

# Northwestern Journal of International Law & Business

---

Volume 5  
Issue 3 *Fall*

---

Fall 1983

## United States Trade Policy Toward Foreign Commodity Markets: A Critique

John V. Rainbolt

Follow this and additional works at: <http://scholarlycommons.law.northwestern.edu/njilb>



Part of the [International Law Commons](#), and the [International Trade Commons](#)

---

### Recommended Citation

John V. Rainbolt, United States Trade Policy Toward Foreign Commodity Markets: A Critique, 5 Nw. J. Int'l L. & Bus. 462 (1983-1984)

This Perspective is brought to you for free and open access by Northwestern University School of Law Scholarly Commons. It has been accepted for inclusion in Northwestern Journal of International Law & Business by an authorized administrator of Northwestern University School of Law Scholarly Commons.

# United States Policy Toward Foreign Commodity Markets: A Critique

*John V. Rainbolt\**

## I. INTRODUCTION

New trading instruments and a concomitant increase in volume in United States futures markets during the past decade has overshadowed somewhat a parallel market expansion involving foreign commodity exchanges serving an expanded United States and international customer base.

Such trading centers as the London Metal Exchange and the terminal markets of the London Commodity Exchange have long played a key role in providing hedging and pricing facilities for world trade. Contemporary foreign commodity exchanges also list financial futures,<sup>1</sup> offer markets in petroleum products,<sup>2</sup> and potentially include offshore markets listing United States based futures contracts,<sup>3</sup> as well as "branch" foreign exchanges linked to United States markets which allow offset of a domestic position by a foreign position, and vice versa.

The various attractions of these markets has resulted in growing

---

\* Partner, Miles & Stockbridge, Washington, D.C.; Member, District of Columbia and Oklahoma Bars. The Author has served as Commissioner (Vice Chairman) of the Commodity Futures Trading Commission (1975-1978), as Majority Counsel of the Committee on Agriculture, United States House of Representatives (1973-1975), and also as a Member, GATT Agricultural Policy Advisory Committee (1978-1979). He is currently Chairman of the Subcommittee on Foreign Traders and Foreign Markets of the American Bar Association Committee on Commodity Regulation. Appreciation is expressed to Kathleen Courtney for her assistance in preparation of this Perspective.

<sup>1</sup> The London International Financial Futures Exchange (LIFFE), the recently established British financial futures market, trades futures on Eurodollars and the British "Long Gilt."

<sup>2</sup> E.g., The London International Petroleum Exchange.

<sup>3</sup> According to statements by promoters of a proposed Bermuda based exchange (*Intex*), the Exchange intends to list, *inter alia*, futures contracts on United States Treasury Bonds.

participation by United States residents.<sup>4</sup> In turn, this has prompted Congress to address more directly the phenomenon of United States trading in such markets through recent amendments to United States regulatory and tax laws. Both laws provide the Executive Branch—primarily the Department of Treasury and the Commodity Futures Trading Commission (CFTC)—with broad discretionary authority to make determinations affecting United States trader access to foreign markets, insofar as it is controlled or influenced by CFTC regulation and United States tax law. Proceeding in accord with their separate mandates, however, the two government entities have made little apparent attempt to balance United States regulatory and taxing concerns with an ongoing interest in international market centers, or to mesh more closely existing regulatory and taxation standards. As a result, the standards are somewhat divergent.

This Perspective highlights aspects of current law shaping the way the federal government addresses foreign commodity markets and explores the interaction of these provisions with suggested predominant United States' interests. It proposes some modest suggestions for bringing existing trader protection and tax rules in line with the United States' interests in individual investor freedom and a viable international marketplace. Finally, in acknowledgment of the evolutionary forces at work in both United States and foreign markets, this Perspective includes some thoughts regarding potential trends in the international marketplace that could eventually encourage reassessment of the pragmatism of relying on traditional forum-based national standards for market regulation of international futures markets.

Before proceeding too far into the subject, however, it may be useful to note what will quickly become apparent regarding the phenomena discussed: the subject area confronts one with something of a statistical wasteland. Accordingly, as time passes and Congress and federal authorities address the topics discussed, there unquestionably will be room for refinement of the views expressed here. Nonetheless, a particular purpose is to highlight certain inconsistencies in existing law in the hope that they eventually will be resolved by the adoption of *some* standard, such as the parity standard suggested here.

The subject matter addressed in this Perspective concerns the trading of commodity futures (including instruments broadly defined as "options") by United States interests on foreign commodity markets, and the impact of domestic rules governing such trading on a greater

---

<sup>4</sup> Senate Comm. on Agriculture, Nutrition and Forestry, S. REP. NO. 384, 97th Cong., 2d Sess. 45 (1982).

international marketplace for pricing, hedging<sup>5</sup> and, in some cases, the acquisition of commodities.

## II. ORIGINS OF UNITED STATES GOVERNMENT INTEREST IN REGULATION OF FOREIGN MARKET TRANSACTIONS

Until the last decade, the typical United States trader in foreign commodity markets was a domestic branch of an international trade house, an American merchant, a fabricator or processor dependent on prices of commodities traded on those markets, or an international arbitrageur<sup>6</sup> belonging to the above trade classes or motivated to speculate in price variations between United States and foreign markets. The usual focal point of such trading was London markets in "soft" tropical commodities or in nonferrous metals.<sup>7</sup>

In contrast to many United States exchanges, London markets are traditionally "trade" or merchant oriented without a large population of independent floor brokers.<sup>8</sup> Accordingly, a higher percentage of trades executed on the foreign market is attributable to commercial hedging, as opposed to transactions of individual speculators. The independent origins and histories of established foreign exchanges, together with political variables in the country involved, have resulted in a number of differences both in market form and in the scope and intensity of government oversight as compared with the United States

---

<sup>5</sup> Although reference to the specialized terms which stalk the commodity industry have been rather ruthlessly pruned here, there are several survivors: "Hedging" implies taking a position in a futures market opposite a position held in the cash market to minimize the risk and financial loss from adverse price change, a purchase or sale of futures as a temporary substitute for a cash transaction that will take place later. *Glossary of Some Terms Commonly Used in the Commodity Exchange Act*, CFTC Publication No. 105 (Aug. 1978) [hereinafter cited as *Glossary*]. A "speculator" is an individual who trades in commodity futures with the object of achieving profits through the successful anticipation of price movements. *Id.*

<sup>6</sup> An international arbitrageur simultaneously buys in one market (e.g. New York) and sells in another (e.g. London) to profit from price differences between the two. Such arbitraging activities play an important role in leveling out price differences between the two or more markets involved.

<sup>7</sup> International "soft" commodities (coffee, sugar, cocoa, etc.) are traded at "terminal" (e.g. futures) markets grouped under the aegis of the *London Commodity Exchange Co., Ltd.* (LCE). LCE markets provide facilities for trading clearinghouse futures and options. Markets for nonferrous metals (copper, zinc, silver, aluminum, lead) are made at *The Metal Market and Exchange Company, Ltd.*, or *London Metal Exchange (LME)*. The LME is a principals market (*inter alia*, a nonclearinghouse market), and arguably, not a futures market at all, as that term is customarily construed in the United States.

<sup>8</sup> A popularly quoted statistic attributes 50% of all United States commodity market volume to the activities of floor traders trading for their own account. See Selig, *Regulation of Floor Brokers and Floor Traders*, in *COMMODITIES AND SECURITIES REGULATION: HOW DIFFERENT . . . FOR HOW LONG?* (A.B.A. COMM. ON COMMODITIES REG. 1982).

model.<sup>9</sup>

As in United States markets, the normal medium of trading and pricing in foreign commodity markets is not the actual commodity but rather a contract to purchase or sell the commodity, commonly—but not in all cases, accurately—equated with the United States concept of a future, including instruments known as options.<sup>10</sup> These contracts may be backed by a clearinghouse which serves a function similar to a clearinghouse for United States markets. Unlike domestic markets, however, the foreign market may utilize a principals contract where the market member and the customers remain in direct contractual privity with one another throughout the life of the position.

