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# COMMENTS

## United States Regulation of Foreign Currency Futures and Options Trading: Hedging for Business Competitiveness

### I. INTRODUCTION

Any firm exposed to the international economy has to realize that it is two businesses at the same time. It is both a maker of goods (or a supplier of services) and a "financial" business. It cannot disregard either.<sup>1</sup>

Since the United States began to experience a merchandise trade deficit, politicians, economists, and those in business have voiced concern over the need for United States business to be competitive, both at home and abroad. Congress in particular has decried the lack of United States business competitiveness and sought to remedy the problem, primarily through broad legislation aimed at forcing foreign economic competitors to "level the playing field" or engage in "fair trade." Yet, in the rush to regulate foreign competition, Congress and government agencies have overlooked measures which can encourage self-help by domestic businesses. In addition to focusing on the regulation of foreign trade practices, Congress should examine domestic business regulation in its effort to promote competitiveness.

United States businesses can improve competitiveness by minimizing the risks attached to operations in the international marketplace. Foreign currency fluctuation risk ("currency risk") is one such risk common to all businesses trading with or competing against foreign parties. Currency risk is the possibility of loss of value due to a decline in the value of a business's domestic currency against foreign currency.<sup>2</sup> This risk has always been a fundamental one in international business transac-

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<sup>1</sup> Drucker, *The Changed World Economy*, 64 FOREIGN AFF. 768, 787 (1986).

<sup>2</sup> See *infra* notes 87-95 and accompanying text.

tions, and may place a great burden on the profitability of a business, thus reducing its competitiveness.

Businesses can control much of their currency risk through hedging.<sup>3</sup> An increasing number of businesses are realizing the benefits of hedging against risk through the use of forward,<sup>4</sup> futures,<sup>5</sup> and options<sup>6</sup> contracts. Congress and government agencies should encourage these self-help risk reduction methods by creating a regulatory environment which facilitates all means of hedging against foreign currency fluctuation risks.

In the United States, the Commodity Futures Trading Commission ("CFTC") regulates futures and options trading.<sup>7</sup> The Commodity Exchange Act<sup>8</sup> ("CEA") gives the CFTC exclusive jurisdiction over domestic futures trading<sup>9</sup> and trading activities on futures contract mar-

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<sup>3</sup> Hedging can be broadly defined as an economic activity that reduces risk. For a more detailed description see *infra* notes 30-37, 90-92 and accompanying text; see also Rogers & Markham, *The Application of West Germany Statutes to United States Commodity Futures Contracts: An Unnecessary Clash of Policies* 19 L. & POL'Y INT'L BUS. 273, 277 (1987).

<sup>4</sup> Forward refers to the "forward market," which is an informal off-exchange market in contracts for commodities to be delivered at a future date. Glossary of Futures Trading Terms, in 1985 CFTC ANN. REP. 138 [hereinafter CFTC Glossary]. It is a cash market for future delivery. For a very complete description of foreign currency forward contracts, see Gilberg, *Regulation of New Financial Instruments Under the Federal Securities and Commodities Laws*, 39 VAND. L. REV. 1599, 1653-59 (1986).

<sup>5</sup> A futures contract is an agreement to purchase or sell a commodity for delivery in the future: 1) at a price that is determined at initiation of the contract; 2) which is normally traded on a board of trade by members of the exchange; 3) which is used to assume or shift price risk; 4) which obligates each party to the contract either to fulfill the terms of the contract or offset the contract by entering into an opposite transaction (by far, the more commonly chosen alternative). CFTC Glossary, *supra* note 4, at 139; see also Gilberg, *supra* note 4, at 1603-10.

<sup>6</sup> A commodity option contract is a unilateral contract which gives the purchaser the right to buy or sell a specified quantity of a commodity at a specific price within a specified period of time, regardless of the market price of the commodity. CFTC Glossary, *supra* note 4, at 145. In an option contract neither party has an obligation to deliver unless the purchaser exercises the option. On the other hand, a futures contract imposes an obligation to deliver on the seller. Like a futures contract, exercising the option rarely results in delivery of the commodity. See also Gilberg, *supra* note 4, at 1610-15.

<sup>7</sup> The CFTC was established in 1974 by the Commodity Futures Trading Commission Act ("CFTCA of 1974"), Pub. L. No. 93-463, 88 Stat. 1389, amending Commodity Exchange Act of 1936 ("CEA"), ch. 545, 49 Stat. 1491 (codified as amended at 7 U.S.C. §§ 1-26 (1982 and Supp. III 1985)).

<sup>8</sup> 7 U.S.C. §§ 1-26.

<sup>9</sup> The CFTC has jurisdiction over all futures and options contracts traded on contract markets, 7 U.S.C. § 2a, except those placed under the jurisdiction of the Securities and Exchange Commission ("SEC") by the Futures Trading Act of 1982 ("FTA of 1982"), Pub. L. No. 97-444, §§ 101, 102, 96 Stat. 2294, 2294-96, amending 7 U.S.C. §§ 2, 2a (1982). The FTA of 1982 implemented the Shad-Johnson Accords, which allocated jurisdiction over options on equity securities, any group or index of securities, or any interest based on the value thereon, and currency options traded on national securities exchanges. See *Joint Explanatory Statement of the SEC and the CFTC*, [1980-1982 Trans-

kets.<sup>10</sup> The CFTC also asserts jurisdiction over off-exchange<sup>11</sup> trading activities,<sup>12</sup> and trading activities by United States residents abroad.<sup>13</sup> The regulatory scheme of the CEA focuses on the "form of economic activity" (futures and options trading) instead of the nature of the subject (commodities).<sup>14</sup> As a consequence, the regulated market activities are defined by general characteristics rather than specific commodities (for example, "foreign futures" transactions<sup>15</sup> or "options on agricultural futures contracts" transactions<sup>16</sup>).

This Comment argues that the current regulatory scheme is inappropriate for foreign currency instruments and should be changed to promote business competitiveness. Under congressional guidance, the CFTC has exercised its general rulemaking authority<sup>17</sup> to promulgate broadly restrictive regulations governing futures and options trading for these market activities in order to control trading. Such a blanket approach to regulation disregards the characteristics of separate commodities within those market activities and the needs of the different types of market participants. On balance, the benefits gained from this approach may outweigh the costs in most individual commodity markets. Foreign currency, however, is a unique commodity.<sup>18</sup> Consequently, the regulation of foreign currency futures and options trading should be based on the underlying commodity in order to take this uniqueness into account.

This Comment first summarizes the existing regulatory scheme and identifies the restrictions imposed on foreign currency futures and options trading.<sup>19</sup> These restrictions undercut much of the apparent flexi-

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fer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,322 (Feb. 2, 1982); T. RUSSO, REGULATION OF THE COMMODITIES FUTURES AND OPTIONS MARKETS § 10.05 (1983).

<sup>10</sup> The physical marketplace for commodities trading is called a "contract market" or "board of trade." CFTC Glossary, *supra* note 4, at 132. A stock market, such as the New York Stock Exchange, is called a "national securities exchange." See, e.g., 7 U.S.C. § 6c(f).

<sup>11</sup> "Off-exchange" trading is any trading not conducted on a contract market or national securities exchange. "Exchange" trading generally means trading listed options or futures on an authorized futures contract market or securities exchange.

<sup>12</sup> See Lyons & Mitchell, *Foreign Currency Option Trading Off-Exchanges*, NAT'L L.J., Jan. 13, 1986, at 15, col. 3.

<sup>13</sup> 7 U.S.C. § 3. See T. RUSSO, *supra* note 9, § 11.01.

<sup>14</sup> P. JOHNSON, COMMODITIES REGULATION § 1.01 (1982).

<sup>15</sup> See Regulation of Foreign Futures Transactions in the United States, 49 Fed. Reg. 29,963 (1984)(advance notice of proposed rulemaking).

<sup>16</sup> See Domestic Exchange Traded Commodity Options; Expansion of the Pilot Program for Options on Agricultural Futures Contracts, 51 Fed. Reg. 11,905 (1986)(final rulemaking).

<sup>17</sup> See 7 U.S.C. § 12a(5). Other sections provide specific authority. See, e.g., 7 U.S.C. §§ 6(b), 6c(c), 7(b), 7a(12), 23(c). The CFTC's enforcement powers are found at 7 U.S.C. §§ 8, 9; see also P. JOHNSON, *supra* note 14, §§ 1.79-.84.

<sup>18</sup> See *infra* notes 87-95 and accompanying text.

<sup>19</sup> See *infra* notes 24-70 and accompanying text.

bility found in the CFTC's recent clarification of its hedging definition. The discussion continues with an explanation of the benefits<sup>20</sup> and costs<sup>21</sup> of hedging against currency risk in today's economic climate. On balance, the benefits of the trading activity—increased competitiveness and financial product innovation—appear to justify the costs of potential abuse and threats to the congressional intent of the CEA. This result justifies a fresh approach to the scheme.<sup>22</sup> Therefore, regulatory changes are suggested to provide alternatives for United States businesses desiring to hedge their currency risks.<sup>23</sup> The proposed changes are designed to promote self-help competitiveness among United States businesses.

## II. REGULATION OF FOREIGN CURRENCY FUTURES AND OPTIONS AS OF 1987

Recently, Congress and the CFTC have addressed several issues that affect foreign currency futures and options trading. In November 1986, Congress passed the Futures Trading Act of 1986.<sup>24</sup> Although the Act does not directly focus on issues important to foreign currency instruments,<sup>25</sup> congressional floor debate and committee reports provided guidance for the CFTC's recent rulemaking activities. Specifically, several members of Congress reiterated their concern over fraud and abuse of the general public through improper marketing activities.<sup>26</sup> In reauthorizing the activities of the CFTC, Congress reaffirmed its belief that the commodities regulatory scheme was necessary to provide protection for the general public and the United States commodity exchanges.<sup>27</sup>

Not unexpectedly, congressional concerns are reflected in the CFTC's clarification of its hedging definition ("Hedging Clarification")<sup>28</sup> and final rules concerning foreign-issued futures and options trading

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<sup>20</sup> See *infra* notes 71-115 and accompanying text.

<sup>21</sup> See *infra* notes 116-130 and accompanying text.

<sup>22</sup> See *infra* notes 131-146 and accompanying text.

<sup>23</sup> See *infra* notes 147-166 and accompanying text.

<sup>24</sup> Futures Trading Act of 1986 ("FTA of 1986"), Pub. L. No. 99-641, 100 Stat. 3556 (1986)(amending the CEA, 7 U.S.C. §§ 1-26).

<sup>25</sup> Only Title I of the FTA of 1986 dealt specifically with futures trading, and only §§ 2-4 of Title I are within the scope of this Comment. See 7 U.S.C. §§ 66, 6c, 9.

<sup>26</sup> See 132 CONG. REC. 13,586-87 (1986); H. REP. NO. 624, 99th Cong., 2d Sess. 73-76, *reprinted in* 1986 U.S. CODE CONG. & ADMIN. NEWS 6005, 6060-62. Much of the discussion of the FTA of 1986 addressed leverage contracts, a form of off-exchange futures contract used mostly to hedge interest rate exposure. The concern over off-exchange abuse, however, clearly applies to all types of trading.

