate, among other things, "[t]he con-

131. Insider Trading Study, *supra* note 8, at app. VI 3–4. The CFTC stated that the rules of the NFA, contained in its Code of Professional Conduct, prohibited NFA officers and employees from trading in futures without the approval of the president or general counsel. *Id.* Also, the Code of Professional Conduct prohibits officers and employees from using confidential information gained by reason of their employment for their personal benefit. *Id.*

132. Calvary Financial Group LLC, NFA Case #02BCC00005, ID No. 0297789 (Nov. 13, 2002).

133. *Id.*

134. NFA Website, http://www.nfa.futures.org/aboutnfa/indexAbout.asp (last visited Sept. 29, 2008).

135. *Id.*

136. NFA Website, http://www.nfa.futures.org/news/newsActionsList.asp (last visited Sept. 29, 2008).

137. Telephone Interview with Thomas W. Sexton III, Vice-President & General Counsel, Nat'l Futures Ass'n (June 29, 2007) [hereinafter Sexton Telephone Interview].

138. NFA Articles of Incorporation, *available at* http://www.nfa.futures.org/nfaManual/manualArticles.asp#A3S2.

duct of business or other activities on the trading floor of a contract market."[139] The NFA Articles, then, devolve authority over trading violations to the commodities exchanges.

The CME and NYMEX, two of the most important commodities exchanges, do not have adequate rules in place to deter insider trading. Under CME Rule 233, titled "Conflict of Interest—Disqualification," the board must take "all necessary steps" to make sure that no board member has a conflict of interest.[140] This rule states that such a board member will be excused from a meeting concerning a matter in which the board member has a "significant and direct financial interest." CME Rule 233 gives three examples of when a board member should be excused from a meeting: (1) when he directly or indirectly owns or controls an account likely to be materially affected by the board meeting; (2) when he has a substantial financial interest in a clearing member likely to be materially affected by the board meeting; and, (3) when the board otherwise determines disqualification is necessary.[141]

CME Rule 432(M), under the section for "Major Offenses," states that it shall be a major offense "to use or disclose, for any purpose other than the performance of an individual's official duties as a member of any committee or the Board of Directors, any nonpublic information obtained by reason of participating in any Board of Directors or committee meeting or hearing."[142] Under CME Rule 431 on penalties, major offenses warrant expulsion, suspension, and denial of access to CME products and/or a fine of up to $100,000 plus disgorgement of any ill-gotten gains.[143]

CME Rule 532 provides: "No person shall disclose another person's order to buy or sell . . . . No person shall take action or direct another to take action based on non-public order information . . . . Violation of this rule may be a major offense."[144]

These rules are ineffective for the same reason the NFA rules are ineffective. Simply stated, they are not enforced.[145] The rules banning employees from insider trading are contained within the employee handbook.[146] In the CME employee handbook there is a provision titled "Insider Trading," which prohibits the buying or selling of securities using material, non-public information.[147] This prohibition,

139. *Id.*

140. Sexton Telephone Interview, *supra* note 137.

141. *Id.*

142. CME Rulebook, *available at* http://www.rulebook.cme.com/Rulebook/Chapters/pdffiles/004.pdf.

143. Sexton Telephone Interview, *supra* note 137.

144. CME Rulebook, *available at* http://rulebook.cme.com/Rulebook/Chapters/pdffiles/005.pdf.

145. These rules were explained to me as being confidentiality rules, rather than insider trading rules. Telephone Interview with Anonymous Member of CME Market Regulation (July 5, 2007) [hereinafter Member Telephone Interview].

146. *Id.*

147. CME, Compliance and Ethics Program, Code of Conduct 7 (2006) [hereinafter CME, Employee Handbook].

while applicable to securities, does not use the word "commodities."[148] The omission of the word "commodities" means that this insider trading rule only applies to security-linked commodities products.[149] In support of the CME enforcement program, the employee handbook provides: "You may not personally profit from confidential information. You may not use confidential information to trade commodities or securities for your own (or related) accounts . . . ."[150]

It is unclear whether the CME has brought specific actions for insider trading pursuant to the employee handbook because the CME's enforcement activity is not public.[151] Even if the CME has enforced this guideline, the penalties for violating the handbook are unlikely to deter violations. In the CME employee handbook, the section titled "Discipline for Violations," provides that conduct not in compliance with the handbook may lead to disciplinary measures "up to and including discharge."[152] This is hardly a deterrent. In comparison to insider trading in securities, where violators might serve jail time,[153] the maximum penalty for insider trading on commodities is only discharge from the commodities exchange.

