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In Defense of Market Self-Regulation

AN ANALYSIS OF THE HISTORY OF FUTURES REGULATION AND THE TREND TOWARD DEMUTUALIZATION*

I. INTRODUCTION

The debate over the efficacy of the U.S. system of market self-regulation—where the securities and futures industries regulate themselves with oversight from the federal government—has been ongoing since its inception some seventy years ago.¹ Populist politicians have long compared the system, primarily in times of regulatory failures or market crises, to the proverbial fox guarding the henhouse. The controversy surrounding recent market scandals has led to new scrutiny of whether exchanges can properly police themselves.²

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¹ In 1963 the efficacy of the self-regulatory system was called into question by stock market abuses reported in a Securities and Exchange Commission study, but the SEC concluded that self-regulation should be maintained. Roberta S. Karmel, *Turning Seats Into Shares: Causes and Implications of Demutualization of Stock and Futures Exchanges*, 53 HASTINGS L.J. 367, 401 (2002) (citing SEC, REPORT OF THE SPECIAL STUDY OF SECURITIES MARKET, H.R. DOC. NO. 95, at 502, 83, 414-15 (1st Sess. 1963) [hereinafter SPECIAL STUDY]); see generally JERRY W. MARKHAM, THE HISTORY OF COMMODITY FUTURES TRADING AND ITS REGULATION (1987) [hereinafter HISTORY OF COMMODITY FUTURES] (illustrating periodic strife between Congress and futures industry since late 1800s regarding self-regulation). Between 1880 and 1920 there were some 200 bills introduced in Congress to regulate futures and options trading. *Id.* at 10.

² See, e.g., Laurie P. Cohen & Kate Kelly, *NYSE Turmoil Poses Question: Can Wall Street Regulate Itself?*, WALL ST. J., Dec. 31, 2003, available at http://online.wsj.com/article_print/0,,SB107282097396518500,00.html (while the current system of self-regulation with government oversight has survived numerous crisis, the scandal surrounding a \$188 million pay package awarded to former New York Stock Exchange Chairman Richard Grasso has forced Wall Street to confront whether the system must be “drastically reformed or even replaced” in order to restore the confidence of investors). Some suggest that a for-profit exchange will not vigorously

The catalyzing events include a price-fixing investigation at the Nasdaq in the late 1990s, an ongoing investigation of floor trading at the New York Stock Exchange (NYSE),³ and governance failures at the NYSE that resulted in the ousting of former chairman Richard Grasso.⁴ Some have called for reforms to overhaul the system, while others say it should be scrapped altogether.⁵

The current debate over self-regulation was actually well under way before these regulatory failures pushed it onto the business pages. Industry and government officials have been actively debating how self-regulation can be adapted to address new conflicts of interest caused by a much more secular change: the ongoing trend of demutualization, where securities and futures exchanges convert to for-profit entities from not-for-profits.⁶ The latest example is the NYSE's announced plan to demutualize as it acquires electronic trading system Archipelago Holdings.⁷

This Note argues that the self-regulatory model, while in need of some type of reform, will survive the latest round of scrutiny because time has shown that it is the most efficient and practical alternative. The debate over self-regulation must be made in the context of the alternatives: the government as the sole securities regulator or no government oversight at all.⁸ It is important to remember that direct governmental regulation raises some of the same concerns that self-regulation does, as well as different concerns that are particular to large government bureaucracies.⁹ The principal

undertake self-regulatory obligations if those obligations negatively affect profitability. THOMAS ERICKSON, FUTURES EXCHANGE DEMUTUALIZATION 5 (2000) (internal Commodity Futures Trading Commission (CFTC) report by former CFTC Commissioner Erickson) (on file at CFTC).

³ See, e.g., Jenny Anderson, *Big Changes at Exchanges Bring Their Self-Regulation Into Question*, N.Y. TIMES, April 28, 2005 (At issue is whether self-regulation works . . . virtually every regional exchange has been cited for turning a blind eye to improper or illegal behavior of one sort or another.)

⁴ Cohen & Kelly, *supra* note 2.

⁵ *Id.*

⁶ See, e.g., SEC. INDUS. ASSOC., REINVENTING SELF-REGULATION, WHITE PAPER FOR THE SECURITIES INDUSTRY ASSOCIATION 8-9 (2000, updated 2003), available at http://www.sia.com/testimony/html/white_paper1.html [hereinafter WHITE PAPER] (outlining the advantages and disadvantages of the current regulatory regime as part of a study into whether an alternative model should be employed).

⁷ See, e.g., Andre Postelnicu et al., *NYSE to Merge with Archipelago Exchange*, FIN. TIMES, Apr. 21, 2005.

⁸ See, e.g., Sam Scott Miller, *Self-Regulation of the Securities Markets: A Critical Examination*, 42 WASH. & LEE L.REV. 861 (1985).

⁹ See, e.g., Raymond Urban & Richard Menckel, *Federal Regulation of*

advantages for self-regulation as an adjunct to government oversight are to minimize intrusion into the marketplace, take advantage of the expertise of professionals working within the exchanges, and defray the costs of monitoring and policing trading practices to the private sector.¹⁰

The self-regulatory model has been in continuous evolution since it was created under the Commodity Exchange Act in 1936, first operating under the oversight of the Commodity Exchange Authority (CEA), and later the Commodities Futures Trading Commission.¹¹ In the case of the securities industry, modern self-regulation began under the Securities Exchange Act of 1934, when the Securities and Exchange Commission was created. For decades the government sought to increase its authority over exchanges, focusing on rooting out fraud and bolstering the financial strength of market participants.¹² With regards to the futures industry, in recent years the government has changed tacks by relaxing the regulatory framework and giving self-regulatory organizations more authority, not less, as a means to improve efficiency.¹³