Until 1975, federal law regulated only markets trading futures on certain identified domestic farm commodities.<sup>11</sup> Trading in metals and tropical commodities was unregulated—even if the trading was conducted on a United States market. Thus, while the foreign market trader domiciled in the United States was free to follow his own instincts, he could not rely on a regulatory scheme to oversee the integrity of the transaction or the qualifications of the broker with whom he was dealing. If a dispute arose regarding the contract, it was resolved according to foreign law, normally pursuant to arbitration at the foreign exchange.<sup>12</sup>

Due in part to a growing volume of trading in unregulated commodities and fraudulent enticements to unsophisticated public custom-

---

<sup>9</sup> For a discussion of foreign market regulatory considerations, see Rock, *Regulatory Control Over the United States, Canadian and United Kingdom Futures Markets*, 37 BUS. LAW. 613 (1982).

<sup>10</sup> The term *futures contract* (or *future*) is used here to describe generically an exchange-created standardized contract to make or take delivery of a specified quantity of a commodity at some time in the future. The standardized features of such contracts imply that one contract differs from another only with respect to price and month of delivery and renders them capable of satisfaction by offset. Following entry of an order (in clearinghouse markets) a clearinghouse is substituted for the original exchange member as the "buyer to every seller and the seller to every buyer." An *option* provides the purchaser with the right—but not, as in futures contracts, the obligation—to make or take delivery of the commodity, or an underlying futures contract for the commodity. For that right, the purchaser pays a premium. United States tax law treats futures or options contracts as interests in personal property; the "formal" United States regulatory address of a futures contract is "a contract of sale of a commodity for futures delivery." In the United States such a contract may only be traded on a CFTC regulated commodity exchange. Options, on the other hand, may be sold in a dealer market, as well as traded on an exchange. Few such restrictions apply in foreign markets.

<sup>11</sup> Generally, these include cattle, wheat, rice, corn, and numerous other U.S. farm commodities. 7 U.S.C. § 2(a)(1)(A) (1976).

<sup>12</sup> For example, the rules governing the London Metal Exchange state in part, "In the event of either party to the difference failing to appoint an arbitrator . . . upon written or cable request of either party an arbitrator shall be appointed from the Arbitration Panel by the Committee of the London Metal Exchange." Part III, Arbitration Rule 3. Similar rules may be found in the rules of many foreign (and United States exchanges), reflecting established merchant practice.

ers, federal commodities law was amended in 1974 to bring all commodities traded under stringent federal regulation.<sup>13</sup> As a result, the foreign market speculator became a member of a class whose transactions with commodity brokers were placed under oversight of the newly created CFTC.<sup>14</sup> Ultimately, rampant fraud and abuse caused options—but not futures—positions on foreign markets to be banned in the United States to all but a small class of trader interests.<sup>15</sup>

Until recently, federal tax law generally did not distinguish between United States and foreign markets in assigning tax consequences to commodity trading activities of United States taxpayers. In 1981, however, Congress responded to the widespread marketing of tax avoidance schemes based on futures trading (in both its United States and foreign permutations) and substantially amended United States tax law.<sup>16</sup> One effect of these changes was to differentiate for tax purposes between foreign and domestic market speculative positions, comparatively penalizing the former.

Thus, within a seven year period the environment in the United States for speculation in foreign markets changed considerably. During this period, foreign markets were responding to economic forces similar to those driving United States markets to create new products to service the needs of commercial interests operating in a volatile international economy.<sup>17</sup> The resulting international product/instrument/exchange mix is a unique assortment of major established markets and new exchanges, with many variants.

At least thirty-four<sup>18</sup> such commodity markets currently exist outside United States' jurisdiction, providing hedging and pricing facilities for a variety of commodities. These markets include the London exchange centers, traditional grain and produce exchanges on the Con-

---

<sup>13</sup> Commodity Futures Trading Commission Act of 1974, Pub. L. No. 93-463, 88 Stat. 1389 (codified in scattered sections of 7 U.S.C.).

<sup>14</sup> *Id.*

<sup>15</sup> 17 C.F.R. § 32.11(a) (1983).

<sup>16</sup> Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, §§ 501-509, 95 Stat. 172, 323-35 (1981).

<sup>17</sup> See *supra* notes 1-4 and accompanying text. One outgrowth of such expansionism is planned "linkages" between international exchanges. As an example, the Chicago Mercantile Exchange recently announced an impending linkage with the Singapore Gold Exchange, and a system which would potentially allow a trader to establish a position in Chicago and remove it in Singapore, and vice versa. Other United States and foreign markets (e.g., COMEX (the New York Metal Exchange) and the Sydney (Australia Futures Exchange) are considering similar plans.

<sup>18</sup> This is admittedly a "rough" count of futures markets and "futures-type" markets based on data obtained from the United States Futures Industry Association. THE GUIDE TO WORLD COMMODITY MARKETS (John Piiy 3rd ed. 1982) lists some 96 entities serving as markets or in marketing capacities.

inent, Japanese markets trading grains, oilseeds, cotton and such exotica as dried silkworm cocoons, and other markets as proximate as Canada and as distant as Australia.<sup>19</sup> For certain commodities and contracts there are no counterpart markets in the United States, but for others certain similarities in markets exist, although contract specifications and trading rules can vary substantially. Many markets are strictly local. Although United States trading is a major factor for market success in many markets, in others it is discouraged by local exchange control regulations or otherwise limited or nonexistent.

As will become apparent, a major objective of this Perspective is not to agitate for a coherent federal policy toward the Toyohuashi Dried (silkworm) Cocoon Exchange or similar localized markets. On the other hand (albeit perhaps more chauvinistically), where the subject commodity is copper, lead, silver, tin, zinc and aluminum priced and hedged on the London Metal Exchange, or rubber, sugar, cocoa or coffee at a terminal market of the London Commodity Exchange, petroleum,<sup>20</sup> gold,<sup>21</sup> United States grown crops,<sup>22</sup> and other commodities<sup>23</sup> increasingly being priced in the United States by futures trading, the utility of a more studied policy regarding United States access to such markets is more apparent.

### III. UNITED STATES REGULATORY AND TAXING RULES APPLICABLE TO TRADING ON FOREIGN MARKETS

Commodity traders operate subject to an amalgam of commercial and financial restraints, but authority relevant to United States trader participation in foreign markets is to be found particularly in the Commodity Exchange Act<sup>24</sup> and certain provisions of the Internal Revenue Code.<sup>25</sup> Although a detailed analysis of either Act is beyond the scope of this Perspective, some appreciation as to how the two laws interact is an appropriate point of departure for further discussion.

---

<sup>19</sup> GUIDE TO WORLD COMMODITY MARKETS, *supra* note 18.

<sup>20</sup> Petroleum is traded in London.

<sup>21</sup> Gold is traded in several foreign futures markets, most notably Hong Kong, Singapore, and London.

<sup>22</sup> These crops, which include flax, oats, and barley, are traded in Winnipeg, Manitoba, Canada.

<sup>23</sup> These include financial instruments.

<sup>24</sup> Commodity Exchange Act, Pub. L. No. 74-675, 49 Stat. 1491 (1936) (codified as amended at 7 U.S.C. §§ 1-26 (1976)).

<sup>25</sup> I.R.C. §§ 1092, 1256 (West Supp. 1983). *See also* Corn Products Refining Co. v. Commissioner, 350 U.S. 46 (1955).