The insider trading rules of NYMEX are similarly inadequate, as they closely follow CFTC Regulation 1.59. Under NYMEX Rule 3.02, titled "Restrictions on Governing Board Members, Committee Members, Consultants, and Other Persons Who Possess Material, Non-Public Information," the NYMEX adopts the same definitions for "material information" and "non-public information" as Regulation 1.59.[154] Also, NYMEX Rule 3.02 distinguishes between governing board members, committee members, consultants, and other persons with material, non-public information, and places more stringent trading requirements on other persons.[155]

The NYMEX rule is inadequate to block insider trading for the same reasons as described above. NYMEX Rule 3.02 does not subject governing members to the same level of trading restrictions as employees. In fact, NYMEX's rule implements the minimal amount of trading restrictions required by Regulation 1.59.[156]

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148. *Id.*

149. Member Telephone Interview, *supra* note 145.

150. CME, Employee Handbook, *supra* note 147, at 5–6.

151. Member Telephone Interview, *supra* note 145.

152. CME, Employee Handbook, *supra* note 147, at 14.

153. Martha Stewart, who was sentenced to five months incarceration, serves as an infamous example of an inside trader serving jail time. *See* United States v. Stewart, 433 F.3d 273 (2d Cir. 2006).

154. *Compare* NYMEX Exchange Rulebook 3.02 (2008) [hereinafter NYMEX Exchange Rulebook], *available at* http://www.nymex.com/rule_main.aspx?pg=3#3.02, *with* 17 C.F.R. § 1.59 (2008).

155. NYMEX Exchange Rulebook, *supra* note 154.

156. 17 C.F.R. § 1.59(b) (stating that self-regulatory organizations should have these rules in place "at a minimum").

IV. ANALYSIS

A. The Ineffectiveness of Regulation 1.59 May Lead to a Less Competitive Commodities Market

The problems with the insider trading regulation rules and enforcement are outlined above. First, section 6b of the CEA is not suited for insider trading claims, as are section10(b) of the Securities Exchange Act and Rule 10b-5, because the breach of fiduciary duty and misappropriation theories used in securities cases do not translate in the commodities context. CFTC Regulation 1.59 is ineffective because commodities trading by governing members is not restricted to the same degree as trading by employees. Although the NFA possesses strong rules against insider trading, it simply does not enforce them.

The CME and NYMEX, two of the most important commodities exchanges, also contribute to the ineffectiveness of Regulation 1.59. In the case of the CME, the employee handbook governs insider trading. The maximum punishment for violations is discharge from the exchange. The NYMEX simply adopts Regulation 1.59, which on its face and as interpreted by the CFTC in its adopting releases is wholly inadequate.

Insufficient regulation of insider trading is problematic for two reasons. First, the present state of insider trading regulation favors hedgers over speculators, which is dangerous to the efficiency of the commodities market. Another problem with insufficient regulation is that insider trading is fundamentally unfair.

B. The Present State of Insider Trading Regulation Favors Hedgers over Speculators

The CFTC, in its 1984 Insider Trading Report, identified hedgers and speculators as key market participants.[157] As stated above, hedgers use futures to protect a cash market position from adverse price movements[158] while speculators seek profit by anticipating changes in cash market prices.[159] The insider trading study, while recognizing that futures markets facilitate the management of risk, also acknowledges that speculators add the necessary liquidity to the market so that the futures market functions efficiently.[160] The study states: "Whereas the futures market hedger seeks protection against unfavorable changes in cash market prices, the speculator willingly assumes the risk of futures price changes."[161]

157. Insider Trading Study, *supra* note 8, at 13–14.

158. *Id.* at 13.

159. *Id.* at 14.

160. *Id.* at 13–14.