Whiskey Labeling: From the Repeal of Prohibition to the Present, 15 J. LAW & ECON. 411 (1972); William A. Jordan, *Producer Protection, Prior Market Structure and the Effects of Government Regulation*, 15 J. L. & ECON. 151 (1972), as cited in Miller, *supra* note 8, at 861. Miller argues that in some cases no regulation at all (other than that provided by privately enforced rights) might be a preferable alternative. *Id.* New York Attorney General Eliot Spitzer said that the Securities and Exchange Commission has become too close with the securities industry, as evidenced by its early rejection of efforts to force Wall Street banks to reform the way they provide stock research. Interview by Reuters News with Eliot Spitzer, New York State Attorney General, New York, NY (Nov. 12, 2003). Spitzer went on to say that the SEC is slow to uncover abuses, is too soft on violators, and is too slow in crafting new rules that address abuses. *Id.* Throughout history, no single government authority has ever been entrusted with regulatory authority over all American banks. See Jerry W. Markham, *Super Regulator: A Comparative Analysis of Securities and Derivatives Regulation in the United States, the United Kingdom, and Japan*, 28 BROOK. J. INT'L L. 319, 405 n.435 (2003) (citing BLUEPRINT FOR REFORM: THE REPORT OF THE TASK GROUP ON REGULATION OF FINANCIAL SERVICES 8 (1984)).

¹⁰ See WHITE PAPER, *supra* note 6.

¹¹ See generally HISTORY OF COMMODITY FUTURES, *supra* note 1.

¹² *Id.*

¹³ See *Hearing Before the Subcomm. on Research, Nutrition and General Legislature, Subcomm. on Agric., Nutrition and Forestry*, 107th Cong. 2 (2000) (statement by C. Robert Paul, General Counsel, Commodity Futures Trading Commission, detailing the content and purpose of the Commodity Futures Modernization Act of 2000, at the time it was being proposed to Congress).

[T]he proposed RFE [(Recognized Futures Exchange)] offers significant regulatory relief compared to the current requirements applicable to designated contract markets. . . . The second category, the derivatives transaction facility [DTF], would be subject to a lesser degree of Commission oversight. . . . Finally, the third category, the exempt multilateral transaction

It is natural that self-regulatory bodies be forced to undergo further reforms as new governance concerns arise. A current concern is the creation of new potential conflicts of interest that stem from the transformation into for-profit entities.¹⁴ But this paper also argues that the underlying forces fueling the move to demutualize—for instance, the advent of electronic exchanges, internationalization of markets and increased competition both domestically and abroad—will create new incentives for exchanges to better police themselves by increasing more competition among exchanges.

This analysis will begin by looking at the historic evolution of self-regulation in the U.S. futures industry,¹⁵ including how power has shifted back and forth between the federal government and the exchanges. The Note then reviews how different exchanges have reacted to recent allegations of conflicts of interest and failures in corporate governance, and finally, it reviews the most widely considered options being proposed to change the system.¹⁶

II. THE EVOLUTION OF SELF-REGULATION

A. *Prior to the Commodities Exchange Act of 1936*

Organized futures trading dates back to the founding of the Chicago Board of Trade (CBOT) in 1848, where

execution facility [MTEF], or exempt MTEF, would operate on an unregulated basis.

Id. at 3.

¹⁴ See WHITE PAPER, *supra* note 6, at 1.

¹⁵ The regulatory regimes of both futures and securities exchanges are similar. This Note addresses issues relevant to both, though unless otherwise noted, it will focus on futures exchanges. The regulation of futures trading is less politicized than that of securities—at least by some measures—because futures and other derivatives contracts are mainly traded by large financial institutions and other sophisticated investors. By contrast, the shares in publicly held companies traded on securities exchange are to a large degree held, both directly and indirectly, by retail investors and pensioners. As a result, the tendency of elected officials to pressure for stricter regulation in the securities industry is more tightly linked to the ups and downs of the market than it is for the futures industry (though regulation of the futures is certainly not immune from political lobbying by market participants). See generally Markham, *supra* note 9, at 399-403 (describing the hysteria within Congress and by various regulatory offices to quickly react to scandals surrounding publicly traded companies like energy trader Enron Corp. and investment bank Merrill Lynch & Co.)

¹⁶ Demutualization is the process of reorganizing a mutualized, or member owned, entity into a for-profit corporation with shareholders. Organized securities and futures exchanges were traditionally operated as non-profit membership organizations, but advances in technology, increased competition and other market forces have led numerous exchanges to demutualize. Karmel, *supra* note 1, at 368-69.

commodities ranging from grain to coal to alcohol were traded.¹⁷ At the outset, U.S. futures exchanges regulated themselves, with some oversight from state regulators, though none from the federal government.¹⁸ The main incentive for self-regulation was to assure high standards of conduct and decorum on the trading floor.¹⁹ It became clear early on that a more rigid form of government oversight would be needed.²⁰

As trading volumes on futures exchanges grew during the late 19th century, there developed a steady flow of allegations that the market was vulnerable to manipulation.²¹ The failures of the system became apparent in the 1880s with the rise of so-called bucket shops, which were poorly financed, off-exchange establishments where speculators bet on commodities prices.²² Many banks would not lend money to brokerages that were not members of the most prominent exchanges, so smaller brokerages would often “bucket” their clients’ money in order to get capital with which to trade.²³ By 1891, the practice had become so prevalent that one member of the CBOT, one of the most respected commodities exchanges, wrote a pamphlet actually defending bucket shops.²⁴ The Consolidated Exchange, a securities exchange which at the time was a powerful rival to the New York Stock Exchange,

¹⁷ See HISTORY OF COMMODITY FUTURES, *supra* note 1, at 4.

¹⁸ *Id.*

¹⁹ See *id.* (citing JONATHAN LURIE, THE CHICAGO BOARD OF TRADE, 1859-1905, at 25 (1979)).