### A. The United States Commodity Exchange Act

The focus of the Commodity Exchange Act is protection against fraud and manipulation on domestic commodity markets.<sup>26</sup> The Act is the source of substantive regulation of all United States commodity exchanges and some 50,000 market professionals interacting with commodity customers, and is administered by the Commodity Futures Trading Commission (CFTC), an independent agency of the United States government.<sup>27</sup>

Transactions regulated by the Commodity Exchange Act are generally those which involve standardized commodity offerings to the public. Excluded from regulation are forward contracts<sup>28</sup> and—with some exceptions—"cash" or "physical" transactions.<sup>29</sup> In the course of six decades the Act's reach gradually has been expanded by Congress to encompass an increasing number of individuals and exchanges involved in the trading of futures and options.<sup>30</sup>

From its 1922 inception until 1975, the Act regulated futures and options trading only in certain listed domestic agricultural commodities.<sup>31</sup> For those commodities, Congress banned options in 1936,<sup>32</sup> while regulated futures contracts were traded under the oversight of the Department of Agriculture. As previously noted, United States exchanges, brokers and sales personnel involved in metals and interna-

---

<sup>26</sup> This is consistent with the Act's 1921 origin as a document to combat the "evils" of commodity speculation, as perceived by agricultural producers and their elected representatives. For one review of the origins of the Commodity Exchange Act see Rainbolt, *Regulating the Grain Gambler and his Successor*, 6 HOFSTRA L. REV. 1 (1977), quoted in H.R. REP. NO. 1181, 95th Cong., 2d Sess. 80 (1978). See also Stassen, *The Commodity Exchange Act in Perspective: A Short and Not So Reverent History of Futures Trading Legislation in the United States*, 39 WASH. & LEE L. REV. 825 (1982). An overview of United States commodity regulation as it respects domestic markets is provided in 1 JOHNSON, COMMODITIES REGULATION (1982), and discussed in RUSSO, REGULATION OF THE COMMODITIES FUTURES AND OPTIONS MARKETS (1983).

<sup>27</sup> Individual states and territories are given authority to enforce certain provisions of the Act in state courts, but in general are prohibited from imposing separate regulations on the commodity marketplace. It should be noted that the 97th Congress provided a limited role for the Securities Exchange Commission in regulating commodity pools and approving certain futures contracts involving securities indices. See Futures Trading Act of 1982, Pub. L. No. 97-444, §§ 101(3), 103(2), 96 Stat. 2294, 2296 (1983) (codified as amended at 7 U.S.C. § 2, 4(g), 6(m) (1982)).

<sup>28</sup> 7 U.S.C. § 2a(i) (1982). Generally, the term "forward contract" describes a contract between buyer and seller to deliver a specialized quality and quantity of a commodity at a future date.

<sup>29</sup> The Act exempts routine commercial contracts (e.g. between a grain farmer and a grain elevator) from regulation. A "cash," "spot," or "actual" transaction implies a simultaneous immediate sale (payment for immediate possession). See 7 U.S.C. § 2, 2a (1982). Fraud in the sale of an actual commodity or manipulation of cash prices may violate Section 4(b) of the Act. Commodity Exchange Act, § 4(b), 7 U.S.C. § 6(b) (1982).

<sup>30</sup> See generally Rainbolt, *supra* note 26.

<sup>31</sup> See Commodity Exchange Act, ch. 369, 42 Stat. 998 (1922); 7 U.S.C. § 2a(ii) (1982).

<sup>32</sup> Commodity Exchange Act, Pub. L. No. 74-675, § 4c, 49 Stat. 1491-94 (1936).



tional "soft" commodities remained essentially unregulated by the federal government, and it has been alleged that Congress did not even remotely consider foreign exchanges in addressing earlier manifestations of the Act.<sup>33</sup> In 1974 Congress amended the Commodity Exchange Act to extend federal jurisdiction to any commodity that was the subject of futures trading<sup>34</sup> and in the wake of these amendments the somewhat benign relationship that existed previously between United States authority and foreign markets became a point of increased regulatory tension.

### *1. CFTC Authority Over Foreign Futures Sales*

When the Commodity Futures Trading Commission Act extended federal oversight over all commodities traded,<sup>35</sup> a brief notation in the Conference Report supported the proposition that the Act was intended to address foreign as well as domestic markets.<sup>36</sup> Accordingly, shortly after it commenced regulation in 1975, the CFTC promulgated an antifraud rule applicable to foreign futures sales,<sup>37</sup> but did little else until 1981 when a CFTC Interpretive Letter concluded that United States sales of foreign futures resulted in CFTC registrant status as a "Commodity Trading Advisor."<sup>38</sup> By 1982, however, the Commission, apparently uncomfortable with regulatory authority over foreign futures derived almost solely from legislative history and staff opinion, requested Congress to extend the Act to provide broad statutory authority to the CFTC over United States persons involved in the sale of foreign futures.<sup>39</sup> This recommendation—to amend Section 4 of the

---

<sup>33</sup> See Schroeder, *CFTC Reauthorization: Some Possible Implications of Futures Trading on Foreign Markets and for Foreigners Trading on United States Markets*, 1 J. FUTURES MARKETS 555-62 (Supp. 1981). See also 41 Fed. Reg. 26,606 (1976) (Retroactive interpretation that wool options banned by 1954 Amendment to Commodity Exchange Act); [1975-77 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 20,175.

<sup>34</sup> Commodity Futures Trading Commission Act of 1974, Pub. L. 93-463, § 201, 88 Stat. 1389, 1395 (1974).

<sup>35</sup> *Id.*

<sup>36</sup> "I wish to emphasize that the words 'any other board of trade, exchange, or market' were included in the conference substitute only for the purpose of giving the Commodity Futures Trading Commission jurisdiction over futures contracts purchased or sold in the United States and executed on a foreign board of trade, exchange, or market." (emphasis added) 120 CONG. REC. H10248 (daily ed. Oct. 10, 1974) (remarks of Congressman Poage). Senate version at 120 CONG. REC. S34995 (daily ed. Oct. 10, 1974). (Remarks of Senator Talmadge). The statements were designed to assuage concerns of the Securities Exchange Commission that the terms cited might otherwise have the effect of placing U.S. securities markets under CFTC regulation.

<sup>37</sup> 17 C.F.R. § 30.02 (1983).

<sup>38</sup> CFTC Interpretive Letter 81-1 [1980-82 Binder] COMM. FUT. L. REP. (CCH) ¶ 21,244.

<sup>39</sup> In its legislative request the CFTC sought to amend Section 4 of the Commodity Exchange Act (7 U.S.C. § 6) as follows: Sec. 4(b)—"In addition to its existing authority, the Commission may adopt rules and regulations governing the offer and sale by any person located in the United States, its

Act—was incorporated into early drafts of the legislation then before Congress. But in the face of opposition from foreign commodity exchanges and United States brokerage houses, the *carte blanche* nature of the original CFTC proposal was amended to a more limited grant of authority.<sup>40</sup>

The resulting amendment, enacted in January 1983, is the touchstone for the Commission's present regulatory authority over United States sales of foreign futures. It authorizes the Commission to promulgate rules governing persons engaged in the "offer and sale of any contract of sale of a commodity for future delivery, that is made or is to be made" on a foreign exchange.<sup>41</sup> With respect to such contracts, the CFTC is empowered to adopt rules and regulations proscribing fraud, to require minimum financial standards, disclosure of risk to customers, filing of certain reports and recordkeeping, safeguarding of customer funds, and registration with the Commission by persons located in the United States, its territories or possessions.<sup>42</sup> The 1983 amend-

---

*territories or possessions, of any contract of sale of a commodity for future delivery which is made or to be made on a board of trade, exchange or market located outside the United States, its territories or possessions."* S. 2109, 97th Cong., 2d Sess. § 3(b) (1981) (emphasis added).

