

History of the Current Regulatory Framework

Futures Regulation and History

Introduction

Federal and industry regulators carry out the regulation of futures markets in the United States under the Commodity Exchange Act (“CEA”). In general, states do not have authority to regulate futures markets. The fundamental aims of futures market regulation resemble those of securities regulation: to help protect market users and the public from fraud and manipulation and to ensure fair and orderly markets.

Although undefined in statute, a “future” or “futures contract” generally refers to a highly standardized agreement between two parties to buy and sell a specific asset at a specified price before or upon some set future date. The first futures contracts focused on agricultural commodities. Today, futures contracts involve a vast array of assets, including agricultural products (except onions), financial instruments and indexes, energy products, and metals.

Background – Futures Regulation Before the Commodity Exchange Act

The organized trading of futures on agricultural commodities in the United States dates back to the middle of the nineteenth century. In 1848, a group of commodities merchants, who began to trade so-called “to arrive” contracts, formally established the Chicago Board of Trade. As in the case of the securities markets, self-regulation of the futures markets preceded federal regulation. The first significant federal law to regulate futures was the Future Trading Act of 1921 (“Future Trading Act”), but the following year the U.S. Supreme Court determined the law to be unconstitutional because of its improper taxing of futures not traded on designated contract markets (i.e., those traded off-exchange). Later, in 1922, Congress enacted the Grain Futures Act, which, rather than taxing off-exchange trading of futures contracts, invoked the interstate commerce clause to ban such transactions. The U.S. Supreme Court later upheld the Grain Futures Act as constitutional.

The Future Trading Act and the Grain Futures Act established certain precedents in the regulation of futures markets persisting to this day. Among the most important are the notions that the regulator should be empowered to designate exchanges or boards of trade that meet certain requirements as “contract markets” (i.e., officially recognized trading venues for futures contracts) and that off-exchange trading of futures is illegal. Today, the basic premise remains that the trading of futures contracts, whenever intermediaries are involved, must be conducted on designated contract markets. However, recent amendments to the CEA, the statute that today governs commodity and futures markets, have significantly relaxed some trading restrictions.

Also, given that the first futures contracts involved agricultural commodities (the Future Trading Act and the Grain Futures Act specifically authorized futures only on selected

grains), the Department of Agriculture (“USDA”) possessed initial federal jurisdiction over futures markets. The Secretary of Agriculture oversaw futures regulation until 1975. Although the USDA no longer has authority over futures markets (and although the bulk of modern futures trading is in non-agricultural assets), an agricultural tie remains through the Senate and House Agriculture Committees’ oversight of the CFTC, the federal agency overseeing futures regulation.

The Commodity Exchange Act and the Commodity Futures Trading Commission

Origin and Early Developments

Replacing the precursor Grain Futures Act, the CEA in 1936 broadened the types of commodities on which futures contracts could trade. Apart from the grains already permitted, the CEA expanded the list of enumerated commodities to include cotton, rice, butter, eggs, and Irish potatoes. The transactions still had to take place on an organized exchange. Over the ensuing three decades, numerous amendments to the CEA continued to add more and more covered commodities to the list. In addition, the Commodity Exchange Authority, the predecessor agency of the CFTC, gradually acquired or exercised additional regulatory powers, including the ability to investigate and enforce authorities, and the ability to set minimum financial standards for futures commission merchants.

Landmark reform of the CEA arrived with the enactment of the Commodity Futures Trading Commission Act of 1974 (“CFTC Act”). First, the CFTC Act moved the authority over the futures markets from the Secretary of Agriculture to a newly created independent federal agency, the CFTC. In addition to transferring to the CFTC the powers of its predecessor agency, Congress conferred upon the CFTC exclusive jurisdiction over “contracts for the sale of a commodity for future delivery” and options on such contracts. The CFTC’s exclusive jurisdiction for all assets, not just with respect to enumerated agricultural commodities, remains in place today. In addition, the CFTC Act authorized the creation of national futures associations, or self-regulatory organizations (“SROs”), for the futures industry.

In 1975, the CFTC, with its new authority over futures markets, approved the first futures contracts on financial assets, including the Chicago Board of Trade’s futures contract on Government National Mortgage Association certificates, and the Chicago Mercantile Exchange’s futures contract on 90-day U.S. Treasury bills. In the years ahead, the growth of financial futures and other financial derivatives, coupled with the increasingly complicated issue of what exactly a future is, would test the limits of the CFTC’s exclusive jurisdiction.