²⁰ See *id.* at 10.

²¹ *Id.* at 4.

²² THOMAS HIERONYMUS, ECONOMICS OF FUTURES TRADING 88 (1971).

²³ ROBERT SOBEL, THE CURBSTONE BROKERS: THE ORIGINS OF THE AMERICAN STOCK EXCHANGE 69 (1970).

²⁴ H. S. Irwin, *Legal Status of Trading in Futures*, 32 ILL. L. REV. 155, 155 n.5 (1938). Bucket shops accepted customers’ orders and funds but did not execute the orders on any exchange. Rather, they simply bet the customer would lose and kept the customer’s money when they did. If the customer won too much, the bucket shop would simply fold its operations and move to a new location. *Comparative Analysis*, *supra* note 15, at 339 n.92 (citing JOHN HILL, JR., GOLD BRICKS OF SPECULATION 37-39 (1904)).

The term “bucketshop” as now applied in the United States, was first used in the late [18]70’s, but it is very evident that it was coined in London as many as 50 years ago, when it had absolutely no reference to any species of speculation or gambling. It appears that beer swillers from the East Side (London) went from street to street with a bucket, draining every keg they came across and picking up cast off cigar butts. Arriving at a den, they gathered for social amusement around a table and passed the bucket as a loving cup . . . the den soon became called a bucket shop. Later on the term was applied, both in England and the United States, as a byword for reproach, to small places where grain and stock deals were counterfeited.

Id.

came to be regarded as a “den of bucketeers.” The Chicago Open Board of Trade, or the “Little Board,” was said to be captured by bucketeers (The Chicago Open Board of Trade later became the Mid-America Commodity Exchange, which eventually joined with the CBOT in 1985).²⁵

As the bucket shops became more influential, the exchanges found themselves in a conflicted position with state regulators. Those that were losing business began to push for more assistance from state regulators, but at the same time, the exchanges tried to defend their right to regulate themselves against mounting criticism that futures trading had become corrupted. Some of the more prominent exchanges tried to put the bucket shops out of business by cutting off access to market quotations.²⁶ In a major victory, the CBOT established the legal right to prevent bucket shops from obtaining market quotations in the 1904 case, *Chicago Board of Trade v. Christie Grain & Stock Co.*²⁷ The CBOT used undercover detectives and eventually prosecuted a number of its members for engaging in bucket shop activities.²⁸ Expulsions resulted, with 281 people in Illinois indicted for violating the state’s anti-bucket shop laws.²⁹

Political pressures to create federal oversight of the exchanges mounted, but the industry still had some powerful supporters. President Herbert Hoover was quoted as saying that the CBOT is “the most economical and efficient agency of the marketing of foodstuffs anywhere in the world.”³⁰ Other politicians stated that it would be a mistake to supplant a system that is dictated by the market with an inefficient government bureaucracy.³¹

²⁵ M. Van Smith, *The Commodity Futures Trading Commission and the Return of the Bucketeers: A Lesson in Regulatory Failure*, 57 N.D. L. REV. 7, 13 (1981).

²⁶ See HISTORY OF COMMODITY FUTURES, *supra* note 1, at 9.

²⁷ Bd. of Trade of Chicago v. Christie Grain & Stock Co., 198 U.S. 236, 253 (1905) (upholding an injunction which cut off quotations to the operations of C.C. Christie). “[T]he plaintiff’s collection of quotations is entitled to the protection of law. It stands like a trade secret . . . that others might do similar work, if they might, does not authorize them to steal the plaintiff’s.” *Id.* at 250.

²⁸ See HISTORY OF COMMODITY FUTURES, *supra* note 1, at 10.

²⁹ See *id.*

³⁰ *Hearing on Futures Trading Before the House Comm. on Agric.*, 66th Cong., 583 (1921).

³¹ *Id.* at 125. Representative Thaddeus Caraway:

I have never believed that someone who sits here in the basement of some Government building with his hair parted in the middle can run this country better than all the people can run their own private business. I have no patience with that. I never went to a department in my life I did not come away thoroughly angry and half ashamed of my government

Id.

The problems with bucket shops continued, however, giving way to a series of congressional investigations and unsuccessful bills that sought to either put heavy regulations on futures trading, or prohibit it altogether.³² The industry drew on the Supreme Court's decision in *Board of Trade v. Christie* to defend against accusations that futures trading was similar to gambling, a charge that was grounded in a general failure to understand how trading activity could be legitimate when the majority of commodities contracts were never actually delivered.³³ Justice Oliver Wendell Holmes validated the concept of futures trading in *Board of Trade v. Christie*.³⁴ Using the CBOT's grain pit as an example, he acknowledged that in three-fourths of the transactions no grain actually exchanged hands.³⁵ Still, Holmes determined that the sales were settled legitimately, proclaiming that the fact that contracts were satisfied in this way detracts in no way from the good faith of the parties and is consistent with a serious business purpose.³⁶

In 1921, Congress approved the Futures Trading Act (FTA), the first legislation to create federal oversight of futures trading.³⁷ But the FTA was quickly struck down. In *Hill v. Wallace*, the Supreme Court ruled that the Act was an unconstitutional exercise of Congress's taxation authority.³⁸ The Act had sought to give the Secretary of Agriculture authority over exchanges by giving it the power to designate exchanges as "contract markets."³⁹ Options and grain futures contracts not traded on government approved exchanges were to be subject to a prohibitive 20-cent per bushel tax.⁴⁰

³² See *id.*

³³ See *id.*

³⁴ See *Christie*, 198 U.S. at 247-48.