<sup>40</sup> As enacted, this provision, Section 4(b), now reads:

The Commission may adopt rules and regulations proscribing fraud and requiring minimum financial standards, the disclosure of risk, the filing of reports, the keeping of books and records, the safeguarding of customers' funds, and registration with the Commission by any person located in the United States, its territories or possessions, who engages in the offer or sale of any contract of sale of a commodity for future delivery that is made or is to be made on or subject to the rules of a board of trade, exchange, or market located outside the United States, its territories or possessions. Such rules and regulations may impose different requirements for such persons depending upon the particular foreign board of trade, exchange, or market involved. No rule or regulation may be adopted by the Commission under this subsection that (1) requires Commission approval of any contract, rule, regulation, or action of any foreign board of trade, exchange, or market, or clearinghouse for such board of trade, exchange, or market, or (2) governs in any way any rule or contract term or action of any foreign board of trade, exchange, or market, or clearinghouse for such board of trade, exchange, or market.

Commodity Exchange Act, § 4(b), 7 U.S.C. § 6(b) (1982). The CFTC also proposed a troublesome provision (S. 2109 § 20, *supra* note 34) where individual states could enforce *any* applicable state law against non-United States exchange instruments. The simultaneous inclusion of Section 12(e) state jurisdiction and Section 4(b) federal jurisdiction over foreign futures was assumed to be drafting error and the provision was subsequently amended to withhold the grant of state jurisdiction over foreign markets unless the Commission deems otherwise. Commodity Exchange Act, § 12e, 7 U.S.C. § 17a (1982).

<sup>41</sup> *Id.*

<sup>42</sup> For a more comprehensive review of the described amendment see Rainbolt, *Commodity Exchange Act Revisions Affecting Foreign Markets and Foreign Traders*, Commodity Law Letter (June 1983). It is apparent that the 97th Congress viewed any necessary regulatory address of "legitimate" foreign commodity exchanges as a federal function, with state regulation reserved for situations involving "the illicit offer and sale" to United States residents of foreign futures contracts. Both sections 4(b) and 12(e) have curious origins, since no abuse—the fodder normally demanded by Congress to enact changes in existing law—was cited by the CFTC to justify the need for broader regulatory authority over sales practices involving foreign market positions. The origin of these preventive provisions is possibly rooted in CFTC experience with other "loop-

ment also provides the CFTC with the authority to differentiate between foreign markets in adoption of such rules.<sup>43</sup>

The CFTC has yet to adopt regulations implementing its new authority. Accordingly, foreign futures sales remain subject only to limited antifraud regulation, in contrast to domestic futures sales which are subject to a host of regulatory measures, and foreign exchange options which remain generally banned from the United States market.<sup>44</sup>

## *2. CFTC Authority Over Foreign Options Sales*

After 1974, the 1936 options ban remained intact only for certain United States produced farm commodities, while the fate of the growing public market in options on the then newly regulated "international" commodities was left to the Commodity Futures Trading Commission.<sup>45</sup> This, in effect, made the Commission responsible for regulating a burgeoning United States public market in "London" options and dealing with the various fraudulent schemes involving options guised as having originated on London commodity markets. Although the Commission had proposed rules aimed toward regulation of foreign exchange options, bringing options under a coherent regulatory policy proved too much for the Commission, and in 1978 the CFTC, subsequently backed by Congress, banned all options sales to the public, subject to some major exceptions.<sup>46</sup> The Commission, however, retained authority to eliminate the ban and to allow options sales to the public under rules later to be adopted.<sup>47</sup>

Pursuant to that authority, the Commission proceeded in 1981 to implement an earlier proposal to allow United States exchanges to list and trade options on a "pilot program" basis.<sup>48</sup> Subsequently, in 1983, Congress altered the 1936 statutory ban to allow the CFTC to authorize trading of options on farm commodities, which cleared the way for the

---

holes" in the Act and the suspected opportunity for miscreants to create fraudulent "offshore," as opposed to "true" foreign exchanges. S. REP. NO. 384, 97th Cong., 2d Sess. 46-47 (1981).

<sup>43</sup> See *supra* note 32.

<sup>44</sup> 17 C.F.R. § 32.11 (1983).

<sup>45</sup> 7 U.S.C. § 6 (1982). The commodities on which options remained statutorily banned ranged from wheat and cotton to livestock and frozen concentrated orange juice.

<sup>46</sup> Excepted were "trade" options where the purchaser is a "producer, processor, commercial user of, or a merchant handling the commodity involved in the transaction or the products or by products thereof." Futures Trading Act of 1978, Pub. L. No. 95-405, § 3(c), 92 Stat. 865, 867 (1978); and public sales by certain well capitalized dealers (under statutory regulation) in the business of granting options on May 1, 1978. *Id.* § 3(d).

<sup>47</sup> Unlike Commission authority over foreign futures sales, its regulatory authority over option sales contains few restrictions. Although the Commission has the authority to remove foreign options from the ban, it has not done so. *Id.* § 3(d)(2).

<sup>48</sup> Regulation of Domestic Exchange-Traded Commodity Options Transactions, 46 Fed. Reg. 54,500 (1981) (codified at 17 C.F.R. § 33 (1983)).

CFTC to authorize exchanges to list options on futures on those commodities as part of the pilot program.<sup>49</sup> Foreign options and options that might be written by most United States dealers are generally banned, but United States exchange and certain other "dealer" options are available to the general public under CFTC regulation.<sup>50</sup> The CFTC also has actively solicited public views as to allowing farm product options to be traded on United States exchanges,<sup>51</sup> and such trading may soon be legitimized as yet another CFTC "pilot" program.

#### B. Tax Law Application to Positions on Foreign Commodity Markets

The other major source of federal authority applicable to commodity market positions is found in sections 1092 and 1256 of the Internal Revenue Code.<sup>52</sup>

Generally, United States tax law treats identified *hedging* positions in commodities as a source of an ordinary gain or loss to the taxpayer<sup>53</sup> while a *speculative* position results in a capital gain or loss.<sup>54</sup>

If the commodity position is entered into for commercial hedging purposes, the law does not distinguish between transactions executed on United States or foreign markets. Gain or loss resulting from transactions on either market is treated as ordinary in character.<sup>55</sup>

Tax law does distinguish, however, between markets with respect to speculative positions. On United States markets, gain or loss resulting from speculative trading is taxed at a rate computed by allocating to the trade a favorable gain/loss ratio of 60% as "long term" and 40% "short term," (the "60/40" rule);<sup>56</sup> while a speculative transaction on a foreign exchange is taxed at a more costly "short term" gain rate,<sup>57</sup> resulting in a maximum tax rate of 50%, unless the position is held a minimum of six months,<sup>58</sup> at which point the gain becomes long-term (i.e., taxed at 20% marginal rates). The running of the six month holding period is denied, however, if the speculative position is offset by a

---

<sup>49</sup> Futures Trading Act of 1982, Pub. L. No. 97-444, § 206, 96 Stat. 2296 (1983). See also CFTC Release No. 2085-84, Jan. 25, 1984, reprinted in 49 Fed. Reg. 2252 (1984).

<sup>50</sup> 17 C.F.R. §§ 1.19, 32, 33 (1983).

<sup>51</sup> 48 Fed. Reg. 46,797 (1983).

<sup>52</sup> I.R.C. §§ 1092, 1256 (1982).

<sup>53</sup> *Id.* Corn Products Refining Co. v. Commissioner, 350 U.S. 46 (1955). Certain defined syndicates are barred from utilizing hedging transaction rules. I.R.C. § 1256(e)(3) (West Supp. 1983).

<sup>54</sup> *Id.*

<sup>55</sup> *Id.*

<sup>56</sup> I.R.C. § 1256(a) (1982).

<sup>57</sup> *Id.*

<sup>58</sup> I.R.C. § 1222 (1982).

position that substantially reduces the risk of loss from the first position.<sup>59</sup> Speculative arbitrage involving United States and foreign market positions is subject to this "balanced position" rule.<sup>60</sup>

Due to normal market volatility, only under exceptional circumstances will a trader be able to hold profitably a given "naked" foreign market position for a sufficient period to take advantage of long-term capital gains treatment. The speculative trader who resorts to offsetting transactions to protect a market position triggers the holding period suspension.<sup>61</sup> Certain positions on foreign markets are also subject to some fairly draconian requirements for proving claimed deductions from transactions on those markets<sup>62</sup> and are denied certain other benefits (primarily certain loss carryback provisions) available to the taxpayer for domestic market positions.<sup>63</sup> Because the rule does not apply to futures positions on a United States market, speculative futures positions on foreign markets are comparatively penalized by United States tax law. Accordingly, the rank and file United States speculator is probably better advised to make or lose money trading domestic rather than foreign markets.