<sup>27</sup> See H. REP. NO. 624, *supra* note 26, at 6-10, 1986 U.S. CODE CONG. & ADMIN. NEWS at 6007-10 (Purpose and Need section).

<sup>28</sup> 52 Fed. Reg. 27,195 (1987).

("Foreign-Issues Rules").<sup>29</sup> Although the CFTC may view these changes as useful for United States businesses interested in shifting currency risk, they are still too restrictive. The shortcomings become evident when the new Hedging Clarification is analyzed in the context of the general regulatory scheme.

#### A. The CFTC's Treatment of Hedging

The CFTC's definition of a "bona fide hedging transaction"<sup>30</sup> serves primarily to determine exemptions from the limits placed on speculative transactions under section 4a of the CEA.<sup>31</sup> Although this definition appears to be limited to a specific role in the regulatory scheme, it essentially defines risk reduction transactions (hedging) differently than transactions which increase risk (speculation). Since the original definition was issued in 1977,<sup>32</sup> the tremendous increase in the use of financial futures and development of new risk reduction strategies cast uncertainty over their classification under the definition. The Hedging Clarification addressed the uncertainty expressed by various users of the new financial futures.

In the Hedging Clarification, the CFTC stated that "users or potential users of financial futures and options" had commented that the definition presented problems for use of financial futures.<sup>33</sup> In particular, some aspects<sup>34</sup> of the old definition appeared to restrict the definition of hedging to "preclude the classification as hedging of numerous strategies that are otherwise risk reducing."<sup>35</sup> The CFTC explained that the language of the definition is not as rigid as the commentators feared. Under the definition, hedging transactions are not restricted to those that serve only as a "temporary substitute" for cash transactions.<sup>36</sup> Rather, many

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<sup>29</sup> Foreign Futures and Foreign Options Transactions, 52 Fed. Reg. 28,980 (1987)(final rules) [hereinafter Foreign-Issues Rules]. See also 7 U.S.C. § 4.

<sup>30</sup> 17 C.F.R. § 1.3(z) (1987).

<sup>31</sup> 7 U.S.C. § 6a.

<sup>32</sup> 42 Fed. Reg. 42,748 (1977).

<sup>33</sup> 52 Fed. Reg. 27,195 (1987).

<sup>34</sup> *Id.* at 27,195-97. The commentators primarily addressed two aspects of the hedging definition. First, Rule 1.3(z) states that bona fide hedging transactions are those that "normally represent a substitute for transactions to be made or positions to be taken at a later time in a physical marketing channel." Several commentators feared that this language required that the hedge be used only as a "temporary substitute" for a cash position. Second, this rule states that the purpose for which the transactions are intended must be to offset "price risks incidental to commercial cash or spot operations." This language is usually referred to as the "incidental test." Some commentators feared that this language restricted the hedging definition to transactions taken solely to offset risks in the underlying cash market for a commodity. *Id.*

<sup>35</sup> *Id.* at 27,195.

<sup>36</sup> *Id.* at 27,195, 27,196.

other risk reduction strategies are encompassed in the language. Similarly, hedges are not confined to transactions which directly offset risks arising from activities in a cash market for a commodity underlying or related to the futures or options contract.<sup>37</sup>

Through the Hedging Clarification, the CFTC encourages and facilitates many new hedging techniques. Nevertheless, the general regulatory scheme raises real problems for a business's ability to hedge foreign currency risk. Regulation prohibits many opportunities to hedge *before* reaching what should be the threshold determination: whether the transaction is a hedging or speculative contract under the hedging definition. This preclusion stems from the regulatory scheme's overbroad concepts applied to the specific commodity of foreign currency. The general regulatory scheme first divides trading activities into transactions on a contract market ("exchange contracts") and those traded elsewhere ("off-exchange contracts"). The scheme further separates contracts of United States origin ("domestic-issued") from foreign origin ("foreign-issued").

Businesses view each of these categories as alternative means of hedging currency risk. Yet, very different rules control trading in each of these categories, and those rules severely restrict trading in all instruments except on domestic exchange contracts. Instead of restricting the other means of risk management, Congress and the CFTC should promote their use by businesses for hedging purposes. This encouragement can be accomplished by adjusting the regulatory scheme to allow businesses to hedge freely using all four categories of instruments.

## B. Exchange Foreign Currency Contracts

Section 4(a) of the CEA restricts the trading of domestic-issued futures contracts to contract markets.<sup>38</sup> This restriction is as old as commodity regulation itself and reflects the view that this activity is best controlled, first through the self-regulation of the contract markets, and then through government supervision. When foreign currency was brought under the CEA in 1974,<sup>39</sup> the exchange-trading requirement was automatically extended to foreign currency futures.

On the other hand, Congress did not directly restrict domestic-issued options on the newly defined nonagricultural statutory commodities

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<sup>37</sup> *Id.* at 27,196-97.

<sup>38</sup> 7 U.S.C. § 6.

<sup>39</sup> The CFTCA of 1974 amended CEA § 2(a) to extend the scope of the definition of commodity to include any item which is the subject of futures trading. 7 U.S.C. § 2 ("The word 'commodity' shall mean . . . all services, rights, and interests in which contracts for future delivery are presently or in the future dealt in"). Foreign currency futures were being traded on at least one exchange at that time. Therefore, foreign currency immediately became a statutory commodity. *See supra* note 14.

(of which currency was one).<sup>40</sup> Instead, Congress placed the CFTC in control of this activity.<sup>41</sup> The CFTC has pointed to legislative history demonstrating Congress's desire to confine options trading to contract markets.<sup>42</sup> Furthermore, the courts have directly ruled that foreign currency options are not subject to the general exception for interbank foreign currency trading.<sup>43</sup> The CFTC has thus confined options trading to contract markets<sup>44</sup> unless the transaction is subject to an exemption.<sup>45</sup>

In the area of foreign-issued contracts, Congress and the CFTC treated options contracts even more restrictively than their domestic counterparts. Until the Foreign-Issues Rules were promulgated, foreign-issued futures contracts traded on a foreign contract market were subject only to the antifraud rules in force for all futures trading.<sup>46</sup> The CFTC banned foreign-issued options along with their domestic counterparts in 1978.<sup>47</sup> They remained banned, with one notable exception, during the

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<sup>40</sup> The CEA does not expressly prohibit this off-exchange activity. 7 U.S.C. § 2a ("[CFTC] shall have exclusive jurisdiction . . . [over] an option . . . and transactions involving contracts of a sale of a commodity for future delivery, traded or executed on a contract market . . ."). Compare this language with the prohibition of off-exchange trading for futures contracts in 7 U.S.C. § 6 (1982): "It shall be unlawful . . . [to trade] a contract for the purchase or sale of a commodity for future delivery . . . unless (1) such transaction is conducted on or subject to the rules of a [contract market] . . ."

<sup>41</sup> 7 U.S.C. § 6c(b).

<sup>42</sup> 7 U.S.C. § 4. See S. REP. NO. 1131, 93d Cong., 2d Sess. 26 (1974), reprinted in 1974 U.S. CODE CONG. & ADMIN. NEWS 5843, 5870; CFTC v. American Bd. of Trade, 473 F. Supp. 1177, 1182-84 (S.D.N.Y. 1979), *aff'd*, 803 F.2d 1242 (2d Cir. 1986); see also 7 U.S.C. § 4.

<sup>43</sup> The question of off-exchange option trading under the authority of the Treasury Amendment exemption, see *infra* text accompanying notes 61-64, was tested in *American Bd. of Trade*. The court stated that options on foreign currencies were transactions "involving" a commodity regulated under the CEA, 7 U.S.C. § 2, as opposed to "transactions in foreign currency," which were exempted from the CEA by the Treasury Amendment, 7 U.S.C. § 2a, *American Bd. of Trade*, 473 F. Supp. at 1182-83. As a result, off-exchange options trading in foreign currency was stifled.

<sup>44</sup> 17 C.F.R. § 33.3 (1987).

<sup>45</sup> See *infra* notes 56-58.

<sup>46</sup> Until January 4, 1988 (the effective date of the Foreign-Issues Rules, *supra* note 29) the only regulation affecting foreign futures sales were the general antifraud prohibitions in CEA § 4b and CFTC Rule 30.02, 17 C.F.R. § 30.02 (1987). In addition the CFTC imposed a procedural rule in Interpretive Letter 81-1, [1980-1982 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,244, that stated that any person selling foreign futures contracts in the United States must register as a "Commodity Trading Advisor," a market participant status under 7 U.S.C. § 2. Until the Foreign-Issues Rules, the offer and sale in the United States of futures contracts traded on foreign exchanges were generally allowed. The volume of trading, however, was small. See Rainbolt, *United States Policy Toward Foreign Commodity Markets: A Critique*, 5 Nw. J. INT'L L. & BUS. 462, 469-70 (1983); 51 Fed. Reg. 12,104, 12,106 (1985). Nevertheless, Congress explicitly authorized the CFTC to issue regulations to control the offer and sale of foreign futures contracts in the United States. 7 U.S.C. § 6b.

<sup>47</sup> The 1978 suspension of option trading, 43 Fed. Reg. 16,153 (1978), applied to all option trading activity within the jurisdiction of the CFTC. 17 C.F.R. § 32.11 (1987). See T. Russo, *supra* note 9, § 7.05. This ban was later affirmed by Congress in the Futures Trading Act of 1978 ("FTA of 1978"), Pub. L. No. 95-405, 92 Stat. 865 (1978) (codified as amended in scattered sections of 7



years when domestic options were traded under a domestic options pilot program.<sup>48</sup> The one exception was the "Montreal Order" issued in 1986,<sup>49</sup> in which the CFTC announced that it would permit a domestic bank to grant foreign currency options traded on a foreign exchange.<sup>50</sup> Despite this exemption, the CFTC refused to give general approval to other financial institutions, preferring instead to take their proposals on a case-by-case basis.<sup>51</sup>

In August 1987, the CFTC finally promulgated rules that permit the offer and sale of foreign-issued futures and options contracts to United States residents.<sup>52</sup> Consistent with the scheme for domestic-issued futures contracts, the foreign-issued contracts sold to United States residents must be subject to the rules of a contract market.<sup>53</sup> Moreover, foreign-issued futures contracts are now subject to a number of additional "regulatory safeguards" designed to make them comparable to domestic-issued futures.<sup>54</sup>

Foreign-issued options are even more strictly scrutinized by the CFTC. Under the new rules, these instruments are not allowed to be sold or offered in the United States under an objective approval process like their futures counterparts. Foreign-issued options can only be sold by direct order of the CFTC on a case-by-case basis.<sup>55</sup> This rule is con-

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U.S.C.). The FTA of 1978 gave the CFTC specific authority to control options trading. 7 U.S.C. § 6c(c)(all option transactions in the regulated commodities under 7 U.S.C. § 2 are prohibited until the CFTC promulgates rules to regulate this activity).