Speculation of this kind by competent men is the self-adjustment of society to the probable. Its value is well known as a means of avoiding or mitigating catastrophes, equalizing prices and providing for periods of want. It is true that the success of the strong induces imitation by the weak, and that incompetent persons bring themselves to ruin by undertaking to speculate in their turn. But legislatures and courts generally have recognized that the natural evolutions of a complex society are to be touched only with a very cautious hand, and that such course attempts at a remedy for the waste incident . . . are harmful and vain.

Id.

³⁵ *Id.* at 246-47.

³⁶ *Id.* at 251.

³⁷ Futures Trading Act, Aug. 24, 1921 c. 86, 42 Stat. 187.

³⁸ *Hill v. Wallace*, 259 U.S. 44 (1922).

³⁹ *Id.* at 63-64

⁴⁰ *Id.* "To give such magic to the word 'tax' would be to break down all

The ruling in *Hill* helps to illustrate the complex nature of the relationship between futures exchanges and the government at a time when it was clear that federal intervention had become inevitable. While members of the futures industry were widely opposed to government oversight, representatives of the CBOT itself were not the ones to challenge the constitutionality of the FTA. A number of members of the CBOT brought the suit, and charged that the exchange's board of directors refused to challenge the statute itself because it did not want to offend the Secretary of Agriculture.⁴¹ In his opinion, Justice William Howard Taft concluded that in not challenging the FTA itself the CBOT's board of directors had failed in their duty to represent the interests of its members.⁴²

However, just a few days after the Supreme Court's decision in *Hill* there was a manipulation of grain prices, which reinforced the belief within Congress that regulation was needed immediately.⁴³ Legislatures quickly passed the Grain Futures Act of 1922,⁴⁴ this time resting authority on its commerce powers rather than taxation powers. The Supreme Court subsequently upheld the Grain Futures Act based on Congress's contention that market volatility on the exchanges was a burden on interstate commerce.⁴⁵ Section 5 of the act permitted the Secretary of Agriculture to regulate futures trading by requiring that such transactions be conducted on a "contract" market that must be licensed by the federal government.⁴⁶ That provision still forms the core of the current regulatory system today. It also required that the exchanges prevent such conduct as price manipulation,⁴⁷ marking the onset of the exchanges' role as self-regulator under oversight of the federal government.

constitutional limitation of the powers of Congress and completely wipe out the sovereignty of the states." *Id.* at 68.

⁴¹ *Id.* at 61, 72. "The averments of the bill are that the Board of Directors refused the request to bring suit because they feared to antagonize the public officials whose duty it was to construe and enforce the act, and not because they thought the act was unconstitutional." *Id.* at 61

⁴² *Id.* at 61. In a concurring opinion, Justice Louis Brandeis asserted that the Chicago Board of Trade should not be required to contest every statute that its members believe to be invalid. *Id.* at 74.

⁴³ Markham, *supra* note 9, at 338 (citing H.R. REP.NO. 67-1095, at 2 (1922)).

⁴⁴ Commodity Exchange Act (Grain Futures Act), ch. 369, 42 Stat. 998 (1922) (codified as amended at 7 U.S.C. §§ 1-25 (2000)).

⁴⁵ Chicago Bd. of Trade v. Olsen, 262 U.S. 1, 56 (1923).

⁴⁶ 7 U.S.C. § 5 (2000).

⁴⁷ *Id.* at § 5(b).

The Grain Futures Administration (GFA), the Secretary of Agriculture office that carried out the Act, had the role of investigating practices at the exchanges, while actual regulation of trading was conducted by the exchanges.⁴⁸ The arrangement had mixed results, with the government in its new role often just as responsible for regulation failures as the exchanges were. For instance, in an effort to boost surveillance the GFA required the clearing members of each exchange to provide daily reports that included the market positions of its customers.⁴⁹ But while members of the CBOT were willing to make their records available, the GFA had only one internal auditor and was therefore unable to monitor the records in a meaningful way.⁵⁰ The GFA suspected fraud and market speculation in many of the cases it reviewed, but it had limited success in prosecuting the cases. It also began to supervise the dissemination of news reports, an effort to stop unsubstantiated reports that were moving the market.⁵¹

A series of trading scandals and the onset of the Great Depression led to a further loss of faith in the exchanges' ability to regulate themselves.⁵² On the political front, a populist movement against futures trading began to gather steam.⁵³ One Senator in favor of heavier government oversight called the CBOT the "world's greatest gambling house."⁵⁴

B. *The Commodities Exchange Act*

In 1936, Congress approved the Commodity Exchange Act, the result of efforts by President Franklin D. Roosevelt, who had pushed for new regulation of both the securities and

⁴⁸ HISTORY OF COMMODITY FUTURES, *supra* note 1, at 15.

⁴⁹ *Id.*

⁵⁰ *Id.*

In 1927, however, the Grain Futures Administration suspended its requirements of daily reports for large traders, because of continuing charges that its reports were keeping large bullish speculators from operating in the wheat market and thereby depressing prices. It suspended reporting requirements from February 26, 1927, until November 1, 1927. It then determined that its reports did not have the effect of discouraging bullish spectators.

Id.

⁵¹ *Agricultural Appropriations Bill, Hearings Before a House Subcomm. of the Comm. on Appropriations*, 69th Cong., 727 (1926).

⁵² See HISTORY OF COMMODITY FUTURES, *supra* note 1, at 22-24.

⁵³ See *id.* at 26-27.