The Act also provides the Secretary of the Treasury with discretionary authority to allow certain foreign market positions to be taxed under the "60/40" rule and other provisions governing United States market positions.<sup>64</sup> In effect, exercising this discretion would largely equalize tax treatment between speculative foreign and United States market positions,<sup>65</sup> however, Section 1256 treatment has yet to be granted to positions involving any foreign market and an attempt to encourage Congress to rewrite existing law to compel such treatment enlisted little support as an amendment to a "Technical Corrections Bill" considered by Congress in late 1982.<sup>66</sup>

---

<sup>59</sup> I.R.C. § 1092(c)(1), (2) (1982).

<sup>60</sup> I.R.C. § 1092(c)(2) (1982).

<sup>61</sup> I.R.C. § 1092 (1982).

<sup>62</sup> Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, § 337, 96 Stat. 324 (1982).

<sup>63</sup> I.R.C. § 1212(c) (1982).

<sup>64</sup> I.R.C. § 1256(b)(3) (1982).

<sup>65</sup> *Id.* The Act may focus such treatment on foreign markets which follow clearing practices identical to United States commodity markets, e.g. a clearinghouse which "marks the position to market" daily. If so, a possible effect of this requirement is to discourage "60/40" treatment for positions on the LME and other *principals* markets.

<sup>66</sup> Congress did extend mark to market treatment to Foreign Exchange (FOREX) interbank trading by the Technical Corrections Bill of 1982, Pub. L. No. 97-448, 96 Stat. 2365 (1982). Press accounts indicate the Chicago Mercantile Exchange will seek such treatment respecting its proposed linkage with the Monetary Exchange of Singapore, *Wall St. J.*, Feb. 21, 1984, at 43, col. 3 (Midwest ed.).

### C. Assessment of Current Policy

At least three questions might be legitimately raised regarding the compendium of regulatory and taxing rules described: (1) do the rules realistically reflect the United States interest in the markets described; (2) are realistic restrictions imposed on United States traders; (3) do the rules provide essential protections expected by the public?

From the discussion thus far it will be apparent that United States law supplies fairly potent regulatory and tax incentives for the speculative commodity trader to trade only on United States markets, although some confusion is exhibited as to the thrust of the underlying policy behind the same rules.

For example, speculative traders, domestic exchanges, and foreign markets each may have some gripe against United States requirements relevant to foreign market speculation. United States exchanges and brokerage houses might look askance at the disparate regulatory burden placed on commodity professionals handling domestic futures contracts, compared with requirements governing foreign futures sales. Tax penalties imposed on speculation in foreign markets and the CFTC's ban on foreign exchange options obviously disadvantage foreign markets. A United States speculator is provided no real United States supervision over his foreign market futures orders, is affected by the ban on foreign option positions traded on the same foreign market and is subjected to punitive tax treatment of gain and loss arising from those positions he nevertheless maintains on a foreign market. The tax penalties imposed on speculative arbitrage transactions may have the distinction of being a potential irritant to each of the named groups.<sup>67</sup>

Although shedding tears over the plight of the foreign market speculator probably ranks as a lesser government priority, there may be something more to be said about the application of existing law than its effect on the individual commodity trader.

Given the substantial role of international commodity markets in facilitating commerce, the potential effect of constricting speculative order flow to foreign markets is arguably broader than its singular ef-

---

<sup>67</sup> A side-effect of United States tax policy—the deterrence of arbitrage against United States and foreign markets—would seem to suggest a certain conclusion regarding the balance between United States and foreign prices of the commodities involved, that the balance may be more dependent upon the activities of a concentrated group of larger concerns arbitraging in conformity with certain technical requirements of United States law in regard to hedging treatment, than a more diverse range of professional traders whose vocational niche does not allow them to take ordinary gain and loss as a result of their transactions, or otherwise avail themselves of “mark to market” gain rates for both sides of the arbitrage transaction. In other words, a potential side effect of the rules discussed concentrates market leveling activities (perhaps limited only to some markets) to a very limited number of commercial concerns.

fect on the relatively limited number of direct users of the same markets.<sup>68</sup> Effective hedging depends upon speculation.<sup>69</sup> The absence of outside speculative orders flowing to a foreign exchange may result in erratic pricing and a market unable to attract or assimilate large commercial hedging orders. A newly established market may be hampered from developing into a more stable entity.

To the extent that United States law frustrates speculation in foreign markets by a substantial pool of United States traders, it also deters liquidity in such markets, which in turn affects the utility of the market and results in a less efficient marketplace.<sup>70</sup> The impact of these inefficiencies—including higher prices—is presumably passed on to the United States economy and its foreign counterparts.<sup>71</sup>

It is unlikely that the commercial trade orientation of the major foreign exchanges renders them totally immune from the phenomena just discussed. The success of any market is contingent upon attracting sufficient speculative interest to provide an opposing view when commercial interests are either pessimistic or optimistic, which allows traders to hedge without distorting price trends away from movements in the physical market.<sup>72</sup>

---

<sup>68</sup> Gray, *The Importance of Hedging in Futures Trading, and the Effectiveness of Futures Trading in Hedging*, in 3 READINGS IN FUTURES MARKETS 223 (1980).

<sup>69</sup> See *infra* note 73 and accompanying text. See also, Working, *Economic Functions of Futures Markets* in FUTURES TRADING IN LIVESTOCK: ORIGINS AND CONCEPTS (H. Baaken ed.) (1970), reprinted in SELECTED WRITINGS OF HOLBROOK WORKING (A. Peck ed. 1978).

<sup>70</sup> "The Commission [CFTC] believes that providing market access to as many participants as possible allows commodities traded on domestic exchanges to reflect more accurately international supply and demand factors and provides additional market liquidity thereby facilitating the price discovery function of United States futures exchanges." 47 Fed. Reg. 44,998 (1982) (emphasis added) [1980-82 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 21,489, at 26,258.

<sup>71</sup> On these points (with respect to United States markets), see studies compiled in 2 SELECTED WRITINGS ON FUTURES MARKETS 151-237 (Peck ed. 1977) and SELECTED WRITINGS OF HOLBROOK WORKING (Peck ed. 1978).

<sup>72</sup> See REES, BRITAIN'S COMMODITY MARKETS 443-44 (1972):

Traders use futures markets in order to protect their profit margins from being eroded by price fluctuations; in principle, hedging enables them to do this at the expense of also denying them the possibility of achieving windfall gains from price changes. (For example, if a trader holds stocks and hedges against a fall in price by selling futures, a rise in price will result in a gain from sales in the delivery market, and an offsetting loss in the futures market.) While traders seek to avert risks arising from price fluctuations, speculators are the market operators who are prepared to assume these risks in the hope of making gains. Thus, because there is unlikely to be a balance between hedgers on the short and on the long side of the market, terminal markets cannot do without speculators. Furthermore, these financial interests broaden markets which would otherwise be extremely thin and so register distorted prices. (On some very active futures markets the turnover is often many times the volume of the physical trade in the commodity over the same period.) The usefulness of speculative activity, provided it is kept under supervision by the market authorities concerned, is thus clear enough. To the extent that traders hedge with one another or with speculators, the uncertainty due to price fluctuations is removed from the trade and borne by financial interests. The pursuit of gain by commodity speculators thus provides a useful economic service in transferring price risks from those who do not wish to bear them to those who do. A market

While United States law clearly restricts this function, the collection of rules discussed also reflects a certain bedrock of hard political reality: government presumably will collect taxes from taxpayers who make money trading commodities, and after several decades of protecting United States speculators from fraud, it is unlikely that the government will now abandon them as a protected class. Accordingly, one suspects that if a case is to be made for a practical alternative to these present rules, it should serve similar ends.