161. *Id.* at 14. As one district court aptly noted, "Speculation in the futures markets can be undertaken only by those who stand ready to lose their entire investment and then some." Comex Clearing Ass'n, Inc. v. Flo-Arb Partners, 711 F. Supp. 1169, 1171 (S.D.N.Y. 1989).

In an article written by David T. Johnston,[162] "Understanding the Dynamics of Commodity Trading: A Success Story," Johnston discusses the importance of speculators to the commodity market.[163] He argues that fifty to seventy-five percent of trading must come from speculators in order for the market to function efficiently, especially during the occasional times when dealers and commercial firms place very large orders.[164] The consequence of less-liquid markets would increase the cost of moving raw materials from producer to consumer.[165]

In *U.S. v. Dial*, the Seventh Circuit highlighted the dangers of insider trading and its possible effect on traders without material, non-public information.[166] Writing for the court, Judge Posner noted that traders on commodities exchanges want assurance that they are not competing with people who have preferential access to information.[167] If these traders feel that others have an unfair advantage, they will seek out other exchanges that are not "rigged."[168]

C. Insider Trading Is Fundamentally Unfair

In addition to ensuring that speculators remain key market participants, insider trading laws should be enforced because insider trading is inherently unfair. Fairness in public trading, according to one academic commentator,[169] requires that market participants have a roughly calculable chance to win[170] and a level playing field.[171]

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162. David T. Johnston, at the time he wrote the article in 1980, was senior vice president for commodities of E.F. Hutton and Co., chairman of the Futures Industry Association (FIA), vice president of the NFA, and a member of many commodity exchanges. David T. Johnston, *Understanding the Dynamics of Commodity Trading: A Success Story*, 35 Bus. Law. 705, 705 (1980).

163. *Id.* at 705–10.

164. *Id.* at 709.

165. *Id.* at 709–10. One interesting trend found in agricultural commodities was that the more liquid they were, the faster they grew. For example, sugar futures and options, which enjoyed great liquidity, accounted for more than half of the increase of volume in trading on the NYBOT in 2004. Galen Burghardt, *FIA Annual Volume Survey: The Invigorating Effects of Electronic Trading*, Futures Industry, Mar./Apr. 2005, *available at* http://www.futuresindustry.org/fi-magazine-home.asp?a=1026; *see also* Galen Burghardt, *Measuring Market Impact: Transaction Cost Analysis Comes to the Futures Market*, Futures Industry, Nov./Dec. 2006, at 62, *available at* http://www.futuresindustry.org/downloads/fimag/2006/outlook07/outlook07_tca.pdf.

166. 757 F.2d 163 (7th Cir. 1985).

167. *Id.* at 165.

168. *Id.*

169. Kim Lane Scheppele, *"It's Just Not Right": The Ethics of Insider Trading*, 56 Law & Contemp. Probs. 123, 157 (1993).

170. Under this theory, traders must be able to ascertain whether they are trading against insiders. If they cannot make this determination, then the trader has no way to calculate his risk. In order to determine whether there is insider trading, there must be disclosure. *Id.* at 157–60.

171. In order to ensure fairness to the greatest extent possible, the market must be a level playing field. This does not mean that all parties trading on the markets will have equal information. A level playing field requires that all market participants have equal access to all pertinent information. *Id.* at 160.

In the context of securities law, the fairness policy behind banning insider trading is endorsed by both the SEC and the Supreme Court.[172] As stated above, the CFTC's mission statement describes its main purposes as protecting against fraud and promoting competition.[173] The CFTC's ineffectiveness in stopping insider trading demonstrates a failure to protect market users from abusive market practices.

One of the biggest opponents to the fairness argument underlying insider trading laws is Professor Henry G. Manne.[174] According to Professor Manne, economic injury to outsiders is random.[175] Professor Manne does not, however, solely rest his pro-insider trading position on the theory that economic injury to outsiders is random. As he states, "the ultimate question of economic desirability of insider trading involves far more than these hypothetical computations."[176] Professor Manne asserts that a key factor in support of allowing insider trading is that it encourages innovation in the market.[177] In order to encourage innovation, he argues, salary and bonuses are an inadequate form of compensation because "the employee is limited to a specific reward no matter how great his innovation."[178]