⁵⁴ U.S. Congress, Senate, *Congressional Record*, 67th Cong., 1st Sess., August 9, 1921, p. 4763 (Sen. Arthur Capper, Republican, Kansas).

futures industries.⁵⁵ Regulation of the two industries was separated because the banking committees controlled securities matters and the agriculture committees controlled commodity exchanges, and neither was willing to cede power.⁵⁶ The CEA was created to replace the Grain Futures Act as the authority over day-to-day regulation.⁵⁷ Drafters of the Act included statutes that prohibited market price manipulation,⁵⁸ created “position limits” in a bid to curtail the taking of big speculative positions,⁵⁹ and established registration requirements for futures brokers, known as futures commission merchants (FCMs).⁶⁰ The Act also initiated the financial requirement that customers place margins in trust with the FCMs.⁶¹

The success of the regulatory effort continued to be mixed. The CEA began to regularly audit the FCMs, and found that oftentimes their clients’ investments were not being properly protected.⁶² At dozens of firms it was found that the positions held by clients did not match the funds that FCMs held in segregated accounts (where the accounts of each client was segregated from other FCM accounts).⁶³ In one investigation the CEA looked at approximately 4500 discretionary accounts by financial advisors, finding that many were not properly executing their clients’ trades on time or were leaving unprofitable trades open so that clients would have a false impression of the value of their trading portfolios.⁶⁴

Even though the members of the futures exchanges had resisted passage of the Act, there is evidence they played an important role in furthering the government’s regulatory efforts once it was passed. For example, in August 1938 the heads of the leading commodity exchanges were asked to meet in Washington to consider what rules were needed to meet the discretionary account problems uncovered by the CEA.⁶⁵ Thereafter, every contract market represented at the

⁵⁵ See Markham, *supra* note 9, at 339-40.

⁵⁶ *Id.*

⁵⁷ Commodity Exchange Act of 1936, ch. 545, 49 Stat. 1491 [hereinafter Commodity Exchange Act] (codified as amended in scattered sections of 7 U.S.C.).

⁵⁸ Commodity Exchange Act § 4(c), 6(b).

⁵⁹ Commodity Exchange Act § 4(a).

⁶⁰ Commodity Exchange Act § 4d(1).

⁶¹ Commodity Exchange Act § 4d(2).

⁶² See HISTORY OF COMMODITY FUTURES, *supra* note 1, at 30.

⁶³ *See id.*

⁶⁴ *See id.* at 31.

⁶⁵ *Id.*

conference adopted amendments to their rules to prevent such practices.⁶⁶

In one of the better examples of futures exchanges making an earnest effort to police themselves, the CBOT pursued one of the country's biggest and most powerful grain traders, Cargill Grain Co., for alleged manipulation of the market.⁶⁷ In 1939 the CBOT required Cargill to liquidate part of a large position in 1937 September corn futures, and later expelled the company from membership on the exchange.⁶⁸ Cargill fought the expulsion with the Commodity Exchange Commission, an overseeing body made up of representatives from the Department of Agriculture, the U.S. Attorney General and the Department of Commerce, on the basis that the board of trade had acted outside of its authority as defined in the Commodity Exchange Act.⁶⁹ In 1940, the CEA dismissed the action, finding that the CBOT had sufficient reason to believe that Cargill's was attempting to manipulate the market.⁷⁰

The CBOT's actions led the Secretary of Agriculture to conduct its own probes of Cargill's trading,⁷¹ which would lead to a series of charges against Cargill over the next several decades. In 1940 the Secretary of Agriculture brought charges against Cargill for engaging in "wash trades"⁷² and manipulating the price of corn, and issued a temporary ban on its trading privileges.⁷³ Cargill was charged with manipulating

⁶⁶ *Id.*

⁶⁷ U.S. DEP'T OF AGRIC., REPORT OF THE CHIEF OF THE COMMODITY EXCHANGE ADMINISTRATION 39 (Sept. 25, 1939). At one time the Cargill Grain Co. held 80% of the total long open contracts. *Id.*

⁶⁸ *Id.*

⁶⁹ *Id.*

⁷⁰ U.S. DEP'T OF AGRIC., REPORT OF THE CHIEF OF THE COMMODITY EXCHANGE ADMINISTRATION 44 (Aug. 31, 1940).

⁷¹ *Id.* at 44-45.

⁷² Wash trading, as defined by the Commodity Futures Trading Commission, is "entering into, or purporting to enter to, transactions to give the appearance that purchases and sales have been made, without incurring market risk or changing the trader's market position." Wash trading involving futures contracts is prohibited by the Commodity Exchange Act, available at http://www.cftc.gov/opa/glossary/opaglossary_wxyz.htm. Wash trades are pre-arranged simultaneous trades entered into for the purpose of artificially inflating volumes or revenues or for the purpose of manipulating prices. C. Bryson Hull, *Suit Says El Paso Engaged in Wash Trades*, REUTERS BUS. NEWS, Nov. 21, 2002.

⁷³ U.S. DEP'T OF AGRIC., REPORT OF THE CHIEF OF THE COMMODITY EXCHANGE ADMINISTRATION 44-45 (Aug. 31, 1940).

[T]he respondents entered into a stipulation with the complainant, admitting that one of the respondents, J.H. MacMillan, Jr., president of Cargill, Inc., directed and was responsible for the trading of the Cargill Grain Co. of Illinois, which executed transactions in grain futures as alleged in the

prices of oats futures in 1951 and 1952, and banned from trading in oats futures contracts.⁷⁴ In 1971 a federal appeals court upheld a ruling that Cargill had manipulated wheat contracts on the CBOT eight years earlier, at one point holding 62% of the long interest in all contracts to be delivered in May of 1963.⁷⁵

Still, despite a few notable instances, such as the Cargill case, there was evidence that self-regulators were not effectively policing exchange floors. The CEA conducted infrequent investigations of trading floor practices, and one investigation showed that an estimated 10% of the trading volume came from wash trades (profitless round trades that can be used to inflate trading volume or falsely inflate revenues).⁷⁶ In another instance, regulators conducted a probe in 1968 into job lot trading (splitting commodities trades into denominations of less than 5,000 bushels) on the CBOT.⁷⁷ The investigation showed a lack of competition in trade execution, and as a result customers were paying a higher premium on their purchases and were being forced to sell at a greater discount. Following the investigation job lot trading on the CBOT was discontinued and complaints were issued against seven floor traders.⁷⁸ Such discoveries put pressure on the CEA to perform more investigations, despite operating with limited resources.⁷⁹

Even so, these investigations did not substantiate one of the government's biggest concerns, that floor traders on the exchanges exercised their special advantages to profit at the expense of the trading public. In 1968 the General Accounting Office (GAO) released a study stating that floor traders had such advantages.⁸⁰ In response, the Commodity Exchange

complaint, and that the other individual respondents acted on instructions from MacMillan.