<sup>48</sup> The CFTC initiated the process of designing a three year pilot program on November 3, 1981. 46 Fed. Reg. 54,500 (1981). Although the pilot program did not involve any foreign currency options, this program was the first step which eventually led to foreign currency options trading on domestic markets. Congress specifically authorized implementation of a pilot program for exchange traded options under 7 U.S.C. § 6c(c). Domestic foreign currency options were traded under the ever expanding pilot program for nonagricultural options until the CFTC made the program permanent. 51 Fed. Reg. 17,465 (1986). Congress affirmed this action in the FTA of 1986 at § 3, which repealed former CEA § 4c(c) and substituted a new text. 7 U.S.C. § 4c(c).

<sup>49</sup> 51 Fed. Reg. 12,698 (1986).

<sup>50</sup> The CFTC recognized that banks were commercial users of foreign currency, able to "purchase and offset put and call options on foreign currencies that are traded outside the United States" pursuant to the trade option exemption. *Id.* While the trade option exemption does not address the status of the option grantor, it is evidence that many commercial enterprises should be treated differently from the general public. *See infra* note 58 and accompanying text.

<sup>51</sup> 51 Fed. Reg. 12,698, 12,699 (1986).

<sup>52</sup> 52 Fed. Reg. 28,980 (1987).

<sup>53</sup> *Id.* at 28,987.

<sup>54</sup> The Foreign-Issues Rules, *supra* note 29, add part 30 to the CFTC regulations, found at 17 C.F.R. § 30 (1987). Part 30 provides a full scheme of registration and reporting requirements for foreign-issued futures and options contracts, despite the fact that these contracts are traded on foreign markets under those markets' own regulations. The CFTC has no jurisdiction over a foreign contract market. 7 U.S.C. § 6(a). Therefore, under the authority of 7 U.S.C. § 6(b), the CFTC regulates only the domestic marketing of these instruments.

<sup>55</sup> 52 Fed. Reg. 28,980, 28,998 (pt. 30.3)(1987)(to be codified at 17 C.F.R. § 30.3).

sistent with the Montreal Order and pre-rulemaking policy toward foreign-issued options.

### C. Off-Exchange Foreign Currency Contracts

The CFTC has strongly resisted allowing any off-exchange trading of risk-shifting instruments. No off-exchange trading is permitted unless it is subject to an exception in the CEA. The three major exceptions are the forward contract exclusion,<sup>56</sup> the Treasury Amendment,<sup>57</sup> and the trade option exemption.<sup>58</sup>

Since the enactment of the Future Trading Act of 1921,<sup>59</sup> the commodities trading regulatory scheme has always excluded cash transactions in the spot or forward markets from its jurisdiction.<sup>60</sup> This forward contract exclusion is carried over in the CEA and applies to any cash foreign currency transaction. However, the far more important exemption for foreign currency is the Treasury Amendment.

The Treasury Amendment specifically exempts "transactions in foreign currency" and several enumerated financial instruments from the general ban on off-exchange trading.<sup>61</sup> Although the effect of this exemption is still debated,<sup>62</sup> the CFTC views it as merely a confirmation of the

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<sup>56</sup> 7 U.S.C. § 2. See *infra* note 60 and accompanying text.

<sup>57</sup> 7 U.S.C. § 2.

<sup>58</sup> *Id.* § 6c(c). For the excepting regulation, see 17 C.F.R. § 32.4 (1987). One other exemption from the general scheme is the dealer option exemption found in 7 U.S.C. § 6c(d); 17 C.F.R. § 32.12 (1987). This exception is not important for foreign currency trading. See Gilberg, *supra* note 4, at 1650. For a general explanation, see T. Russo, *supra* note 9, § 7.06.

<sup>59</sup> Pub. L. No. 67-66, 42 Stat. 187 (1921) (declared unconstitutional as an improper exercise of the taking power in *Hill v. Wallace*, 259 U.S. 44 (1922), and replaced by the Grain Futures Act of 1922, Pub. L. No. 67-331, 42 Stat. 998 (1921)).

<sup>60</sup> Spot refers to a "[m]arket of immediate delivery of the product and immediate payment." CFTC Glossary, *supra* note 4, at 151. It is a cash market. See generally Committee on Commodities Regulation of the Bar of the City of N.Y., *The Forward Contract Exclusion: An Analysis of Off-Exchange Commodity Based Instruments*, 41 BUS. LAW. 853, 856-59 (1986) (legislative history of the forward contract exclusion) [hereinafter *N.Y. Bar Comment*]. The CEA excludes this forward cash market activity by stating that "[t]he 'term future delivery,' as used in this chapter, shall not include any sale of any cash commodity for deferred shipment or delivery." 7 U.S.C. § 2.

<sup>61</sup> The Treasury Amendment included in the CFTCA of 1974 states: "Nothing in this chapter shall be deemed to govern or in any way be applicable to transactions in foreign currency, security warrants, security rights, resales of installment loan contracts, repurchase options, government securities, or mortgages and mortgage purchase commitments, unless . . . for future delivery on a board of trade." 7 U.S.C. § 2. Congress added this exemption for currency trading in the cash markets at the insistence of the Department of the Treasury. Letter from Donald L.E. Ritger, Acting General Counsel to Hon. Herman E. Talmage, Chairman, Committee on Agriculture and Forestry (July 30, 1974), reprinted in S. REP. NO. 1131, *supra* note 42, at 499-501, 1974 U.S. CODE CONG. & ADMIN. NEWS at 5887-89.

<sup>62</sup> See Stassen & Young, *Exchange Trading for Futures and Options*, 19 Rev. Sec. & Comm. Reg. 258 (Dec. 10, 1986) (supporting the restrictions on off-exchange trading and the CFTC's limited

present exemption.<sup>63</sup> Moreover, the CFTC has adopted the position that transactions involving members of the general public are not exempted.<sup>64</sup> Instead, the CFTC confines the exemption to transactions among large institutional participants, banks, and other sophisticated investors.<sup>65</sup>

The trade option exemption allows the off-exchange purchase of options for a purchaser who is a "producer, processor, commercial user of, or a merchant handling" the underlying commodity.<sup>66</sup> Although no specific congressional guidelines defining the scope of this exemption exist,<sup>67</sup> the CFTC has developed the boundaries through interpretive letters and rulemaking. These CFTC regulations appear to exempt banks and qualified corporations<sup>68</sup> with non-speculative purposes,<sup>69</sup> but generally do

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interpretation of the Treasury Amendment); Gilberg, *supra* note 4, at 1655-59 ("Despite the unequivocal terms of the Treasury Amendment itself, the legislative history is at best unclear.").

<sup>63</sup> See CFTC Interpretive Letter No. 84-7, Banking Institutions as Purchasers of Foreign Currency Options, [1982-1984 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,025 (Feb. 22, 1984) [hereinafter CFTC Letter 84-7]; Notice of Statutory Interpretation, 50 Fed. Reg. 42,983 (1985).

<sup>64</sup> 50 Fed. Reg. 42,983-84 (1985).

<sup>65</sup> *Id.*

<sup>66</sup> The trade option exemption is found at 17 C.F.R. § 32.4 (1987). This regulation contains a "reasonable belief" standard for the offeror when determining whether the offeree is a "producer, processor, or commercial user" of the commodity which is the subject of the option. However, the CEA contains no such standard. The trade option exemption removes parties from the general prohibition on option trading in 7 U.S.C. § 6c(c), but not the antifraud provisions in 17 C.F.R. §§ 32.8, 32.9 (1987) and the prohibited commodities of § 32.2. See also T. RUSSO, *supra* note 9, § 7.14.

The relaxation of the off-exchange options ban is in part due to the CFTC's belief that persons purchasing options contracts under the trade options exemption did not need the protection of the CFTC, while the general public was protected by the extensive regulation. See 50 Fed. Reg. 10,790 (1985)(trade option exemption is applicable to a commercial user class "which does not require extensive protection by the [CFTC]").

<sup>67</sup> Congress repealed 7 U.S.C. § 6c(c) in the FTA of 1986, including the language of the trade option exemption. Congress made clear, however, that it did not intend the repeal to affect the existing law that allows trade option exemptions. H. REP. 624, *supra* note 26, at 17-18, 1986 CODE CONG. & ADMIN. NEWS at 6018-19. In doing this, Congress approved of CFTC interpretations of the trade option exemption.

<sup>68</sup> The CFTC's most illustrative interpretation appeared in CFTC Letter 84-7, *supra* note 63. The CFTC took a no-action position against a United States bank that purchased a foreign currency option sold through a foreign contract market. The requirements of commercial dealing in the commodity would be satisfied when the bank purchased the options for its own account and the bank had a direct relationship for the underlying foreign currency. *Id.* at 28,595. The rules for non-financial businesses are not clear. See Gilberg, *supra* note 4, at 1652 n.226. Nevertheless, there is a market for over-the-counter options on foreign currencies. See *Controlling Risk With Foreign Currency Options*, EUROMONEY, Feb. 1985, at 2 (Supp.)[hereinafter *Foreign Currency Options Supp.*].

<sup>69</sup> Nonspeculative transactions may be bona fide hedge transactions under 17 C.F.R. § 1.3(z) (1987), and the hedging clarification at 52 Fed. Reg. 27,195 (1987). However, a strict § 1.3(z) bona fide hedge is not the only type of transaction which is non-speculative. See Markham, *The Role of the Commodity Futures Trading Commission in International Commodity Transactions*, 18 GEO. WASH. J. INT'L L. & ECON. 581, 606 (1985). This leaves some flexibility for non-financial institutions using foreign currency options under the trade option exemption. The CFTC also clarified that

not permit foreign currency dealers or options writers to trade off-exchange.<sup>70</sup>

### III. THE BENEFITS AND COSTS OF HEDGING FOREIGN CURRENCY FLUCTUATION RISK

During the past decade, the global economy has undergone profound changes which have affected the source and volatility of exchange rate risk.<sup>71</sup> International trade in goods and services has grown rapidly,<sup>72</sup> as has the world financial system.<sup>73</sup> Both of these changes necessitate a vast increase in the number of currency transactions.<sup>74</sup> An

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the trade option exemption applied only to commercial enterprises and that future commission merchants, defined at 17 C.F.R. § 1.3(p) and floor traders, defined at 17 C.F.R. § 1.3(x), who have only indirect contact with the underlying commodities would not qualify as commercial users. CFTC Letter 84-7, *supra* note 63, at 28,595.

<sup>70</sup> The activity of buying and selling options is different from granting options. The grantor writes the option contract, put (sell) or call (buy), receives a payment (premium) from the purchaser, then has no further obligation unless the option is exercised. Upon the exercise of the option, the grantor must fulfill his part of the agreement by either buying or selling the commodity from or to the other party. The plain language of the trade option exemption does not address grantors. In 1978, however, the CFTC expressed its view that persons eligible to use the trade option exemption could grant an option on a foreign exchange. 43 Fed. Reg. 54,220, 54,222 (1978) (final rule adopting statutory requirements for dealer options, pursuant to 7 U.S.C. § 4c(d)(2)). It later reversed this position. See CFTC Letter 84-7, *supra* note 63, at 28,585 n.12 ("trade option exemption does not authorize banks or any other person to grant options on a foreign exchange.").