In particular, the emergence of innovative financial instruments such as swaps, stockindex futures, and other derivative instruments, some of which were traded off-exchange, began to introduce uncertainty as to where the line between futures regulation and securities regulation should be drawn. In 1981, for example, the CFTC and the SEC negotiated an agreement that divided jurisdiction and regulatory responsibility over stock

index futures among the two agencies. This jurisdictional agreement, known as the Shad-Johnson Accord, was later codified in the Futures Trading Act of 1982, and resulted in a statutory ban on single-stock futures and narrow-based stock index futures that lasted almost 20 years. Subsequently, the CFTC in 1989 issued a policy statement concerning swaps in which it identified certain transactions that it would decline to regulate as futures or futures options. Also, the Futures Trading Practices Act of 1992 provided the CFTC the authority to exempt certain off-exchange, or over-the-counter (“OTC”) transactions, from most provisions of the CEA. The following year, the CFTC began using this new authority to exempt certain swap agreements, hybrid instruments, and certain OTC energy contracts.

None of these statutory amendments or CFTC actions, however, addressed the fundamental question of whether or not swaps and other derivative instruments were indeed futures contracts or futures options. Lacking such clarification, and coupled with the CEA’s exchange-trading requirement and the CFTC’s exclusive jurisdiction, the legal uncertainty in the area of financial derivatives continued to swell. In 1998, following a legislative moratorium preventing the CFTC from taking additional regulatory action in the area of OTC derivatives, Congress asked the President’s Working Group on Financial Markets (“PWG”) to conduct a study of OTC derivatives markets and to develop legislative recommendations. In 1999 the PWG issued its report, *Over-the-Counter Derivatives Markets and the Commodity Exchange Act* (“1999 PWG Report”), and the unanimous recommendations advanced in that report became the basis for some of the most significant reforms to the derivatives markets since the CFTC’s creation.

The Commodity Futures Modernization Act of 2000

The Commodity Futures Modernization Act of 2000 (“CFMA”), amending the CEA, took as its starting point the recommendations in the 1999 PWG Report on OTC derivatives. Most fundamentally, the PWG had concluded that the trading of OTC financial derivatives between certain sophisticated counterparties (which mainly includes regulated financial institutions, state and local governments, and certain businesses, pension funds, high net worth individuals, and other institutions) should largely be excluded, as opposed to exempted, from the CEA. The primary justifications for recommending exclusion for such transactions were a determination that most OTC financial derivatives (e.g., interest rate swaps) were not susceptible to manipulation and that the counterparties in such transactions did not need the same protections as smaller, unsophisticated market participants who relied on intermediaries to conduct their transactions.

The CFMA excluded a broad range of transactions from most provisions of the CEA, thereby providing much needed legal certainty for the burgeoning OTC derivatives markets. In general, the exclusions provided by the CFMA depended, as did the PWG recommendations, upon the types of assets being traded, the sophistication of the counterparties, and where and how the transactions were executed. The CFMA created several new definitions to facilitate the exclusions:

- Excluded commodity: generally includes financial assets such as securities and currencies, interest rates, exchange rates, economic measures or indexes of risk, return, or value, and contingencies beyond the control of the parties.
- Eligible contract participant: the main type of sophisticated investor that includes financial institutions, registered market professionals (e.g., broker-dealers and futures commission merchants), other institutional investors, and certain high net worth individuals.
- Eligible commercial entity: a certain eligible contract participant (as defined above) that deals in one or more commodities as part of their business.
- Trading facility: a catch-all term for either a physical or electronic facility where multiple participants are able to trade with each other through mutually available bids and offers.

Thus the CFMA excluded from most provisions of the CEA, including the antifraud provisions, the following:

- Agreements, contracts, and transactions in excluded commodities
 - o between eligible contract participants that are not executed on a trading facility; or
 - o between eligible contract participants, on a principal-to-principal basis, and executed on an electronic trading facility.
- Agreements, contracts, and transactions in assets, other than agricultural commodities, between eligible contract participants are subject to individual negotiation by the parties and are not executed on a trading facility.

In addition, the CFMA excluded transactions in hybrid instruments that are (as determined by a “predominance test”) chiefly securities, and electronic trading facilities that limit trading to certain types of transactions that are otherwise excluded.