Id.

⁷⁴ See HISTORY OF COMMODITY FUTURES, *supra* note 1, at 32.

⁷⁵ Cargill, Inc. v. Hardin, 452 F.2d 1154, 1160-61 (8th Cir. 1971).

The Government's theory of this case is that Cargill manipulated the price . . . by means of a device known as a "little corner" or "squeeze." . . . Squeeze (congestion): These are terms used to designate a condition in maturing futures where sellers (hedgers or speculators), having waited too long to close their trades, find there are no new sellers from who they can buy . . .

Id.

⁷⁶ HISTORY OF COMMODITY FUTURES, *supra* note 1, at 51.

⁷⁷ *Id.*

⁷⁸ *Id.*

⁷⁹ *Id.*

⁸⁰ *Id.*

Administration (CEA) conducted a test study of potato futures contracts traded on the New York Mercantile Exchange (NYMEX). It found that day trading by floor traders represented only a small, relatively stable percentage of trading, and that short-term intra-day price movements resulted principally from trading by the general public, not trading by floor traders.⁸¹ It also found that two times as often as not, floor traders were trading against price movements, which indicated to the CEA that day traders actually helped to limit volatile price movements.⁸²

Congress approved amendments to the Commodity Exchange Act in 1968 to step up the CEA's regulatory authority.⁸³ The Agriculture Department was a driving force behind implementation of the changes, which helps to show an animosity that had developed between the government and the futures industry.⁸⁴ The CEA's power was broadened to include the establishment of minimum financial requirements for FCMs,⁸⁵ livestock and concentrated orange juice futures contracts were brought under its jurisdiction,⁸⁶ and criminal penalties (from misdemeanor to felony) for market violations were made more severe.⁸⁷ However, one major amendment also had an unintended effect of weakening self-regulation. The CEA was given the power to disapprove rules implemented at the exchanges.⁸⁸ This government involvement led courts to begin to view the exchanges' rules as carrying a guarantee that members of the exchanges would not violate them.⁸⁹ As a result, the amendments had the unintended effect of weakening self-regulation because exchanges began to reduce their regulatory schemes in order to minimize the potential liability from private litigation.⁹⁰

⁸¹ HISTORY OF COMMODITY FUTURES, *supra* note 1, at 51.

⁸² *Id.*

⁸³ 1968 Amendments to CEA, Pub. L. No. 90-258, 82 Stat. 30.

⁸⁴ HISTORY OF COMMODITY FUTURES, *supra* note 1, at 52.

⁸⁵ Commodity Exchange Act Sec. 4d.

⁸⁶ UNITED STATES GENERAL ACCOUNTING OFFICE, THE COMMODITY EXCHANGE ACT: ISSUES RELATED TO THE COMMODITY FUTURES TRADING COMMISSION'S REAUTHORIZATION 55 (May 1999), available at <http://www.gao.gov/archive/1999/gg99074.pdf>.

⁸⁷ 7 U.S.C. § 9(a) (2000).

⁸⁸ 7 U.S.C. § 8a(7) (2000).

⁸⁹ See HISTORY OF COMMODITY FUTURES, *supra* note 1, at 62.

⁹⁰ See *id.*

C. *The Commodity Futures Trading Commission Act of 1974*

By the early 1970s there was a growing consensus that futures markets were as important to the general public as securities markets were.

A series of market manipulation scandals and a sharp increase in trading volumes for both regulated and non-regulated commodities led to criticism that the CEA was not properly protecting small traders and the consuming public.⁹¹ At the time, the country was in the midst of the Cold War, and there was concern within Congress that the futures markets were susceptible to manipulation by companies from the USSR and other foreign nations.⁹² There was sentiment within Congress that regulation within the exchanges was lax, but of equal concern was that the CEA was not properly overseeing the exchanges.⁹³ An internal report prepared for the inspector general of the Department of Agriculture found that the CEA relied on the exchanges too heavily to enforce its rules, and that self-regulation was insufficient.⁹⁴ In 1973 a damaging article in the Des Moines Register stated that the CEA had turned the task of regulation over to the exchanges, and that the exchanges were run in a “club like atmosphere.”⁹⁵

Congress concluded it needed to establish a regulatory authority similar to the Securities and Exchange Commission, which was created by the 1934 Securities and Exchange Act.⁹⁶ The Commodity Futures Trading Commission Act (CFTCA) of 1974 dramatically increased the government’s authority over futures exchanges.⁹⁷ The most important provision of the Act

⁹¹ See *id.* at 56-57.

⁹² “In the early 1970s, Congress became concerned about the ‘Great Grain Robbery,’ that the Soviets were using the commodity futures markets as a means to manipulate prices and obtain large profits at the expense of American consumers.” *Id.* at 56. “The ‘Grain Robbery’ of 1972 was one of those economic events that, like the OPEC oil embargo . . . can truly be said to have changed the world.” *Id.* at 262 n.10 (quoting DAN MORGAN, *MERCHANTS OF GRAIN* 120-21 (1979)).

⁹³ H.R. REP. No. 93-975, at 46-47 (1974).