<sup>71</sup> Perhaps the greatest change affecting currency risk was the abandonment of the Bretton Woods System in March 1973. During the period of fixed but adjustable exchange rates, 1944-1973, currency rates remained relatively stable. The member nations of the International Monetary Fund ("IMF") were required to notify the other members of any changes. Devaluations or revaluations greater than 10% were required to be approved by the IMF. Even changes smaller than 10% were unpopular. See J. HOGENDORN & W. BROWN, *THE NEW INTERNATIONAL ECONOMICS* 55-62 (1979). Risk management in this environment was not difficult. The direction of a change in the value of a currency was generally known, so the only variable was the magnitude. Taking a speculative position in this situation is characterized as a "one-way option." *Id.* at 58. For a good explanation of the role of the IMF in the Bretton Woods System, see A. LOWENFELD, *INTERNATIONAL MONETARY SYSTEM* 80-279 (2d ed. 1984).

<sup>72</sup> Between 1971 and 1980 world trade in goods and services doubled to reach more than 15% of global gross national product. J. BARTON & B. FISHER, *INTERNATIONAL TRADE AND INVESTMENT* 23 (1986). More businesses are involved in the international marketplace than at any other time in history. See Drucker, *supra* note 1, at 782; *Foreign Currency Options Supp.*, *supra* note 68, at 1.

<sup>73</sup> Even though there is some evidence that growth in international trade may be slowing down, international investment is still booming. *From World Trade to World Investment*, Wall St. J., May 26, 1987, at 30, col. 3 (Midwest ed.). However, the current trend is towards real investments, such as factories and real estate, rather than financial investments, as in the past decade. *Global Finance and Investing*, Wall St. J., Sept. 18, 1987, § 4 (Special Report) (Midwest ed.) (discussion of real investments); *A Survey of the Euromarkets*, *THE ECONOMIST*, May 16, 1987 (Supp.) (discussion of the lapse in some Euromarket activity).

<sup>74</sup> Foreign exchange transactions have reached the level of about \$35 trillion per year, twelve times the level of trade in goods. Drucker, *supra* note 1, at 782.

important trend in this recent growth is the internationalization of financial markets, formally through physical links in the stock exchanges<sup>75</sup> and commodities markets,<sup>76</sup> and informally through parallel trading times and branch offices in different time zones throughout the world.<sup>77</sup> This growth is marked by the rise of international financial services industries as a powerful separate force in the global economy. One prominent scholar has described the phenomenon as an "uncoupling" of the financial markets from the goods markets.<sup>78</sup> The independence of the burgeoning financial markets make foreign currency volatility greater than ever.<sup>79</sup> This increased trade and investment causes more businesses than ever to bear currency risk.

The changes in the world economy make the international marketplace a different place in 1987 than it was a mere decade ago. Conse-

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<sup>75</sup> Bernard, *Case Studies in International Market Structure Issues: Market and Clearing Linkages*, in BROKER-DEALER INSTITUTE 1986 (Practicing Law Institute, Corporate Law and Practice Course Handbook No. 539, 1986).

<sup>76</sup> Perhaps the most prominent link is the arrangement between the Chicago Mercantile Exchange ("CME") and the Singapore International Monetary Exchange. See Comment, *Extraterritorial Application of United States Commodity and Security Laws to Market Transactions in an Age of Transcontinental Trading Links*, 7 NW. J. INT'L L. & BUS. 351 (1985); see also *Chicago, Singapore Link Is Now Open For Trading*, Wall St. J., Sept. 7, 1984, at 41, col. 2 (Midwest ed.). The Amsterdam, Montreal, Vancouver, and Sydney Options Exchange have also linked. See *Exchanges Move Slowly Towards Links to Provide Round-the-Clock Trading*, Wall St. J., Sept. 29, 1986, at 32, col. 3 (Midwest ed.); *Clockwise*, THE ECONOMIST, Nov. 15, 1986, at 103, col. 1. Exchanges are also linking with clearing houses to provide faster, less expensive global settlement. See *Clearing Futures*, THE ECONOMIST, Sept. 13, 1986, at 82, col. 2.

<sup>77</sup> For example, the interbank market is a well-established 24-hour market. See R. KUBARYCH, FOREIGN EXCHANGE MARKETS IN THE UNITED STATES 8 (rev. ed. 1983). Contract markets are attempting to catch up through non-physical links as well. See *CBOT Opening of Night Session Attracts Throng*, Wall St. J., May 1, 1987, at 28, col. 5 (Midwest ed.); *Comex Considers Night Trading in Gold*, Wall St. J., Aug. 10, 1987, at 32, col. 3 (Midwest ed.); cf. *Foreign Links by Exchanges Lose Appeal*, Wall St. J., Sept. 21, 1987, at 32, col. 1 (Midwest ed.) (discussing moves away from a physical link and into electronic trading); *Chicago Merc and Reuters Plan System To Allow Exchange to Trade 24 Hours*, Wall St. J., Sept. 3, 1987, at 4, col. 2 (Midwest ed.) (summarizing plans to establish 24-hour trading through international computer links). Large financial institutions have branch offices in the various money centers that allow them to "pass the book" from zone-to-zone in order to trade on a unitary strategy. *Endless Dealing*, Wall St. J., Sept. 10, 1986, at 1, col. 1 (Midwest ed.).

<sup>78</sup> Drucker, *supra* note 1, at 786-88. Also relevant to the vastly increased foreign exchange transactions are new models on exchange rate determination which view foreign currency as an asset, rather than a good. Under this view, exchange rates are not determined by flows of goods and services, but by desires to hold short-term assets. Short-term capital movements play a major role in the determination of exchange rates in the asset models. See Mussa, *Empirical Regularities in the Behavior of Exchange Rates and Theories of the Foreign Exchange Market*, J. MONETARY ECON. 9 (Supp. to the Carnegie-Rochester Conference Series on Public Policy, 1979).

<sup>79</sup> R. KUBARYCH, *supra* note 77, at 4; see also *Dollar's Plunge Raises Doubts in Washington About Possible Impact*, Wall St. J., Jan. 20, 1987, at 1, col. 6 (Midwest ed.); *EMS Strains Relieved for Now but New Alignment is Vulnerable*, Wall St. J., Jan. 13, 1987, at 37, col. 1 (Midwest ed.).

quently, congressional goals for regulation of foreign currency futures and options must change as well. The scheme should continue to guard against fraud and abuse, but it should also encourage self-help competitiveness on the part of any private parties affected by foreign currency fluctuation risk.

A. The Players in the International Marketplace

1. *Businesses Directly Affected by Foreign Currency Fluctuations*

Businesses involved in the export or import of a good or service must deal with the financial reality of foreign currencies. All businesses involved with production and distribution of such products assume a price risk before resale.<sup>80</sup> The ultimate exporter or importer also assumes the risk that the value of the product or service will change due to the fluctuation of the foreign currency involved, relative to its domestic currency.<sup>81</sup> This necessary currency risk may directly affect the profitability of a transaction.

From the standpoint of currency risk, financial service businesses which trade financial instruments are very similar to companies in the goods and nonfinancial services sector. Financial instruments are products, and when they are denominated in a foreign currency they require a currency translation transaction. These financial products also may change hands during a distribution process similar to that in the non-financial goods and services market. When a financial instrument is denominated in a currency other than the holder's own, the holder bears both price risk and foreign exchange risk. In this way, non-financial services are indistinguishable from financial services (excluding pure foreign currency services) for the purposes of describing direct foreign currency risks.

2. *Businesses Indirectly Affected by Foreign Currency Fluctuations*

The second category of businesses affected by foreign currency fluctuations includes any business competing with foreign competitors at home or abroad. The foreign currency risk for these businesses does not result from short-term currency fluctuations.<sup>82</sup> Rather, an indirect long-

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<sup>80</sup> Rinehimer, *Hedging*, in HANDBOOK OF FUTURES MARKETS: COMMODITY, FINANCIAL, STOCK INDEX, AND OPTIONS 9.7 (P. Kaufman ed. 1984)[hereinafter FUTURES HANDBOOK].

<sup>81</sup> *Id.*

<sup>82</sup> See *Companies and Currencies*, THE ECONOMIST, Apr. 4, 1987, at 81; *Currency Trades Again Aid Bank Results*, Wall St. J., July 27, 1987, at 25, col. 1 (Midwest ed.). The term "foreign currency market" does not usually refer to a physical place; foreign currencies are traded internationally by thousands of participants, generally by electronic transfer of funds. The market for foreign currency is one in which the currencies, or "means of national payments," are traded. R. DUFY & I. GIDDY,

term risk from price trends of a business's home currency may make the competitor's products relatively cheap compared to other currencies.<sup>83</sup> When such currency realignment occurs, the foreign competitor may cut prices in an attempt to increase its market share or maintain its price structure, thereby increasing profitability.<sup>84</sup>

This type of long-term risk is a fundamental element of international competition. Exchange rates are no longer merely a mechanical transaction collateral to a transaction in goods, services or financial instruments, but also influence whether those transactions will occur in the first place. Thus, the exchange rate has become part of the comparative advantage equation of international competitiveness, an equation vastly different from the comparative advantage expressed in the traditional elements of labor, land, and capital.<sup>85</sup>

Businesses in such competitive product markets must be aware of this indirect foreign currency risk. Moreover, businesses must realize that they may need to forego competition altogether in some product markets due to the comparative advantage in currency values. This comparative advantage problem is not unsolvable, however. For this long-term problem, currency risk management can serve to increase the competitiveness of affected businesses.<sup>86</sup>

## B. The Benefits Derived From Foreign Currency Hedging

Given the current state of the world economy and the size and diversity of the international marketplace, the potential benefits of diverse risk management techniques are tremendous. It is axiomatic that businesses can and must improve their competitiveness in order to survive. Even businesses which traditionally did not think of themselves as participants in the international economy must now come to grips with the threat of indirect foreign currency fluctuation risk. Before examining some of the techniques used to manage risk, it is useful to explore further the nature of this risk.

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THE INTERNATIONAL MONEY MARKET 5 (1978). This market should be contrasted with contract markets. See *supra* notes 10-11.

<sup>83</sup> *Companies and Currencies*, *supra* note 82, at 83.

<sup>84</sup> *Most U.S. Firms Seek Extra Profits in Japan at the Expense of Sales*, Wall St. J., May 15, 1987, at 1, col. 6 (Midwest ed.); *Nations' Devaluations of Currencies Spark a Global Trade War*, Wall St. J., Dec. 22, 1986, at 1, col. 6 (Midwest ed.).

<sup>85</sup> Drucker, *supra* note 1, at 786-88.

<sup>86</sup> *Id.*; see also *Companies and Currencies*, *supra* note 82, at 83.

*1. The Economics of Foreign Currency Transactions and  
Foreign Currency Risk*

There are three types of foreign currency transactions and four associated foreign currency risks. The first and best known type of transaction is that necessary to complete an international sale of goods or services.<sup>87</sup> Since foreign currency must be used for any purchase or sale of a commodity denominated in that foreign currency, this transaction is a common one. To complete the transaction, the parties must bear a foreign currency price risk ("necessary risk"). Necessary risk also arises from the purchase or sale of foreign equity or debt instruments. Thus, two types of price risk arise from all international transactions: one for the value of the underlying commodity and one for the necessary risk of the foreign currency.