However, the CFMA went further than (and actually contradicted) the PWG recommendations in this area by exempting certain transactions in exempt commodities. The CFMA also defined exempt commodities to mean a commodity that is not an excluded commodity or an agricultural commodity. In practice, exempt commodities include mainly metals and energy products. Under the CFMA, agreements, contracts, and transactions in exempt commodities are exempt from most provisions of the CEA (but not including the antifraud provisions or other powers of the CFTC) if they are between eligible contract participants and not executed on a trading facility or if they are between eligible commercial entities on a principal-to-principal basis and traded on an electronic trading facility.

In addition to addressing swap transactions, the CFMA also included several other

important aspects:

- It clarified the CFTC's jurisdiction over certain retail foreign currency transactions.
- It repealed the eighteen year-old Shad-Johnson ban on single-stock futures and other security future products and implemented a system of "coordinated regulation" for such products.
- It provided legal certainty that products offered by banks would not be regulated as futures contracts.

The CFMA also codified a regulatory relief proposal developed by the CFTC. In early 2000, the CFTC proposed a "New Regulatory Framework" in an effort to modernize the regulatory structure of the U.S. futures markets. In November 2000, the CFTC approved rules implementing this framework, but the CFMA superseded this action and the rules were withdrawn. In large part, the CFMA borrowed from the CFTC's framework and created a three-tiered structure for the trading of derivatives that distinguishes among markets based on the types of contracts traded and the sophistication of the market participants. The upper tier resembles a traditional futures exchange (with some important modifications), while the two lower tiers are permitted to operate largely outside of the CEA.

The Commodity Futures Trading Commission

The CFTC Act established the CFTC as an independent federal agency with exclusive jurisdiction over the futures markets. The executive structure of the CFTC is similar to that of the SEC. The Commission consists of five Commissioners, appointed to staggered five-year terms by the President, with the advice and consent of the Senate. The President also designates one of the Commissioners to serve as Chairman, but unlike the SEC, the Senate must separately confirm this designation.

Regulated Entities – Markets, Clearing Organizations, Intermediaries, SROs

Until the year 2000 it had been a fairly consistent principle in the federal regulation of U.S. futures markets that futures transactions had to occur on registered or regulated exchanges and that off-exchange trading of futures were appropriately banned. This requirement became especially pronounced following the creation of the CFTC by the CFTC Act of 1974 and the concurrent expansion of the term commodity to include almost any conceivable agricultural, physical, financial, and intangible interest (e.g., interest rates) or contingency asset (except onions). In sharp contrast to the founding model of futures regulation, today's futures markets are characterized by a risk-based, tiered approach to regulation.

Markets

The CFMA prompted a comprehensive overhaul of both the structure and the regulation of U.S. futures markets. Previously, the regulatory approach to futures trading in the United States was “one-size-fits-all.” As a result, all trading occurred on regulated exchanges and all futures and options were generally subject to the same rules and regulations without regard to differences in the underlying assets or the types of participants in a given market segment.

A fundamental achievement of the CFMA was to consider the differences in products and market participants and to create a structure that provided a specific intensity of regulatory oversight that corresponded with the needs of the markets. The new riskbased, tiered structure included designated contract markets (“DCMs”), derivatives transaction execution facilities, and exempt markets, all of which are differentiated based upon the types of products offered and market participants. In addition, the CFMA moved the regulation of futures markets away from a purely prescriptive rules-based approach and toward a system that relies more on compliance with principles. DCMs, for example, must comply with specific “core principles” designed to elicit minimum standards of market behavior and integrity while permitting flexibility in the implementation of the standards.

Designated Contract Markets

DCMs are essentially the traditional organized futures exchanges or boards of trade. They may be open-outcry exchanges with physical trading floors or electronic exchanges. Since DCMs may list for trading futures or options contracts on any type of asset, index, or instrument, they are able to offer the widest range of products for trading compared to other market types. But DCMs generally must allow access to all types of traders, including retail market participants, and therefore they are subject to the highest level of CFTC regulatory oversight.

Exchanges must apply to the CFTC to receive the DCM designation. In general, in order to qualify for a designation as a contract market by the CFTC, the exchange must demonstrate to the CFTC in its application that it satisfies several standards for designation. These include such criteria as the ability to prevent market manipulation, rules to ensure fair and equitable trading, rules for the operation of the trade execution facility, financial integrity of transactions, public access to rules and contract specifications, and the ability to obtain the information necessary to perform its other required functions.