⁹⁴ CEA relied on exchanges to enforce their rules and to insure that all trades were executed “competitively. Insufficient effort was made to determine whether trading rules were enforced. . . . [W]e also found other suspected violations of trading rules which we believe indicate a lack of control, detection and enforcement of rules governing the execution of customer orders.” *Id.*

⁹⁵ Clark Mollenhoff, *Probe CEA False Reports—Gross Fraud Alleged*, *THE DES MOINES REG.*, Oct. 1, 1973.

⁹⁶ Markham, *supra* note 9, at 341.

⁹⁷ Commodity Futures Trading Commission Act of 1974, Pub. L. No. 93-463, 88 Stat. 1389 [hereinafter CFTC Act] (codified in scattered sections of 7 U.S.C.).

was the creation of the Commodity Futures Trading Commission (CFTC), an independent five-member regulatory commission.⁹⁸ The agency was given exclusive jurisdiction over the trading of futures and options on all commodities.⁹⁹ Just as in the securities industry, exchanges would continue to regulate themselves, though the CFTC would be overseer with broader authority and more resources.¹⁰⁰

But while the debate leading up to the CFTCA focused on how to increase the government's authority, the reality of attaining that goal forced legislatures to concentrate on what is still a major consideration today: cost and efficiency. The result was actually to increase the responsibility of the exchanges, though under broader and stricter guidelines so that the government could be a more efficient overseer.¹⁰¹ In a hearing before the Senate's Committee on Agriculture and Forestry in May of 1974, Senator George McGovern from South Dakota argued that registered exchanges should be performing many of the routine checks and investigations that the government was currently responsible for, while the federal regulatory arm should have a heavier hand in making sure the exchanges enforce the government's rules.¹⁰² In one example of inefficiency, McGovern said that the CEA's professional staff spent about 25% of its time performing routine audits of the hundreds of FCMs. It made more sense to place the primary responsibility for those audits with the exchanges themselves.¹⁰³ The size of the CEA's staff, he pointed out, remained at 165 between 1970 and 1973, even though the volume of derivatives contracts traded had surged by 73% during the same period.¹⁰⁴ By McGovern's estimation, the growth in the market was fast outpacing the CEA's resources.

⁹⁸ CFTC Act § 201.

⁹⁹ *Id.*

¹⁰⁰ The CFTC was given increased enforcement powers, the regulatory reach of the Commodity Exchange Act was expanded to include commodity trading advisors, commodity pool operators, and associated persons of futures commission merchants. Markham, *supra* note 9, at 341.

¹⁰¹ See *Hearings Before the Subcomm. on Agric. and Forestry*, 93d Cong. 199-200 (1974).

¹⁰² *Id.*

¹⁰³ *Id.*

¹⁰⁴ *Id.* at 199. In another example, McGovern said the exchanges should be responsible for regularly reviewing the need for position limits on specific commodities in order to head off attempts to manipulate the market; be given a time limit for implementing and enforcing trading rules; and conduct investigations to seek out abusive practices. As futures trading escalated, the CEA simply could not handle these sorts of responsibilities. *Id.*

Exchange members who had opposed increased government authority over rulemaking argued that the 1974 Act would destroy the exchanges' free market traits. In the same senate committee hearing, Carlos Bradley, President of the Board of Trade of Kansas City, Mo., said that "the effect of such a proposal could be to abdicate completely to the government the responsibility of the exchanges, the expertise of their members, their public responsibility etc. There would be no need for exchange governments."¹⁰⁵ Those arguments, however, were generally lost in Congress, where there remained strong support to increase government oversight.

Under the CFTCA, the CFTC's authority was expanded from the statutory list of physical commodities to include futures contracts on all goods, articles, services and rights and interests—thereby defining the term commodity to include anything on which a contract is traded (except onions).¹⁰⁶ The CFTC was given power to grant reparations to any person hurt by a violation of the Act,¹⁰⁷ and commodity trading advisers, commodity pool operators (enterprises who solicited and received funds from others in order to trade in commodity futures) and associated persons (employees of FCMs who solicited or accepted customer orders or supervised such persons) were now required to be registered with the agency.¹⁰⁸

Also, the CFTC now had a direct involvement in the regulation by the exchanges. Exchanges were required to submit proposals for new rules pertaining to futures contracts or trading requirements to the CFTC for advance approval.¹⁰⁹ The CFTC was given long desired authority to intervene in the trading of contract exchanges when it deemed market disturbances to be emergencies.¹¹⁰ It was also given injunctive authority, a power that the Department of Agriculture had sought for years.¹¹¹ The CFTCA increased the potential

¹⁰⁵ *Id.* at 225.

¹⁰⁶ CFTC Act § 201 (1974). Onion farmers successfully lobbied to have onions withheld from futures trading after onion futures disastrously plummeted in 1955. The lobbying effort resulted in the so-called Onion Futures Act, passed by Congress in 1958. David S. Jacks, *Populists v. Theorists: Futures Markets and the Volatility of Prices*, at 14, at <http://aghistory.ucdavis.edu/jackspaper04.pdf>. Onions are the only commodity to be banned from futures trading. *Id.* The law was upheld as constitutional in 1959. *Id.* Subsequent studies have shown that onion prices have been volatile when futures trading was permitted than after the law was passed. *Id.*

¹⁰⁷ CFTC Act § 209.

¹⁰⁸ *Id.* at § 4k.

¹⁰⁹ *Id.* at § 210.

¹¹⁰ *Id.* at § 215.