The second type of foreign currency transaction, speculative transactions,<sup>88</sup> is distinct from that used to accomplish international sales and investments. Speculative transactions involve currency trading unaccompanied by underlying sales or investments. Here risk is speculative since it is not necessary to complete the underlying transaction. However, the speculator is often used by other parties to assume some or all of the necessary risk associated with a transaction.<sup>89</sup> Thus, the conceptual difference between speculative and necessary risk turns on whether the currency risk is undertaken alone or in order to complete a transaction in goods or services.

Hedging is a third type of foreign currency transaction performed to reduce currency risk. Hedging is a position taken opposite to an existing or expected cash position in a commodity,<sup>90</sup> and is a means of offsetting the risk of loss of value in assets due to price fluctuations.<sup>91</sup> Foreign currency hedging offsets currency fluctuation risk.<sup>92</sup> The risk hedged against may have arisen from an initial speculative position or from a necessary risk associated with a transaction for goods, services, or investment. The conceptual difference between risk-bearing activity (speculative or necessary) and hedging turns on whether the party assumes risk where none existed before, or shifts existing risk.

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<sup>87</sup> See *infra* note 127 and accompanying text.

<sup>88</sup> Speculators take on price risk for the purpose of gaining profits "through the successful anticipation of price movements." CFTC Glossary, *supra* note 4, at 151. See also *Speculation*, in FUTURES HANDBOOK, *supra* note 80, at 9.7.

<sup>89</sup> See Rogers & Markham, *supra* note 3, at 277-79.

<sup>90</sup> CFTC Glossary, *supra* note 4, at 140; see also FUTURES HANDBOOK, *supra* note 80, at 9.8.

<sup>91</sup> 52 Fed. Reg. 27,196; see also H. REP. NO. 624, *supra* note 26, at 45-46, 1986 U.S. CODE CONG. & ADMIN. NEWS at 6046-47.

<sup>92</sup> Rogers & Markham, *supra* note 3, at 277 n.14.



The final risk associated with international competition is indirect foreign currency risk.<sup>93</sup> This risk may also be shifted through hedging,<sup>94</sup> even though it does not arise directly from a transaction but rather from increased costs or prices relative to a foreign currency.<sup>95</sup> Although it arises indirectly, it is conceptually related to the direct risk found in transactions requiring currency exchanges for goods, services, or investment. Consequently, currency transactions designed to offset this indirect risk should be characterized as hedging rather than speculation.

## 2. *Available Risk Management Techniques*

Effective exchange risk management protects a business from the detrimental effects of both long-term and short-term movements in a foreign currency. Businesses which trade or invest in the international marketplace are subject to three kinds of foreign exchange risks: 1) loss of sales revenue value; 2) loss of value in working capital devoted to overseas enterprises; and 3) loss of value in foreign investments.<sup>96</sup> These foreign exchange risks manifest themselves in two ways: 1) through accounting risk, due to periodic translation into dollars and reporting of all aspects of foreign operations denominated in a different currency;<sup>97</sup> and 2) economic risk, which is the actual effect of exchange rate fluctuations on the profitability of overseas operations.<sup>98</sup> Management of these risks is difficult,<sup>99</sup> but can be accomplished through several alternatives.

### a. Off-exchange methods

Although accounting risk is important to financial reporting, the greater currency exchange danger to businesses results from economic risk.<sup>100</sup> Economic risk stems from the actual need to convert currencies, rather than to translate them solely for accounting purposes.<sup>101</sup> Reduction of economic risk was the primary reason for creation of the futures

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<sup>93</sup> This is long-term economic risk arising out of a realignment in the value of the currency of one party against the value of a foreign currency. See *supra* text accompanying notes 82-86.

<sup>94</sup> See Drucker, *supra* note 1, at 787; *Companies and Currencies*, *supra* note 82, at 83.

<sup>95</sup> This type of risk is now a real and substantial one borne by competitors in the international market. See Drucker, *supra* note 1, at 787.

<sup>96</sup> See W. STRENG, *INTERNATIONAL BUSINESS TRANSACTIONS TAX AND LEGAL HANDBOOK* 517 (1978).

<sup>97</sup> See A. PRINDL, *FOREIGN EXCHANGE RISK* 8-20 (1976).

<sup>98</sup> *Id.* at 21-26.

<sup>99</sup> See *id.* at 1 (companies with extended operations face many problems when trying to manage exchange rate risk).

<sup>100</sup> *Id.* at 21-26.

<sup>101</sup> See, e.g., *FOREIGN CURRENCY TRANSLATION*, Statement of Financial Accounting Standards No. 52, 4-14 (Financial Accounting Standards Board 1981)[hereinafter FASB 52].

markets.<sup>102</sup> The most common way of reducing economic risk is through direct hedging,<sup>103</sup> either wholly or selectively.<sup>104</sup>

Off-exchange hedging takes place in the spot and forward currency markets, as well as through currency swaps.<sup>105</sup> Currently, over-the-counter options on foreign currency are another limited alternative.<sup>106</sup> All of these transactions occur among banks in the interbank market, and among dealers, brokers, and customers off-exchange.<sup>107</sup> The off-exchange domestic and foreign financial markets are linked through electronic funds transfer and information sharing.<sup>108</sup> The existence of these large off-exchange markets provides the means for custom hedging of any currency risk.<sup>109</sup> Nevertheless, these traditional methods often require more time and effort to initiate and maintain the proper positions in these markets. This additional time and effort is necessary despite the close integration of the off-exchange markets.<sup>110</sup>

#### b. Exchange instruments

Exchange futures contracts on foreign currencies became available

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<sup>102</sup> For a discussion of the evolution of market regulation, see *Merrill, Lynch, Pierce, Fenner & Smith v. Curran*, 622 F.2d 216 (6th Cir. 1980), *aff'd on other grounds*, 456 U.S. 353 (1982), *quoted in* H. REP. NO. 565, 97th Cong., 2d Sess. 73, *reprinted in* 1982 U.S. CODE CONG. & ADMIN. NEWS 3871, 3922. For a general discussion of hedging, see P. JOHNSON, *supra* note 14, at xxviii.

<sup>103</sup> See A. PRINDL, *supra* note 97, at 58-69; W. STRENG, *supra* note 96, at 514-17.

<sup>104</sup> Some risk management strategies leave certain risks uncovered by hedges. See, e.g., *Foreign Currency Options Supp.*, *supra* note 68, at 6. Although leaving a risk uncovered is sometimes characterized as speculation, see FUTURES HANDBOOK, *supra* note 80, at 9.7, this action is distinguished conceptually in that the risk uncovered is necessary risk, not speculative risk. See *supra* text accompanying notes 87-95.

<sup>105</sup> "A swap is a pair of spot and forward transactions in which the forward transaction offsets or unwinds the spot transaction." M. STIGUM, *THE MONEY MARKET: MYTH, REALITY AND PRACTICE* 134 (1978). This transaction limits foreign exchange risk during the period in which the forward contract is held.

<sup>106</sup> See Gilberg, *supra* note 4, at 1648-50; *Foreign Currency Options Supp.*, *supra* note 67 (comparing over-the-counter ("OTC") options to listed options).

<sup>107</sup> See R. KUBARYCH, *supra* note 77, at 7-16.

<sup>108</sup> See *A Survey of International Banking*, THE ECONOMIST, Mar. 21, 1987, at 7 (Supp.); *Is Your Stockbroker User-Friendly?*, THE ECONOMIST, Oct. 25, 1986, at 79 (discussing electronic innovations). The money market is a credit market in which short-term claims are allocated over time, depending on the interest rates available. The domestic money market is the short-term credit market for a single country; the Eurocurrency market is any short-term credit market in domestic currency external to the domestic money market. Longer-term credit markets are called capital markets. Using these markets to shift risk arising out of currency fluctuations reinforces their interdependence. See H. RIEHL & R. RODERIQUEZ, *FOREIGN EXCHANGE MARKETS* 4-11 (1977). Cf. R. DUFY & I. GIDDY, *supra* note 82, at 4-9 (rejecting the usual distinction between money and capital markets according to maturity of instruments).

<sup>109</sup> *Tailor-made 'Hedges' Appeal to Big Corporate Clients*, Wall St. J., Dec. 18, 1986, at 6, col.1 (Midwest ed.).

<sup>110</sup> See *supra* note 106.

in 1972.<sup>111</sup> These instruments allow hedging against (or speculating on) foreign currency movements and are useful risk management tools.<sup>112</sup> The benefits of exchange instruments arise primarily from the structure of the trading market and the design of the exchange contract. All provisions of exchange contracts (save price) are standardized; the price is set through active and ongoing trading. The contracts are sponsored by the exchange and its clearing house, and thus exchange contracts carry few of the risks inherent in a forward contract.<sup>113</sup>

The support of a clearing house and the relative ease in trading on the contract market attract many hedgers and speculators. As a result, sufficient and regular demand for a particular type of contract generates a substantial trading volume. This market liquidity benefits all participants by enhancing confidence in the market and ensuring that risks may be easily shifted by the participants.<sup>114</sup> The significant differences in market structure between off-exchange transactions (cash and over-the-counter markets) and exchange transactions make exchange contracts a valuable alternative for hedging foreign currency risk.

### 3. *Increased Competitiveness through Risk Management Alternatives*

The role of futures and options contracts is growing in the portfolio of risk management techniques. Each business has a unique set of financial needs and can benefit from the existence of a variety of risk management choices for tailoring its particular hedging needs. As futures and options contracts are better understood as risk management tools, they become more popular.<sup>115</sup>

International competition depends on how well businesses can man-

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<sup>111</sup> CHICAGO MERCANTILE EXCH., 1985 ANNUAL REPORT 12 (1986)[hereinafter CME ANNUAL REPORT].

<sup>112</sup> *Dollar's Drop Helps Most Multinationals*, Wall St. J., Sept. 3, 1986, at 6, col. 1 (Midwest ed.). See generally *Foreign Currency Options Supp.*, *supra* note 67 (concentrating on the advantages of listed options on foreign currencies versus OTC options).

<sup>113</sup> CHICAGO MERCANTILE EXCH., A WORLD MARKETPLACE 5 (1985) (available from the Chicago Mercantile Exchange)[hereinafter CME WORLD MARKETPLACE]. Forward contracts, however, are privately negotiated, making the parties bear the risk of nonperformance or other breach.

<sup>114</sup> See *id.* at 5-6; P. JOHNSON, *supra* note 14, § 1.15 (shifting risk).

<sup>115</sup> In 1981 Dufey & Giddy described foreign exchange options as only a minor success in the international financial markets. Dufey & Giddy, *Innovation in the International Financial Markets*, 12 J. INT'L BUS. STUD. 33 (1981). However, foreign currency options and futures are now a tremendous success. From 1975 to 1985 currency futures trading volume on the CME has increased a hundred fold. CME ANN. REP., *supra* note 111, at 10. CHICAGO MERCANTILE EXCH., TRADING AND HEDGING WITH CURRENCY FUTURES AND OPTIONS 3 (1986)(available from the CME)[hereinafter CME TRADING BOOK]; see also Wilkerson, *Hedging the Value of Collective Assets: Financial Institutions Excluded From Regulation as Commodity Pool Operators Under the Commodity Exchange Act*, 42 WASH. & LEE L. REV. 769, 769-74 (1985).

age their currency risk. Therefore, greater access to a wide range of instruments (swaps, futures, and options) in alternative markets (contract and off-exchange) would be a substantial benefit to businesses. In the current world economy, the benefits derived from a range of alternatives for hedging risks may not only be substantial, but essential for effective business competition.