#### IV. A SUGGESTED UNITED STATES POLICY TOWARD FOREIGN MARKET TRANSACTIONS

##### A. Considerations

The preceding discussion does not necessarily imply that an improved policy—taxing authority aside—must involve comprehensive governmental oversight. The long history of self-regulation practiced by established British markets, the availability of experienced dispute resolution machinery (exchange arbitration and private litigation) and recent developments in the United Kingdom and elsewhere indicating a growing awareness that public traders have a legitimate expectation of fair treatment by market professionals handling their orders,<sup>73</sup> collectively offer support for questioning the need today for any overt United States regulation of foreign market sales practices.

---

in prices—which, in essence, is the purpose of futures trading—is thus ultimately beneficial to society because traders are enabled through its use to charge lower prices. In other words, traders would require higher margins in the absence of futures markets because of the greater risk of losses entailed by fluctuating prices. The greatest fallacy is to believe that the elimination of speculative markets would abolish speculation, when in reality it would merely shift the incidence onto other shoulders. When, for example, the State imposes an organization (such as the post-war Raw Cotton Commission) into the channel of distribution which absorbs price changes, it, in effect, assigns to the taxpayer the role of risk bearer for the trade concerned. Where no market or institution acts as the risk bearer for price changes, the trader himself perforce assumes the role of speculator. Viewed in this light, therefore, the speculator is a middleman who provides insurance against the risk of price fluctuations. His operations on markets in prices thus expedite the passage of the good to the ultimate consumer in a way which is no different, in principle, from that of other middlemen, be they bankers, insurance companies, acceptance houses, warehouse-keepers or shipping agents. REES, *BRITAIN'S COMMODITY MARKETS* 443-44 (1972).

<sup>73</sup> For a discussion of British regulation, see Rock, *supra* note 9. British exchanges are establishing a self-regulatory organization, the Futures Brokers Association, and certain guarantee funds in the event of brokerage house failure. *SECURITIES WEEK*, Oct. 3, 1983, at 9. See, e.g., Review of Investor Protection Report (Part I) ("Report presented to Parliament by the Secretary of State for Trade and Industry by Command of Her Majesty," January 1984). The Report recommends overhaul of certain investor protection standards in Britain with stronger standards to be enforced by certain established self-regulatory entities recognized by the British government. Similarly, British commodity market leaders have moved to establish a new self-regulatory organization (the Association of Future Brokers and Dealers). Various commodity markets are creating special "guarantee funds" to provide a source of compensation for small investors potentially aggrieved under existing law.



To this question history suggests two responses depending on whether the beneficiary of such activities is the public or a commercial entity. The self-regulatory activities mentioned above apparently have been sufficient to protect the reputation of the British marketplace as a major forum for pricing and hedging and have attracted little criticism as mechanisms of merchant regulation governing the trading activities of market professionals. Nonetheless, in analogous circumstances these same mechanisms failed as a useful regulatory presence when alleged foreign options were being sold to unsophisticated United States public customers, and the issue was protection of the United States investor. Accordingly, proposing self-regulation of various foreign markets (or source regulation by foreign governments) as an adequate antifraud substitute for United States regulation encounters a historical obstacle that may prove insurmountable.<sup>74</sup> An easier task may be debating the question of the *degree* of United States government regulation necessary to protect identified United States interests, and whether the source of that regulation is to be federal or state authority, a question Congress has rather consistently answered in favor of the former.<sup>75</sup>

Once one capitulates to the argument for some form of government regulation, secondary issues arise that relate to both the degree and application of regulation. As to degree, a necessary caution in application of any proposed government regulatory presence relates to the nature of organized commodity markets outside the United States. As noted previously, United States law limits futures trading to organized exchanges during stated trading hours. At foreign exchanges, traded futures may be only a tip of the totality of commodity related transactions oriented around the marketplace. Thus, a host of spot and forward transactions—whether through members of exchanges or non-members—are also available to a customer. Because these latter transactions are rarely regulated in any form, a suggested overall goal is to

---

<sup>74</sup> Additional points that suggest this conclusion are: (1) recourse to private litigation is not usually cost effective when the amounts at stake are small (for example, less than \$15,000) (this is even more the case when litigation involves recourse to foreign law and foreign courts); (2) perpetrators of commodity fraud in the United States have demonstrated amazing adeptness at legal combat and moving funds out of reach of customers; and (3) foreign arbitration is rarely a remedy for customer fraud involved in the United States solicitation of an order.

<sup>75</sup> Another answer may be warranted if, instead of a customer protection question, the issue is a United States interest in well ordered foreign markets, free of manipulation. As the United States has little or no jurisdiction to extend its anti-manipulative presence to encompass foreign market practices, United States traders must remain solely dependent on the regulatory oversight represented by the foreign government, by the foreign markets, or a combination. This reliance is, of course, shared by traders of both consuming and producing nations. Fortunately, the fact that certain foreign markets are well used by commercial interests probably attests to the effectiveness of the marketplace in policing itself for such purposes.

avoid the creation of a United States regulatory presence which penalizes legitimate firm dealings with United States customers, in effect "squeezing" both parties into an amorphous world of "forward" and "spot" commodity transactions not regulated by the Commodity Exchange Act. The temptation to further expand CFTC powers to bring regulatory "order" to such a world is probably flirting with the regulatory equivalent of a cosmic "black hole," swallowing government resources without resultant public benefit.

As to application, certain foreign governments ban citizens from trading on foreign commodity markets. Because these edicts disadvantage both United States markets and their users, a temptation might be to permit United States trader access to foreign markets only on a reciprocal basis. In large part, however, such foreign restrictions are based on exchange control considerations, and if a beneficiary of open access to foreign markets is the American economy, reciprocity is pointing the regulatory finger in the wrong direction. Of course, "true" reciprocity could also result in the engrafting of a morass of foreign standards and restrictions onto the already complex regulatory environment governing United States commodity firms—again probably nullifying any realistic benefit the principle otherwise provides.

In the name of customer protection, government has three alternatives: it can regulate, it can ban, or it can simply do nothing (the latter proposal relies almost singularly on competition as a curative). As has been noted, present law does all three, to the detriment of customers and informational markets which suggests some need for a principle to harmonize the various United States regulatory and taxing interests discussed with a certain dependence on viable international markets.

One need not look far for such a principle. Several statements emanating from the CFTC in recent years describe a goal of United States regulations imposed on United States and foreign traders (in United States markets) as invoking the principle of "parity" of regulatory treatment.<sup>76</sup> Because the parity concept implies fairness and uniformity in regulatory treatment—principles rather absent from existing rules—it seems reasonable that such a standard might have equal validity when applied to United States regulatory and tax requirements governing United States traders in foreign markets.

## B. Achieving Regulatory and Tax Parity Between Foreign and Domestic Markets

To explore how a rough system of parity might be achieved within

---

<sup>76</sup> CFTC Release No. 177-76 (Aug. 4, 1976), *reprinted in* 45 Fed. Reg. 30,426 (1980).

the existing statutory framework, three adjustments to existing regulatory or tax rules governing foreign commodity market positions are suggested.