Arguments in support of insider trading must be rejected. First, it is incorrect to assert that insider trading causes no economic harm in the markets.[179] Some traders may feel, regardless of the economic effects, that insider trading is simply not right.[180]

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172. In *United States v. O'Hagan*, the Supreme Court stated that the "animating purpose" of the Securities Exchange Act of 1934 was "to ensure honest securities markets." 521 U.S. 642, 658 (1997). Justice Ginsburg cited an SEC release from 1980 in support of this statement. The SEC states, "The Commission continues to believe that [insider trading] undermines the integrity of, and investor confidence in, the securities markets . . . ." Tender Offers, 45 Fed. Reg. 60,410, 60,412 (Sept. 12, 1980) (to be codified at 17 C.F.R. pt. 240).

173. About the CFTC, *supra* note 68.

174. Jonathan R. Macey, *From Fairness to Contract: The New Direction of the Rules Against Insider Trading*, 13 Hofstra L. Rev. 9, 10 n.4 (1984). Macey states that Professor Manne's work was the origin of the intellectual opposition to the fairness conception. *Id.*

175. Manne states that in the case of a price increase, for example, while some outsiders may lose if they sell early, some outsiders may gain from increased insider trading activity if they hold. Henry G. Manne, Insider Trading and the Stock Market 99–107 (1966).

176. *Id.* at 104.

177. For example, without allowing insider trading as a form of compensation, the director doing his job at the exchange is going to get his fixed salary regardless of whether he revolutionizes the industry or not. *Id.* at 132–33.

178. *Id.* at 138. Manne states that the salary merely gets the person into the job. The bonus paid to compensate entrepreneurs is usually paid out through a profit-sharing plan where a percentage of profits is determined in advance rather than as a result of a new discovery. As opposed to seeing this as a windfall to the insider, Manne refers to this insider trading as a "rather inexpensive form of compensation." *Id.* at 107.

179. *See generally* William H. Painter, *Rule 10b-5: The Recodification Thicket*, 45 St. John's L. Rev. 699 (1971) (using insider trading as an example to examine whether rules should be made legislatively, administratively, or judicially).

180. *Id.* at 714. Painter notes that whether this feeling is rational or irrational is not relevant:

> The problem with [Manne's theory that the investing public consists of only those solely preoccupied with the economic effects of market regulation] is that investors do not concern

Although Professor Manne "characterizes this argument as little more than foot stomping," this admittedly emotional reaction may have serious adverse economic consequences for the markets if enough people stomp their feet.[181] Investors could lose confidence in the integrity of the markets and stop trading.[182]

Professor Manne's argument that entrepreneurs are not sufficiently compensated without insider trading is as dubious as his claim that insider trading causes no economic harm in the market. To argue that banning governing members from trading commodities will deter talented people from taking these positions is absurd in view of governing members' actual salaries.[183] The compensation offered by these positions is so great that plenty of talented people will seek out positions as governing members even if they are not allowed to trade in commodities.[184]

In addition to traditional arguments against Professor Manne's position, the 1984 CFTC insider trading study criticizes Professor Manne's position on insider trading.[185] The study notes that Professor Manne's theory is based on hypothetical conjecture, as it is not possible to correctly determine whether entrepreneurs are over- or under-compensated.[186] In any case, the study notes that whatever force Professor Manne's arguments may have in a securities context is lost in the futures context.[187]

Admittedly, insider trading in the securities markets and insider trading in the commodities markets are two different things. As set forth in the introduction, there is a fundamental difference between the two markets. The CFTC noted three

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> themselves exclusively with economic effects and are motivated by a wide variety of factors, many of which can only be described as irrational.

Id. at 714 n.51.

181. *Id.* at 714 n.53.

182. *Id.* at 713–14.

183. As mentioned above, the CFTC noted in its 1986 release that several industry groups took this position including ALCOA, CME, NFA, the NYSE, and ten other groups. *See* Activities of SRO Employees, *supra* note 117.

184. *See id.*

185. *See* Insider Trading Study, *supra* note 8, at app. IV–A 6–11.

186. The study states that there is no empirical evidence to support Manne's view that entrepreneurs are undercompensated. While recognizing that there are certainly some underpaid entrepreneurs, the CFTC stated, "there is no reason to expect them as a group to be systematically underpaid." *Id.* at 11.