### C. The Costs of Foreign Currency Trading Activity

Risk-shifting activities involving commodities have always been suspect due to potential problems from irresponsible speculation and manipulation.<sup>116</sup> Indeed, since commodity regulation was assumed by the United States in 1921, Congress has justified interference with free market forces by the need to protect producers, consumers, and purchasers from these abuses.<sup>117</sup> At first, Congress was concerned with particular agricultural commodities that it perceived to be vital to the economic health of the country.<sup>118</sup> This focus changed with the introduction of the modern regulatory scheme.

In 1974, Congress passed the Commodity Futures Trading Commission Act ("CFTCA" or "1974 Act"), a substantial restructuring of the CEA of 1936.<sup>119</sup> The CFTCA was designed to regulate the type of activity—futures and options trading—rather than the underlying commodity.<sup>120</sup> This regulatory focus demonstrates congressional concern over the effects of trading activity on users of the commodity. The legislative history of the 1974 Act indicates its broad scope. A wide variety of items were designated as statutory commodities, meant to: 1) provide a uniform regulatory structure for the economic activity of futures and options trading; and 2) facilitate opportunities for economic benefit through this trading's two main purposes (risk-shifting and price discovery).<sup>121</sup> By regulating futures and options trading, Congress intended to protect

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<sup>116</sup> S. REP. NO. 1131, *supra* note 42, at 1, 1974 U.S. CODE CONG. & ADMIN. NEWS at 5844; *see also* P. JOHNSON, *supra* note 14, § 1.16.

<sup>117</sup> A fundamental purpose of the CEA is "insuring fair practice and honest dealing on the Commodity exchanges and providing a measure of control over those forms of speculative activity which often demoralize the markets to the injury of producers, consumers and the exchanges themselves." S. REP. NO. 1131, *supra* note 42, at 1, 1974 U.S. CODE CONG. & ADMIN. NEWS at 5844.

<sup>118</sup> These are the enumerated agricultural commodities found in 7 U.S.C. § 2.

<sup>119</sup> Pub. L. No. 93-463, 88 Stat. 1389 (1974), *amending* 7 U.S.C. §§ 1-26 (1982 & Supp. III 1985).

<sup>120</sup> *See* P. JOHNSON, *supra* note 14.

<sup>121</sup> In the consideration of the FTA of 1978 the Senate expressly recognized that the regulations of the futures trading activity were meant to ensure that businesses would benefit by providing opportunities for safe risk-shifting and price discovery. S. REP. NO. 850, 95th Cong., 2d Sess. 10 (1978), *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS 2087, 2098. Clearly the emphasis of regulation was not just aimed at shutting down the negative effects on investors stemming from fraud and other abuses, but the regulations were also meant to encourage and assist businesses. Trading

the public from abuses which occurred in connection with certain nonfinancial commodities<sup>122</sup> as well as assist legitimate business activity concerning any commodity.<sup>123</sup>

Prior to 1974, however, businesses which were experiencing foreign currency risk exposure during periods of floating exchange rates routinely hedged their positions through the off-exchange cash markets or the interbank market.<sup>124</sup> Additionally, the contract markets had just developed futures contracts on foreign currency, designed to shift risk in transactions in the forward and spot markets.<sup>125</sup> Neither the off-exchange activity nor the new contract market trading of foreign currency instruments appeared to be the source of abuse which made Congress exercise tighter control of futures and options trading.<sup>126</sup>

The practice of hedging foreign currency positions in the forward/futures market arose from a need to protect persons in the international marketplace from negative fluctuations in the value of sales revenue derived in international trade.<sup>127</sup> Many of these businesses or traders were not "sophisticated investors"<sup>128</sup> or financial institutions. They would be classified as "general public" by the Securities and Exchange Commission for failing to meet the statutory requirements in the securities laws.<sup>129</sup>

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foreign currency instruments for risk management purposes does not contradict these Congressional goals.

<sup>122</sup> The most prominent cases of abuse surrounded the "London Options" of the Goldstein-Samuelson operation involving "world" commodities. For a thorough discussion of this scheme, see Long, *The Naked Commodity Options as a Security*, 15 WM. & MARY L. REV. 211-12 (1973).

<sup>123</sup> S. REP. NO. 1131, *supra* note 42, at 14, 1974 U.S. CODE CONG. & ADMIN. NEWS at 5843, 5856.

<sup>124</sup> See Rainbolt, *supra* note 46, at 462; J. HOGENDORN & W. BROWN, *supra* note 71, at 68-69.

<sup>125</sup> See CME ANNUAL REPORT, *supra* note 111.

<sup>126</sup> Foreign currency trading was not cited as a problem in the legislative history of the 1974 Act. Moreover, the Department of the Treasury's successful effort to remove the interbank market from within the jurisdiction of the CFTC is evidence that the Treasury Department is less worried about foreign currency trading abuses and more concerned with the smooth operation of the various foreign currency markets. See Bettleheim & Carey, *Regulating Foreign Options Internationally*, INT'L FIN. L. REV., Sept. 1986 17, 18-19 (citing the Department of Treasury's objections to the CFTC's interpretation of the Treasury Amendment in 50 Fed. Reg. 12,698 (1986)). There have been two cases concerning off-exchange foreign currency option contracts. See *American Board of Trade*, 803 F.2d 1242 (2d Cir. 1986)(no fraud alleged); *CFTC v. Sterling Capital Co.*, [1980-1982 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,389 (N.D. Ga. 1981).

<sup>127</sup> See A. PRINDL, *supra* note 97, at 58-69; W. STRENG, *supra* note 96, at 514-17.

<sup>128</sup> At one time, the courts attempted to define a sophisticated investor in the context of securities laws. See, e.g., *SEC v. Ralston Purina Co.*, 346 U.S. 119 (1953); *Doran v. Petroleum Corp.*, 545 F.2d 893 (5th Cir. 1977), *aff'd on reh'g*, 576 F.2d 91 (5th Cir. 1978). Recently, Congress has defined the status of an accredited investor. 15 U.S.C. § 77b(15)(ii). There is no similar definition in commodities law.

<sup>129</sup> See Rule 215, 17 C.F.R. § 215 (1986).

Congress has sought to protect this class of unsophisticated investors through legislation in both the securities and commodities area.<sup>130</sup> These congressional efforts represent a broad line-drawing approach to protect the unsophisticated public from unscrupulous purveyors of the various financial instruments. Obviously, the costs in terms of public or producer (in the case of some commodities) abuse were perceived by Congress as unacceptable.

#### IV. THE ARGUMENT AGAINST THE CURRENT REGULATORY SCHEME

The current regulation of foreign currency instruments is too blunt for the sensitivity of the world currency markets and is not justified in terms of a cost-benefit analysis. By regulating the activity, Congress sought to prevent fraud and abuse of the general public. Congress also hoped to facilitate growth of the futures markets by eliminating market manipulation and encouraging contract market trading. While this regulatory focus on the type of trading activity may generally accomplish these objectives, foreign currency should be viewed differently.

First, hedge users presently appear to be suffering no abuse from foreign currency instruments.<sup>131</sup> Congressional and CFTC concern for commodity trading abuse in the futures markets was also not premised on hard evidence of abuse in the foreign currency trading.<sup>132</sup> While speculative activity may more readily lend itself to abuse in trading both on

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<sup>130</sup> Extensive regulation in the securities laws seek to protect sales of unregistered securities to unsophisticated investors. See, e.g., Schneider, *The Statutory Law of Private Placement*, 14 REV. SEC. REG. 869 (1981). Similarly, the CFTC attempts to achieve the same goal by its broad restrictions on off-exchange trading. See, e.g., CFTC Letter 84-7, *supra* note 63, at 28,595 (prohibiting a bank from purchasing an option from a foreign exchange as an agent for its customer, who is presumed to be unsophisticated).

<sup>131</sup> Despite these concerns, a recent congressionally mandated study, *A Study of the Effects on the Economy of Trading in Futures and Options presented to the House Comm. on Agriculture*, 98th Cong., 2d Sess. (1985), lent support to the use of futures and options as an important means of risk management. *Id.* at I-8 to I-12. The study determined that financial futures and options markets serve a useful economic purpose by allowing parties to shift risk as needed. This study also determined that most market participants were using the various instruments to hedge rather than speculate. *Id.* at IV-17. There were no significant harmful effects on the economy stemming from this activity. *Id.* at IV-1 to IV-37. It noted that participants in the financial futures markets use these markets to reach a variety of management goals, including foreign currency risk management. *Id.* at IV-17. Using these financial futures to reduce risk is a normal course of operations for many of these commercial enterprises. See generally *id.* at IV-1 to IV-45. Much of the growth in futures and options trading has occurred in the futures and options products which are based on the underlying commodities exempted by the Treasury Amendment, such as foreign currency. *N.Y. Bar Comment*, *supra* note 60, at 869-72.

<sup>132</sup> See 43 Fed. Reg. 16,153, 16,154-55 (1978) (discussion of CFTC's experience with fraudulent practices).

and off exchanges,<sup>133</sup> hedging activity is different. Hedges are placed according to an economic strategy designed to offset an identified risk over a certain time period.<sup>134</sup> Businesses which hedge through contract markets place their trades through brokers, then leave the hedge in place until its economic value is depleted.<sup>135</sup> Hedging does not require daily or even weekly trades in most cases. Off exchange, businesses effect hedges with banks or other parties on a principal-to-principal basis in the cash markets. This activity is based on the same economic risk-shifting strategy as the contracts markets, and has been used by businesses for years.<sup>136</sup> It is not the kind of activity where fraud presents a serious risk.

A good example of the heavy-handedness of the current regulatory approach is in the area of foreign-issued currency instruments. Taking its guidance from Congress, the CFTC insisted on constructing a scheme to extend "comparable" regulatory protection<sup>137</sup> to domestic users of futures and options products "wherever they originate."<sup>138</sup> The rulemaking procedure, therefore, was preoccupied with providing comparable protection to all domestic users of a futures product. Given certain constraints discussed below, the CFTC should not insist on comparable protection, but should instead allow parties to choose whether they want to deal in a potentially less regulated (and protected) market.<sup>139</sup> This type of risk-balancing choice is the essence of a freer market in which all products are not equal. Businesses bearing foreign currency risk should be

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<sup>133</sup> The abuses identified in the past stemmed from speculative trading. *Id.*; see *supra* note 122. Lately, however, many commentators have been questioning the restrictions of off-exchange trading in general. The common theme espoused by the critics is that: the off-exchange market is a good alternative to the contract markets; commercial entities can take care of themselves; and off-exchange markets may even help traders gain experience for the faster-paced contract market trading. See *Off-Exchange Futures Trading Is Rising*, Wall St. J., Mar. 3, 1987, at 10, col. 1 (Midwest ed.); *Future Tense*, THE ECONOMIST, Mar. 14, 1987, at 72.