### *1. Eliminate the Foreign Options Ban*

The foreign options ban was the result of a set of circumstances that overwhelmed the agency in its efforts to bring under regulation an unregulated situation—the commodity options market in the United States prior to 1973.<sup>77</sup> As a result, present policy allows a public trader unrestricted, essentially unregulated exposure and access to foreign futures positions, yet bars sales of a similar market instrument—an option—traded on the same exchange.<sup>78</sup>

Several contemporary factors support again allowing a restricted offering of legitimate foreign exchange options into the United States public marketplace; these include the recent initiation of a pilot program of United States exchange traded options on a broad spectrum of commodities,<sup>79</sup> the recent statutory repeal of the long-standing 1936 ban on agricultural options, and the continued existence—apparently without regulatory disaster—of a small group of United States dealers writing options for sale to the public under regulatory monopoly.<sup>80</sup> If one assumes that the regulatory values supporting the composition of the current United States options marketplace are a result of the presumed economic utility of options trading, fairness standards, and some acknowledgement that potential purchasers may be presumed to share some responsibility for their own investment decisions, and if one also assumes that certain fundamental customer protection standards can be met, there appears little reason why foreign commodity exchange options could not be freed from their present status as something fit only for an elite priesthood of commercial traders.

As noted, the CFTC has authority to repeal the foreign options ban and promulgate separate regulatory standards governing United States sales practices.<sup>81</sup> In acknowledgement of the history of customer

---

<sup>77</sup> See *supra* notes 45-51 and accompanying text. In addition to customer gullibility, a generally overlooked contribution to the customer protection problems facing the CFTC in the 1975-1978 period (when fraud problems involving sales of so-called "London" options sales were at their peak) was that certain tax advisors at the time were promoting the use of foreign options as a tax shelter device. A manifestation of that market sector is litigation before the United States Tax Court consolidating over 1400 IRS challenges to 1975-1977 taxpayer returns which claimed certain tax benefits as a result of London option transactions.

<sup>78</sup> 17 C.F.R. §§ 1.19, 32, 33 (1983).

<sup>79</sup> *Id.*

<sup>80</sup> *Id.*

<sup>81</sup> Commodity Exchange Act, § 4c(b), 7 U.S.C. § 6 (1982).

protection problems associated with foreign options, such sales should be subject to some sort of regulatory framework, perhaps such as Congress has authorized to govern foreign futures sales.<sup>82</sup> Additional special restrictions, perhaps limiting United States sales to vendors regulated by the National Futures Association,<sup>83</sup> and/or restricting eligible option writers to foreign exchange members, or any of several rules earlier proposed by the Commission to bring foreign exchange options "in from the cold" might have merit as a guide for CFTC regulations in this area.

## *2. Invoke Realistic Regulations Governing the Sale of Foreign Futures in the United States*

It was noted earlier that prior to passage of the Futures Trading Act of 1982, a United States firm handling foreign futures positions for United States customers was subject to registration with the CFTC as a "Commodity Trading Advisor,"<sup>84</sup> but the 1982 Act essentially eliminated this requirement for United States firms that solely handled foreign futures, in favor of new powers granted to the Commission under Section 4(b) of current law.<sup>85</sup> Because the CFTC has not exercised its Section 4(b) powers, the elimination of the registration requirement has created a partial loophole that disadvantages public customers, United States exchanges, as well as, arguably, the reputation in the United States of established foreign exchanges.

Suggested regulatory measures in this area include requiring CFTC registration for United States firms or individuals involved in handling United States orders in foreign markets, adopting a standard disclosure statement to alert speculators that they are not dealing in United States markets but rather in markets governed by foreign law where practices and principles may not be compatible with United States law, imposing certain recordkeeping requirements to permit the

---

<sup>82</sup> See *supra* note 40 and accompanying text.

<sup>83</sup> The National Futures Association (NFA) is a statutorily authorized United States commodity industry self-regulatory association. The CFTC has approved the Charter and rules of the NFA pursuant to Section 17(a) of the Commodity Exchange Act, 7 U.S.C. § 21(a) (1982).

<sup>84</sup> See *supra* note 26. The Trading Advisor registration requirement provided a regulatory "hook" to the CFTC to oversee activities of United States professionals involved, *inter alia*, solely in foreign futures sales. In all likelihood, however, the preponderance of such sales were made through other CFTC registrants, such as large commodity brokerage houses (already registered with the CFTC as "Futures Commission Merchants") or through "Commodity Pool Operators."

<sup>85</sup> The amendment still allows the Commission to include within the Commodity Trading Advisor definition, persons advising "as to the value of commodities." As this was the language of the previous definition, the Commission could presumably still resurrect its earlier interpretations and reincorporate foreign sales firms within the new definition. Commodity Exchange Act, § 2(a)(1)(A), 7 U.S.C. § 4 (1982).

Commission to determine whether customer orders and customer funds are being correctly handled, and amending the CFTC antifraud standards already extant.<sup>86</sup> Each of the suggested regulatory requirements is possible within the scope of the CFTC's new powers and, therefore, probably would not involve recourse to statutory amendment.<sup>87</sup>

### 3. *Eliminate the Disparate Tax Treatment Between Foreign and Domestic Market Positions*

A key factor affecting futures trading is treatment by United States tax law. It is apparent that one effect of the recent tax law changes has been to create separate tax standards for United States and foreign exchange positions, toward questionable ends. While adjustment in certain accounting practices might be appropriate if a position emanates from a foreign exchange that does not clear transactions on a technically "pure" mark to market system, it is questionable whether government-erected barriers to foreign commodity market speculation and arbitrage should be more than those minimally necessary to obtain reasonable compliance with the tax laws. As noted, Section 1256 of the Internal Revenue Code now authorizes the Secretary of the Treasury to allow gains and losses derived from certain foreign commodity exchange positions to be taxed like domestic futures contracts, thus equalizing treatment of speculative positions in both markets.<sup>88</sup> As also noted, Congress has recently extended "60/40" treatment to certain foreign exchange (FOREX) dealings (nonclearinghouse principal transactions)<sup>89</sup> and the Treasury Department has recommended that exchange traded commodity options on United States futures contracts

---

<sup>86</sup> In adopting the provisions related to regulation of foreign exchanges, the House and Senate Committees also adopted fairly stringent provisions restricting use of CFTC authority to interfere with foreign market operations and contracts. It is abundantly clear from the language of Section 4(b) and from legislative history that, unlike CFTC authority over foreign *options* trading, the CFTC has no authority to ban United States sales of foreign futures. Commodity Exchange Act, § 4(b), 7 U.S.C. § 6 (1982); S. REP. NO. 384, 97th Cong., 2d Sess. — (1982); H.R. REP. NO. 565, 97th Cong., 2d Sess. —, reprinted in 1982 U.S. CODE CONG. & AD. NEWS 3871-4022. With respect to the existing CFTC antifraud regulations one could argue that the particular wording of the regulation (17 C.F.R. § 30.02 (1983)) limits its application to transactions that occur *on*—as opposed to "*on or subject to the rules of*"—a given foreign exchange, thus limiting its utility when applied against "Kerb" and other after market trading activity—that also occurs in conjunction with established foreign markets.

<sup>87</sup> An alternative approach would be to resurrect the inclusion of foreign future sales within the ambit of the Commodity Trading Advisor definition. See *supra* note 85.

<sup>88</sup> It is not completely clear whether foreign clearinghouses would be required to change the manner of "marking positions to market" at the foreign exchange to comport with practices at United States exchanges. See *supra* note 46-47 and accompanying text.

<sup>89</sup> Technical Corrections Tax Act of 1982, Pub. L. No. 97-448, 96 Stat. 2365 (1982). (Amendments related to Title V of Economic Recovery Act of 1981, Pub. L. No. 97-34, § 105(a)(4) (1981)).

also be taxed at 60/40 rates, although the Department has vacillated somewhat on the subject.<sup>90</sup> While a technical correction to the statute may be in order if established foreign markets cannot be accorded Section 1256 treatment under existing law, most of the principles that justified assisting FOREX traders—who also do not technically mark positions “to market”—would seem applicable here.

### C. Suggested Effect of Proposed Changes

The recommendations suggested differ from current United States rules in several respects, but each is oriented toward the theme of enhancing the foreign marketplace for United States customers without a resultant negative impact on United States customer protection standards or tax policy.