In addition, to maintain their status DCMs must demonstrate ongoing compliance with eighteen core principles that were established in the CFMA.⁹ Although the DCMs, through their self-regulatory programs, are responsible for ensuring their own compliance with the core principles, the CFTC conducts regular reviews of each DCM’s adherence to the designation standards, the core principles, and other requirements. However, as part of the more streamlined approach to futures regulation, DCMs are permitted to list new contracts and to implement new rules or rule amendments through a self-certification process.

Exempt Markets

Exempt markets are the least regulated trading facilities established by the CFMA. However, because they are exempt from most requirements of the CEA and most CFTC oversight, they face the highest restrictions on the types of commodities that may be traded and who may participate. Exempt markets are not registered with, or designated, recognized, or in any way officially sanctioned by the CFTC and are prohibited from representing otherwise.

There are two types of exempt markets: exempt boards of trade and exempt commercial markets. Exempt boards of trade must limit trading to transactions between eligible contract participants and for which the underlying asset has a nearly inexhaustible deliverable supply, a deliverable supply that is unlikely to be susceptible to manipulation, or has no cash market. Exempt commercial markets must limit trading to agreements, contracts, and transactions in *exempt commodities* (e.g., metals and energy commodities) executed on a principal-to-principal basis between eligible commercial entities. Exempt markets may not trade futures or options on any security.

Qualifying transactions on exempt markets are not subject to the CFTC's regulatory or enforcement jurisdiction, except for certain antifraud and manipulation provisions. Exempt markets must, however, notify the CFTC of the market's intention to operate in reliance on an exemption. Moreover, if the exempt market is determined by the CFTC to be performing a price setting function for a particular commodity, not only for its own market but for other key markets in that commodity, it may be required to make public certain pricing and trade information.

Clearing Organizations

The CFMA amended the CEA to require derivatives clearing organizations ("DCOs") to register with the CFTC in order to clear commodity futures and options. A DCO is a clearinghouse or other similar entity that serves a specific purpose:

- It enables each party to an agreement, contract, or transaction to substitute the credit of the clearing organization.
- It arranges or provides on a multilateral basis for settlement or netting of obligations resulting from the transactions.
- It otherwise provides services or arrangements that mutualize or transfer credit risk among the participants in the clearing organization.

The term DCO specifically excludes some types of entities, including those that provide settlement or netting on a bilateral basis, or settlement or netting of cash payments through an interbank payment system.

A clearinghouse that seeks to provide clearing services for commodity futures and

options traded on a DCM or a derivatives transaction execution facility must register with the CFTC as a DCO and comply on an ongoing basis with fourteen core principles (established under the CFMA).¹⁰ A DCO may also clear agreements, contracts, and transactions that are excluded or exempted from the CEA, or any other OTC derivative instruments. DCOs that limit their clearing services to such excluded or exempted agreements, contracts, or transactions need not register with the CFTC, but they may do so on a voluntary basis, in which case they would need to comply with the core principles for DCOs. DCOs that are registered with the SEC under the securities laws and only clear security futures are also not required to register with the CFTC, but may do so voluntarily.

Intermediaries

The CFTC oversees a number of types of intermediaries, market participants that act on behalf of other persons in trading futures and options. Intermediaries perform a variety of trading, advisory, and other services for market participants, including:

- Futures commission merchants (“FCMs”);
- Introducing brokers;
- Commodity pool operators;
- Commodity trading advisers; and

- Floor brokers and floor traders.

In general, intermediaries must register with the CFTC unless an exemption or exclusion applies. Intermediaries’ registrations generally are continuous, but annual updates usually are required. Under the CEA and the CFTC’s regulations, intermediaries are subject to a wide range of disclosure, reporting, recordkeeping, and ethical requirements, depending on the nature of their activities. Intermediaries are also generally subject to rules governing certain aspects of their interactions with other market participants and customers, such as the treatment of customer funds. Some intermediaries are subject to capital requirements to help ensure the fulfillment of obligations to customers and counterparties.

Self-Regulatory Organizations

In addition to the CFTC, SROs oversee designated and registered futures and options markets and intermediaries in those markets. The designated contract markets (i.e., boards of trade or exchanges) themselves as well as the National Futures Association (“NFA”), a registered futures association overseeing FCMs, serve as SROs.

The NFA (which is not affiliated with any particular market) and the exchange SROs generally have responsibilities to help promote market integrity, protect investors, and enforce financial requirements, sales, and trading practices for their members. To carry out these functions, the NFA and the exchanges develop and enforce rules and other programs under the CFTC’s oversight. The NFA also conducts arbitration and dispute resolution functions for industry participants and processes the registrations of FCMs.