<sup>134</sup> See FUTURES HANDBOOK, *supra* note 80, at 9.36; *Foreign Currency Options Supp.*, *supra* note 68, at 4-18.

<sup>135</sup> See CME TRADING BOOK, *supra* note 115; *Foreign Currency Options Supp.*, *supra* note 68.

<sup>136</sup> See M. STIGUM, *supra* note 105, at 134-136; R. KUBARYCH, *supra* note 77, at 7-8.

<sup>137</sup> 52 Fed. Reg. 28,980 (1987).

<sup>138</sup> *Id.* at 28,985.

<sup>139</sup> This "freedom of contract" approach toward international contracts between private commercial parties has been affirmed by the United States Supreme Court with respect to arbitration agreements calling for a foreign law forum. *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth*, 473 U.S. 614 (1985); *Scherk v. Alberto-Culver*, 417 U.S. 506 (1974); *Bremen v. Zapata Off-Shore Co.*, 407 U.S. 1 (1972). Allowing United States parties to enter into contracts for foreign-issued options and futures regulated under the laws of another jurisdiction should be no more repugnant than arbitration agreements. Nevertheless, the CFTC generally insists that the foreign market in a link agreement must substantially structure its regulations to meet CFTC standards. CFTC Interpretive Letter No. 84-19, [1984-86 Transfer Binder] 2 Comm. Fut. L. Rep. (CCH) ¶ 22,389 (Aug. 9, 1984) (Singapore-Chicago Mercantile Exchange link); see also 51 Fed. Reg. 12,698-99 (1986) (the Montreal Order).

able to make their own decision on where and at what price to hedge. Yet, to make a meaningful decision, the choices must be available.

Congress and the CFTC should facilitate these private choices rather than restrict them. There is no reason why businesses cannot decide for themselves how much risk they can bear from trading in foreign markets or using foreign-issued instruments. In fact, the CFTC is fully aware of the importance of flexibility towards rulemaking in order to facilitate the development of international markets.<sup>140</sup> Moreover, the CFTC recognizes that United States residents who choose to trade on foreign markets do so voluntarily with knowledge that the CFTC's ability to protect them is more limited.<sup>141</sup> Nevertheless, congressional insistence on comparable protections pervades the recent Foreign-Issues Rules. Regardless of the merits of this approach in general, it is inappropriate for foreign currency instruments.

The other main congressional concern with abuse is that the markets operate efficiently, without distortions from private parties. This concern is irrelevant to foreign currency trading. The very size of the foreign currency markets<sup>142</sup> prevents any serious threat of market manipulation by private traders in the major trading currencies. The vast amounts of foreign currency traded by government and private traders in the foreign exchange markets places it nearly beyond the long-term control of even the combined efforts of central banks.<sup>143</sup> It is improbable that any private manipulation of the market for any of these currencies could ever occur.

Second, Congress sought to encourage the growth of contract markets to facilitate price discovery and risk shifting. In recent years these objectives have been effected by ever increasing restriction of off-ex-

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<sup>140</sup> Recent rulemaking notices expressly recognize the changed nature and importance of the international financial futures markets. See, e.g., 52 Fed. Reg. 28,980 (1987) ("vehicle for harmonizing regulatory programs among international markets, thus facilitating the growth of these markets"); 51 Fed. Reg. 12,104, 12,105 (1986) ("regulations recognize the development of international markets"); 49 Fed. Reg. 29,963, 29,964 (1984) ("growing volume of foreign futures contracts [and] . . . development of proposed links between foreign and U.S. exchanges"); 51 Fed. Reg. 12,698 (1986) ("the scope and nature of the international markets for financial-based instruments has changed significantly since 1978").

<sup>141</sup> 51 Fed. Reg. 12,104, 12,105 (1986) (the CFTC's "recognition that its ability to provide . . . protection to U.S. residents who elect to trade on foreign exchanges is necessarily more limited").

<sup>142</sup> See Drucker, *supra* note 1, at 782. But see *Thin Currency Market Seen Vulnerable to Swings Based on Trading Futures*, Wall St. J., Dec. 22, 1986, at 23, col. 2 (Midwest ed.). Futures trading affecting currency movements, however, is not a serious threat of market manipulation. It is only a threat when most of the large players (central banks and large banks in the interbank market) are not in the market. They could easily step in to protect themselves against unfavorable currency movements.

<sup>143</sup> *Currency Rate Accord Shows Versatility*, Wall St. J., Aug. 22, 1987, at 28, col.1 (Midwest ed.).



change trading in an effort to force all futures and options to be traded on contract markets.<sup>144</sup> This regulatory hammer strengthens the contract markets but limits legitimate alternatives. Both exchange and off-exchange trading should be encouraged as alternatives for risk shifting. An additional benefit stemming from off-exchange alternatives is found in the many potential financial product innovations that might develop. This product innovation is needed by businesses of all sizes to enable them to keep abreast of the protean world markets.

Finally, these costs and benefits should be viewed through a balancing model. Even if some abuse occurs or has occurred in this area, the compelling need for competitive risk management demands that the risk of abuse be measured in relative terms. This model compares the level of actual abuse or other potential market failures to the benefits provided by the activity. While use of this cost-benefit model may not be desirable for other regulated commodities, it is applicable to foreign currency instruments because of their unique character.

The argument that the characteristics of foreign currency make it appropriate for special treatment relies heavily on the hedging function of foreign currency instruments. Businesses derive benefits primarily from the hedging function, not the speculative function. Consequently, this special treatment emphasizes a loosening of the rules controlling hedging activities, not necessarily speculative trading in foreign currency instruments. Although speculation is essential for market liquidity,<sup>145</sup> a blunt approach toward regulating speculative activity may be justified. However, to limit the ability of statutorily defined unsophisticated businesses or traders to use any means available to hedge their positions is an unnecessarily restrictive posture. Reducing the ability of United States businesses to undertake self-help competitive steps is itself "not in the public interest"<sup>146</sup> and contrary to the congressional goal of facilitating business growth.

#### V. A SUGGESTED SCHEME FOR FOREIGN CURRENCY FUTURES AND OPTIONS TRADING ACTIVITY

The goal of the suggested regulatory scheme is to allow United States businesses as much flexibility as possible to hedge both their direct

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<sup>144</sup> See *supra* text accompanying notes 56-70.

<sup>145</sup> H. REP. NO. 975, 93rd Cong., 2d Sess. 138 (1974).

<sup>146</sup> The "public interest" standard is used by the CFTC to measure applications for new products and other proposed regulations. See 7 U.S.C. § 5. Congress was also concerned about various abuses which would harm the "public interest." See S. REP. NO. 1131, *supra* note 42, 1974 U.S. CODE CONG. & ADMIN. NEWS at 5856; see also T. RUSSO, *supra* note 9, § 1.39 (economic and public interest requirements).

and indirect foreign currency risks. Ideally, Congress should amend the CEA to permit some off-exchange futures and options activity in foreign currency. This trading would be in the form of an exception to the regulatory scheme similar to the Treasury Amendment. Alternatively, Congress could make clear that the Treasury Amendment itself, combined with the trade option exemption, is broad enough to encompass off-exchange hedging in foreign currency instruments.

Additionally, Congress should provide clear guidance to the CFTC with respect to exchange-traded futures and options on foreign contract markets. As a regulatory agency, the CFTC has more expertise than Congress for determining and adjusting the regulations relating to trading foreign-issued currency instruments. However, Congress should approach the issue with an eye toward encouraging competitive self-help measures by United States business. This intent, manifested in legislation and legislative history, would assure the CFTC that its goal is to provide all businesses with access to foreign contract markets on more flexible terms.

#### A. Exchange Contracts

Currently, there is a tremendous amount of activity on the United States contract markets,<sup>147</sup> a substantial portion of which is in trading foreign currency instruments.<sup>148</sup> These domestic-issued instruments on contract markets are useful and successful, and the Hedging Clarification reflects the CFTC's facilitation of this type of hedging. These rules encourage domestic exchange hedging as one alternative for businesses.

On the other hand, the new rules controlling foreign-issued futures and options contracts are not really designed to provide a strong alternative to domestic-issued contracts. These foreign-issued instruments are treated with suspicion, almost as an evil caused by consumer demand.<sup>149</sup> Yet, other than unfounded congressional fears of abuse and United States markets' worries about their own competitive advantage,<sup>150</sup> there seems to be no reason why these regulations are necessary. These rules should be amended to permit freer access to these foreign-issued contracts.

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<sup>147</sup> See CME ANNUAL REPORT, *supra* note 111, at 2; *Options for Londoners*, THE ECONOMIST, Dec. 6, 1986, at 97.

<sup>148</sup> H. REP. NO. 624, *supra* note 26, at 7, 1986 U.S. CODE CONG. & ADMIN. NEWS at 6008.

<sup>149</sup> See FUTURES HANDBOOK, *supra* note 80, at 47.12-13 (foreign exchange futures); CME WORLD MARKETPLACE, *supra* note 113, at 5; Bettelheim & Carey, *supra* note 126, at 19.

<sup>150</sup> For example, in the new foreign futures and options rules, 52 Fed. Reg. 28,980 (1987), the foreign exchanges complained that the additional disclosure requirements for foreign-issued contracts "suggested that trading on a foreign exchange is riskier than trading on a U.S. exchange." *Id.* at 28,981.

Keeping in mind that this suggested scheme is designed to benefit domestic businesses, the relaxation of the Foreign-Issues Rules should stress access to this alternative hedging tool. United States businesses need a general commercial exemption similar to the commercial exemption originally proposed by the CFTC in its rulemaking proposal for foreign-issued instruments.<sup>151</sup> This exemption would apply to all businesses which desire to purchase or write a foreign currency instrument as a hedge against currency risk stemming from some other commercial activity. In the case of foreign-issued products, it would permit the exempted entities to transact freely in foreign-issued exchange instruments. The exemption should also generally apply to businesses desiring to shift risk through off-exchange means. The details of the exemption are discussed more fully in the next section.

### B. Off-Exchange Traded Contracts

Congress and the CFTC are more concerned about off-exchange transactions than exchange trading, as evidenced by the narrow interpretations of the trade option exemption and Treasury Amendment. This concern seems reasonable because there are no self-interested contract markets to assist in the prevention of unfair practices off-exchange. Parties who agree to trade futures or options off-exchange rely only on contract rules and negotiation principles to protect themselves.

The restrictive interpretation of the off-exchange trading exemptions may prevent "widows and orphans" from dealing in futures and options instruments off-exchange, but it also imposes high costs on commercial entities. For example, there is no straightforward definition of the difference between a forward contract and a futures or options contract.<sup>152</sup> While the CFTC and the courts have determined several characteristics which are common to each type of contract,<sup>153</sup> new products and new markets will continue to test the boundaries of the currently accepted guidelines. In this situation, the scope of the Treasury Amendment and forward contract exclusion eludes clear definition, leaving an aura of uncertainty. This uncertainty inhibits innovation in the financial markets.