187. *Id.* at app. IV-A 9. Futures prices, unlike securities prices, very rarely fluctuate based on one firm's performance. Consequently, allowing an insider to trade on non-public information in the futures markets would not accurately compensate that person for their efforts. *Id.* at app. IV-A 8.

major categories of information that have value in futures trading: futures trading environment,[188] transaction information,[189] and cash market fundamentals.[190]

Of the CFTC's four enumerated categories of traders that may potentially engage in insider trading, outlined above,[191] governing members are in the unique position of having simultaneous access to information regarding the futures trading environment, transaction information, and cash market fundamentals.[192] Consequently, a strict ban on commodity futures trading by governing members would eliminate the potential for governing members to engage in insider trading. A total ban would eliminate confusion surrounding what is non-public, what is material, and what information was obtained as a result of their duties as a governing member. The new rule would be crystal clear. Instead of providing that no governing member "shall use or disclose—for any purpose other than the performance of official duties . . . material, non-public information obtained as a result of the performance of such person's official duties"[193] the rule would be unambiguous like section 16(b) of the SEA.

V. CONCLUSION

The commodities market is a key component to the success of the U.S. financial markets. Like the securities market, maintaining public confidence in the commodities markets should be of paramount importance to commodity regulators.[194] Unfortunately, the current insider trading rules have the potential to undermine public confidence in the commodities markets. Allowing governing members, who have informational advantages over other market participants, the opportunity to trade on inside information is unfair.[195] If enough market participants, particularly

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188. Futures trading environment is defined as information regarding various market rules and regulations. *See* Insider Trading Study, *supra* note 8, at 16.

189. Transaction information is knowledge of the "past, current and/or anticipated cash or futures market transactions of a market participant." *Id.*

190. "Cash market fundamentals information" is information regarding changes in the supply or demand in commodities that underlie futures market transactions. *Id.* at 17–18.

191. The CFTC identified four categories of potential inside traders: government employees, employees of futures SROs (this would include governing members), individuals who trade as agents, and employees of cash and futures firms. *See supra* pp. 608–09.

192. By definition, governing members will have access to information regarding the futures trading environment because they are passing rules for their exchanges. In addition, governing members, through their auditing of market participants and their surveillance of the futures markets, also have access to transaction information and cash market fundamentals. Due to access to aggregated information, governing members consistently possess material, non-public information not available to other market participants. Insider Trading Study, *supra* note 8, at 20–21, 85–86.

193. 17 C.F.R. § 1.59(c).

194. As noted above, section 16(b) provides an absolute ban on certain types of potential insider trading, and section 10(b) and Rule 10b-5 are used to sue those who engage in insider trading. *See supra* Part III-B.

195. Governing members consistently have access to information regarding futures trading environment, transaction information, and cash market fundamentals. *See* Insider Trading Study, *supra* note 6, at

speculators, leave the commodities market, decreased liquidity in the market will drive up transaction costs for the entire market.[196]

To avoid these problems, the CFTC should redraft Regulation 1.59 to completely ban insider trading by governing members. The goal of placating large regulatory bodies and corporations that animate Regulation 1.59 is unrealistic. Strong insider trading laws will not disincentivize talented people from serving in leadership positions on commodities exchanges. Governing members of commodities exchanges enjoy great prestige and plenty of monetary compensation without the need to trade on inside information.

The futures SROs should be responsible for ensuring that their governing members do not trade. However, because governing members have great influence over their exchanges, the CFTC also needs to play an active role in ensuring compliance with a new Regulation 1.59. In order to make certain that the new regulation is effective, the CFTC Division of Market Regulation, not the futures SROs, should examine the procedures in place to prevent insider trading in their annual rule enforcement reviews.[197] In addition, the CFTC's Division of Enforcement should devote some of its resources specifically to investigating and enforcing against insider trading abuses.

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196. *See* Johnston, *supra* note 162; *see also* Burghardt, *Measuring Market Impact*, *supra* note 165.

197. See Div. of Mkt. Oversight, *supra* note 67, for more information on the Division of Market Regulation's Rule Enforcement Reviews.