One effect of such proposals arguably would be partially to transmute unregulated foreign commodity markets into public markets, perhaps at the expense of United States exchange business or the interests of United States customers. In reality, the goals of the actions suggested are more modest: first, to more closely integrate the regulatory and tax treatment of a relatively complex area to comport with legislative pronouncements made by Congress; and second, to acknowledge a rather elementary principle—that United States and foreign markets are each components of a larger international marketplace, and as such, may be governed by the same “parity” principle now governing policy respecting incoming foreign orders to United States markets.

The beneficial effects of such a policy are projected as follows: (1) to stimulate and broaden the arbitrage base between United States and foreign markets to the benefit of the price discovery and hedging functions in both United States and foreign markets, (2) to allow United States noncommercial traders to employ additional trading vehicles to assist in their speculative ventures, (3) to stimulate liquidity and price discovery in foreign markets, admittedly with some view toward commodities traded on foreign markets but not presently available at United States markets, (4) to place the United States government in the position of encouraging the free flow of commodity

---

<sup>90</sup> That is, in November 1983 the Treasury Department supported extending R.F.C. treatment to commodity options, *Statement of John E. Chapoton, Assistant Secretary (Tax Policy), Department of the Treasury, Before the Committee on Ways & Means, U.S. House of Representatives*, Nov. 2, 1983; but the Department reversed itself in February out of concern for the effect of the proposal on U.S. markets for listed stock options. See, e.g., “Summary of Administration Revenue Proposals in the FY 1985 Budget Proposal,” Joint Comm. on Taxation, U.S. Congress, Feb. 3, 1984. At this writing, Congress appears to be en route to adopting Treasury’s initial proposal. See, e.g., H.R. 4170, § 102, 98th Congress, 2d Sess., Mar. 5, 1984 (Comm. Print Substitute). See also S.2370, Feb. 29, 1984.

orders to the United States, as well as to foreign markets, and finally, (5) to provide more adequate customer protection than currently exists.

In the same context, the negative aspects of such changes would not have a terrible impact on the status quo; there should be no great hemorrhage of the national Treasury nor increased abuse of the public trader. Perhaps on a given day a speculative trader would lose (or make) more money than at present, but, a certain currency risk (in some markets) aside, whether a trader wins or loses in the marketplace is rarely a function of the nationality of an established market. Instead, it is a function of those universal factors that determine successful traders everywhere.

#### V. CLOSING THOUGHTS—WHO REGULATES THE “EXCHANGE” OF THE FUTURE?

While the changes proposed might cure some ills attributed to current law and current markets, one cannot, in candor, fail to note certain ragged edges to the otherwise tidy character of the recommendations mentioned,<sup>91</sup> or more importantly, the existence of potential international trends in central market mechanisms which could necessitate a more wholesale reassessment of the relationship between national governments and markets.

One such trend relates to the relationship between United States and foreign exchanges: although the relationship arguably may be largely symbiotic, in practice, markets often compete for customer orders.

In this context, the process of obtaining United States government permission to list a contract for trading on a United States exchange is often complex and time consuming and grows increasingly expensive as exchanges are required to pay for the CFTC's services in approving the proposed contract for trading.<sup>92</sup> Costs associated with the construction and promotion of proposed futures contracts may be high. Exchange and National Futures Association transaction costs, passed inevitably to the economy, if not to the customer, represent cost factors often peculiar to United States markets. Comprehensive CFTC oversight of exchanges and professionals can be an expensive irritant. The

---

<sup>91</sup> This includes the role and relationship of principals markets to current United States law. There are several uncertainties in interpretation of current tax law respecting options positions both as to how taxed and whether (and when) an option is deemed to offset futures positions for purposes of Section 1092 of the Internal Revenue Code.

<sup>92</sup> Pub. L. No. 97-444 amends Section 26(c) of The Futures Trading Act of 1978 (92 Stat. 377) to authorize the CFTC to impose service fees on United States exchanges for CFTC approval of proposed futures contracts. 48 Fed. Reg. 38,214 (1983).

United States commodity industry, in sum, seems more pervasively regulated by the government than is the international norm.<sup>93</sup>

This scenario does create a potential breeding ground for the propagation of entrepreneur "offshore" United States exchanges regulated loosely or not at all by the host government. The contracts offered by such an exchange might consist of contracts already offered by United States or other markets. Although evidence that such a market was diverting orders from United States markets could result in pressures to relax the United States regulatory presence in domestic markets, an equally likely reaction could be the erection of additional regulatory barriers against outside markets. If so, there would be an accompanying need to define more closely the offshore target for regulatory purposes to avoid subjecting established market centers to inordinate United States regulatory requirements.

An intriguing issue involves the true locus of foreign markets for regulatory and jurisdictional purposes. If one keeps in mind that trading of futures away from exchange floors is common and legal in many foreign jurisdictions, the forum question becomes difficult to manage when a network of international traders ("members" of the "exchange") are linked both to the site of the order execution machinery—the exchange—as well as to one another in a dealer network. In such markets the choice may exist of either positioning or executing customer orders among members or passing them to the central market. Although the law probably will adopt the situs of the trading floor as the basis for asserting regulatory jurisdiction over the market, application of this theory in the United States easily might be questioned if all, or a preponderance, of the members of such a market are United States entities.

Similarly, possible challenge to accepted precepts is found in the potential for proposed international linkage systems between markets. The motivating force behind such experiments is not necessarily to escape United States regulation, but rather to extend trading hours by pursuit of common contracts and clearing mechanisms at more than one exchange, allowing a contract position established in Chicago to be closed out in Singapore. Such systems raise jurisdictional questions, depending upon the particular arrangement contemplated. "Linkage" of a Far Eastern market with a United States market, for example (perhaps with a clearinghouse located in either jurisdiction or in a third

---

<sup>93</sup> Because there are also significant advantages to CFTC regulation, the relationship between the CFTC and U.S. commodity exchanges is not necessarily antagonistic, where certain "big picture" (e.g. jurisdictional) issues are at stake.



locale), would seem to pose jurisdictional issues similar to those already noted relating to the locus of the market.

Present strides in technology probably already have eliminated a presumed traditional requirement respecting exchanges, the assumption that marketplaces inevitably require the actual presence of a governing body at a given trading center. With diffusion of the traditional commodity marketplace, accompanying jurisdictional questions could involve issues such as whether the situs of the exchange should continue to be a determinative jurisdictional consideration, or, assuming the likely continuance of some degree of forum-based regulation over markets, whether the significance of national standards arguably should diminish to be replaced, if at all, by international standards.

While forum-based government regulation for customer protection purposes is probably destined to continue to be the United States norm for some time into the future,<sup>94</sup> one suspects that the current United States system, involving reliance on government in effect to "second-guess" and backstop the day-to-day anti-manipulative activities of exchanges, may be found wanting as markets increasingly become forum independent. In such a circumstance, choices might involve, on the one hand, an international regulatory presence—perhaps some sort of an "international CFTC"—or continuation of traditional market self-regulation as the major anti-manipulative presence.

An uncertain United States regulatory situation with respect to its domestic markets has already fostered several studies and calls<sup>95</sup> for a more precise United States policy toward futures trading in its several manifestations. It seems rather clear that any such policy which might be developed must address the phenomena of foreign markets, particularly if (as one suspects), the distinction between United States and foreign markets is subject to increasing erosion.

In function many of today's markets realistically may be argued to be beyond the sole claim of any nation, belonging instead to international commerce. Regulation of access to such markets accordingly should not be approached on the basis of a "we" versus "them" regulatory mentality, but rather along the lines suggested to facilitate a policy that acknowledges the reality that United States and foreign markets are both components of a larger international marketplace.

---

<sup>94</sup> Depending on the success of an organization such as NFA, the CFTC presence could shrink drastically during the same period.

<sup>95</sup> See, e.g., Robert K. Wilmouth, President and Chief Officer, National Futures Association, Remarks of the Conference on the Futures Markets and National Policy: An Agenda for the 1980's, in Washington, D.C. (Oct. 5, 1983).