Likewise, the trade option exemption is not clearly defined. The CFTC has explained its application through interpretive letters,<sup>154</sup> but

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<sup>151</sup> 51 Fed Reg. 12,104, 12,107 (1986).

<sup>152</sup> See *N.Y. Bar Comment*, *supra* note 60, at 854.

<sup>153</sup> *Id.* at 879 (forward contracts), 873-75 (futures contracts), 875-76 (options contracts). The differences between a futures and forward contract were noted in *In re Stovall* [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,941 (CFTC Admin. L. Judge Dec. 6, 1979).

<sup>154</sup> See *N.Y. Bar Comment*, *supra* note 60, at 859-62; see also Markham, *supra* note 69, at 604-08.

these do not seem satisfactory in light of the increased use of financial futures by businesses of all types. Unlike the forward contract exemption, the trade option exemption focuses on the parties to the transaction, not the transaction itself.<sup>155</sup> Should the purchaser qualify, then the transaction is legitimate. Therein lies the uncertainty: who qualifies as a “producer, processor, commercial user, or a merchant handling, the commodity involved”? Currently these exemptions must be analyzed on a case-by-case basis.

### *1. The Proposed Scheme*

The Committee on Commodities Regulation of the Association of the Bar of the City of New York (“N.Y. Committee”) addressed delineation of the forward contract (off-exchange) exclusion.<sup>156</sup> The N.Y. Committee proposed a “safe harbor” solution combining elements of the trade option and Treasury Amendment exemptions.<sup>157</sup> The proposal focused on the nature of the parties (certain commercial entities) and suggested that if the parties were eligible by their status, then their off-exchange transactions should fit into the forward or trade option exemption.<sup>158</sup> While this suggestion is a useful step toward reducing the general uncertainty inherent in the exemptions, it does not go far enough.

A foreign currency trading exemption should apply to transactions of *all* businesses desiring to hedge to offset foreign currency risk stemming from commercial activities, regardless of the size or nature of the business. This Comment suggests an exemption which focuses on both the nature of the parties and the particular type of transaction (the hedging function). Like the N.Y. Committee’s suggestion, the parties would have to be of a commercial nature. This proposal, however, would extend the N.Y. Committee’s safe harbor to all commercial entities, regardless of the size or nature of the business. In addition, the present proposal would concentrate on the transaction itself, requiring one of the parties to be placing a hedge against necessary risk,<sup>159</sup> and would only permit hedging activities. This proposal would create a separate exemption for any activity (forward, future, option) rather than attempt to clarify the existing exemptions as does the N.Y. Committee’s proposal. Therefore, this proposal is based both on status and transactional qualifications.

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<sup>155</sup> 42 Fed. Reg. 18,246, 18,252 (1977); *see also* 51 Fed. Reg. 12,698 (1986).

<sup>156</sup> *See N.Y. Bar Comment, supra* note 60.

<sup>157</sup> *Id.* at 899-902.

<sup>158</sup> The N.Y. Committee also noted that the safe harbor was not exclusive and that there are more traditional transactions falling outside the safe harbor. *Id.* at 900.

<sup>159</sup> *See supra* text accompanying note 87 (discussion of necessary risk).

Like the trade options exemption, this proposal would concentrate on one party to the transaction. It would be difficult to find parties on opposite ends of a transaction using it to effect exactly opposite hedges. Consequently, like the trade option exemption, one party need not be hedging (e.g., the option grantor) so long as that party falls into certain commercial categories and is approved by the CFTC. Those categories could be published by the CFTC, and parties could register under them in order to engage in these transactions.<sup>160</sup> Once the commercial entity registered and was approved as a party eligible to take a position opposite the bona fide hedging party, it could enter into these transactions without case-by-case supervision.

## 2. *The Elements of Proof*

The status element for eligibility would be relatively straightforward. Any party acting as a commercial entity which bears necessary foreign currency risk due to commercial operations would be eligible. Proof of this status would be relatively easy. The party desiring to hedge could simply demonstrate that it is a business entity.<sup>161</sup> The party on the opposite side of the transaction, if not hedging, could demonstrate that it was listed on the CFTC's classification list. This demonstration would operate as a prima facie test for parties desiring to hedge, because any party who was not a business entity could not meet the transactional requirement. The parties would be able to rely on the documentation presented. There would be no duty to investigate the representations of each party.<sup>162</sup>

The transactional element, requiring that at least one of the parties be hedging a necessary foreign currency risk, would likewise place no costly burden on the parties. The party desiring to effect the hedge would be required to demonstrate to the other party that it actually bears or will bear necessary foreign currency risk. Any evidence of a commercial transaction or investment would suffice.<sup>163</sup> The opposite party, the

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<sup>160</sup> The N.Y. Committee's suggestion of using the CFTC's current list of trading classifications, Commercial Categories for Options Traders, 52 Fed. Reg. 2920 (1987), is an appropriate list. See *N.Y. Bar Comment*, *supra* note 60, at 899.

<sup>161</sup> Internal Revenue Service tax returns might serve as documentation. Certainly the means chosen should be relatively easy to produce, and preferably would be part of the entities' current documentation.

<sup>162</sup> This is in contrast to the current duty imposed on options writers under the trade option exemption. 17 C.F.R. § 32.4.

<sup>163</sup> Commercial entities must prepare certain documentation under both the Internal Revenue Code and accounting standards. See Blanco, *Fully Hedged Foreign Currency Transactions Involving Debt Instruments: IRS Notice 87-11*, 16 TAX MGMT. INT'L J. 324 (1987); FASB 52, *supra* note 101.

classified commercial currency business, would be entitled to rely on the representations of the party effecting the hedge.

Additionally, the exemption might parallel the requirements imposed by the Financial Accounting Standards Board ("FASB")<sup>164</sup> for determining a hedge. Under the FASB's standards, a foreign currency transaction relating to an investment or commercial transaction is a hedge only when the business declares that the transaction is a hedge and it is effective as a hedge.<sup>165</sup> The business must satisfy these requirements in order to exclude from the net income computations any foreign currency gains or losses. By adhering to the FASB requirements for the purposes of the exemption, businesses are relieved of additional administrative burdens. Their hedging documentation would serve as proof for the reporting requirements of both the accounting and commodities regulatory bodies.

Enforcement of these rules would not be difficult with some minimal reporting requirements. All parties desiring to hedge would have to make a declaration at the time of the transaction. These declarations could be made available to the CFTC, so that if there were any reason to suspect speculative activity, the CFTC could require further proof of the underlying necessary risk being offset. Parties on the commercial classifications list would be registered with the CFTC and could be required to report their transactions with the hedging parties. Of course, this activity would still be subject to the antifraud provisions of the CEA and CFTC regulations.<sup>166</sup>

These considerations characterize a more realistic approach to rulemaking that will facilitate the risk management techniques needed in the current economic climate. The proposed scheme focuses on alternative means of hedging necessary risk. Off-exchange methods should be encouraged as alternatives to the contract markets, not a substitute for them.

## VI. CONCLUSION

The changed state of the international financial markets and the growing involvement of United States businesses in the international marketplace require a new approach to regulation of foreign currency futures trading. The compelling needs of businesses to be competitive and profitable in the current world economy should be weighed heavily in any strict decision to limit the ability of a business to manage its for-

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<sup>164</sup> See *supra* note 101.

<sup>165</sup> FASB 52, *supra* note 101, ¶¶ 20-21.

<sup>166</sup> 7 U.S.C. § 4 (1982); CFTC Rules 32.8-9, 17 C.F.R. § 32.8-9; Rule 30.9, 17 C.F.R. § 30.9.

foreign currency risk. Congress can facilitate self-help competitiveness in United States businesses by adjusting the commodity futures regulatory scheme to accommodate foreign currency risk hedging.

Unfortunately, the financial marketplace continues to evolve rapidly while commodities regulation continues to adjust slowly. The goal of the regulatory scheme for foreign currency should be to provide as many alternatives as possible for businesses to hedge against the ubiquitous foreign currency risk. The two major alternatives are exchange trading and off-exchange trading. Both of these alternatives are important and should be encouraged and strengthened. The controlling regulatory scheme, however, should provide enough flexibility to accommodate financial innovation in both markets. This innovation is essential if the means by which businesses shift risk is to keep abreast of the ever-changing financial markets.

Congress and the CFTC can strengthen both of these major alternatives for hedging foreign currency risk. With the guidelines proposed in this Comment, businesses can have more alternatives immediately and benefit from the future financial innovations<sup>167</sup> in their risk-shifting activity. Although many American businesses do not hedge—out of ignorance or because they do not see the current alternatives as being cost effective for their businesses—this does not mean that they will not hedge in the future.

By providing more alternatives, Congress would encourage advisory and brokerage services for small businesses as well as large ones. New foreign currency instruments could be created in smaller denominations to allow small businesses to take advantage of hedging.<sup>168</sup> Also, new long-term hedging instruments for protecting against terms-of-trade currency adjustments might be further developed.<sup>169</sup> Skeptics who point to the system now and say that the demand is weak even for foreign currency contracts on some exchanges underestimate the power of the free market incentives. Congress and the CFTC should undertake the duty to encourage the education of all United States businesses. Consistent with this duty to promote and educate, Congress should provide a regu-

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<sup>167</sup> Such innovations are common in the current financial climate. See Dufey & Giddy, *supra* note 115; *A Survey of International Banking*, *supra* note 108, at 39-40; *Currency Warrants Get a Financing Role*, Wall St. J., July 24, 1987, at 22, col. 1 (Midwest ed.); *Interest-Rate Differences in Currencies Protected From Change by New Product*, Wall St. J., Jan. 27, 1987, at 37, col. 2 (Midwest ed.).

<sup>168</sup> Cf. *Foreign Currency Options Supp.*, *supra* note 68, at 18-20 (discussing small corporations and their use of listed options as a risk management tool). Likewise, new off-exchange instruments might be developed to provide small corporations an alternative for more customized hedging.

<sup>169</sup> *Companies and Currencies*, *supra* note 82, at 83.

latory scheme that gives all businesses a wide variety of choices to shift their foreign currency risk.

To a large extent the benefits and costs that are to be weighed cannot be fully quantified, so a strict numerical decision-making process is not possible. Yet, this strict measure of value is not necessary for determining when benefits outweigh costs. Given the current state of the economy and integration of international business, the CFTC and Congress should not need numbers to recognize the efficacy of a more relaxed regulatory approach toward foreign currency contracts trading. The potential benefits of such a system should create a presumption that these risk management techniques are worthwhile. This presumption of worth is rebuttable by strong evidence of high cost in terms of public abuse, which might nullify most of the benefits to business competitiveness. The suggested reforms are a means of making the regulatory scheme more efficient. The benefits derived from reducing uncertainty and transaction-type costs are great. On the other hand, the cost to society in terms of abuse to the general public appears to be low.

Moreover, even if sharp practices have occurred, the suggested restrictions to commercial entities should prevent that abuse from spreading to the "widows and orphans" of the investment world. The remaining businesses should be allowed to benefit from the use of these risk management tools. Under this cost-benefit approach, some abuse resulting from regulatory gaps or laxities should be tolerated, especially when it is a small price to pay for assisting the international competitiveness of United States businesses.

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