¹¹¹ *Id.* at §6c.

penalties for market manipulation to \$100,000 from \$10,000,¹¹² and provided the framework for the creation of a quasi-public regulator that would, similar to the National Association of Securities Dealers in the securities market, govern the conduct of market participants who are not members of contracts markets.¹¹³

The CFTCA encouraged exchanges to enforce its rules under the CFTC's oversight by explicitly authorizing them to discipline their members.¹¹⁴ The exchanges were required to report any such actions to the CFTC, which could in turn affirm, modify them or set the disciplinary actions aside.¹¹⁵

Two years later, in 1976, the CFTC commenced one of its most significant regulatory reforms. The liquidity requirements of FCMs were increased in a move designed to ensure that their financial position could not deteriorate to the point of endangering customer funds.¹¹⁶ The requirement, while imposing substantial costs on the system, was designed to insure the financial integrity of the system.¹¹⁷ To defray the cost of the audits from the government, the CFTC required FCMs to be audited by independent financial accountants.¹¹⁸ Other provisions were included in the Bankruptcy Act of 1978 to further protect owners of the futures contracts from financial failure of a FCM.¹¹⁹ The capital requirements would set in motion an important trend of consolidating trading into the hands of the most financially sound FCMs, which in turn would allow both government and self-regulators to focus on issues like trading violations and market manipulation.

¹¹² CFTC Act § 6B.

¹¹³ *Id.* at §17.

¹¹⁴ *Id.* at § 8C.

¹¹⁵ *Id.*

¹¹⁶ See HISTORY OF COMMODITY FUTURES, *supra* note 1, at 86. For amended statute see 7 U.S.C.A. § 6f(b) (2002).

¹¹⁷ See HISTORY OF COMMODITY FUTURES, *supra* note 1, at 87. The certification requirement, coupled with early warning requirements, is also designed to ensure that the CFTC is on early notice when a firm is in financial trouble, so steps can be undertaken to prevent or limit injury to customers. *Id.*

¹¹⁸ *Id.* at 86.

¹¹⁹ *Id.* at 87.

The primary protection for investors in commodity futures contracts is that their funds are kept in segregated trust accounts. It often happens, however, that a breach of such trust may occur—the broker could convert the funds, either to trade for its own account or to meet the margin calls of another customer. In such instances, the new Bankruptcy Code provisions provide for the equal sharing of all customers in any remaining segregated funds. . . . [T]hese customers have a priority over all other creditors in such funds.

Id.

In the ensuing years, regulation of futures exchanges was subject to harsh criticisms, but oftentimes it was directed at failures of the CFTC rather than at the exchanges. In addition to criticism of the CFTC's handling of a series of options scandals in the late 1970s,¹²⁰ a report prepared for Congressman James Whitten of Mississippi by the Surveys and Investigations Staff of the House Committee on Appropriations showed that the CFTC was in many respects incompetent.¹²¹ The report found that the CFTC employed a disproportionately large number of political appointees and that there had been a flagrant misuse of funds, ranging from the use of outside consultants in order to avoid civil service hiring restrictions, to overpayment for parking spaces and driving services for CFTC employees.¹²² Abuses were also found in the awarding of government contracts. For example, one former employee in the chairman's office was given two consulting contracts, which if aggregated, would have exceeded a threshold amount that would have triggered a requirement to open the contract up to a competitive bidding process.¹²³

D. *The Commodity Futures Modernization Act*

After six decades of strengthening its oversight, government regulators began to contemplate changing tacks in the late 1990s. The CFTC had determined that the financial underpinnings of the futures industry had been strengthened enough that it would now be more efficient to loosen its grip on self-regulators.¹²⁴ Trading volumes had surged and technological advances were giving way to growth of electronic

¹²⁰ *Id.* at 94-96. (detailing in particular the attempt by brothers Bunker and Herbert Hunt of Dallas, Texas to corner the soybean market in 1977, at times owning the right to take delivery of over one-third of the U.S. carryover inventory for old crop soybeans covered by the Chicago Board of Trade contracts).

¹²¹ HOUSE COMM. ON APPROPRIATIONS, 95th Cong., INVESTIGATIVE STUDY ON THE COMMODITY FUTURES TRADING COMM. (Comm. Print 1978) (by Mr. Whitten for use by the Subcomm. on Agric., Rural Development and Related Agencies).

¹²² *See id.* at 51, 64-66, 72. "While the schism between the former CEA employees and the newly hired CFTC group may have contributed to some of the early organizational problems of the Commission, the [Subcommittee's] Investigative Staff was advised that of even greater significance was the rivalries between the new senior-level staff appointees." *Id.* at 23.

¹²³ *Id.* at 64.

¹²⁴ *See Hearing Before the Subcomm. on Research, Nutrition and General Legislation, Senate Comm. on Agriculture, Nutrition and Forestry, 107th Cong. 2-3 (2000)* (statement of C. Robert Paul, General Counsel of Commodity Futures Trading Commission).

exchanges that could operate across borders.¹²⁵ The industry argued that the current regulatory system had bogged it down to the point that it may not be able to compete effectively with foreign exchanges. Under heavy pressure from the industry,¹²⁶ the CFTC approved a series of amendments called the Commodity Futures Modernization Act of 2000.¹²⁷ The aim of the CFMA was to make the regulatory framework more flexible. Exchanges were now allowed to create a regulatory framework from sets of “core principles” that fit their particular operation, rather than have to adhere to a one size fits all system.¹²⁸ The framework also created three regulatory tiers for markets, with a lower level of regulatory oversight where access to the exchange or trading facility is limited to commercial participants and the nature of the underlying commodities provides a low risk of manipulation.¹²⁹

Unlike the fiery debates that preceded prior regulatory legislation, there appeared to be little contention between the industry and government regarding the CFMA. In a March, 2000 hearing before the Senate Subcommittee on Research, Nutrition and General Legislation, of the Committee on Agriculture, Nutrition and Forestry, Senator Peter Fitzgerald, the chairman, opened by saying that “the CFTC has suggested that it is willing to grant broad regulatory relief to futures exchanges.”¹³⁰ C. Robert Paul, General Counsel of the CFTC, followed by saying that one of the CFTC’s main policy goals should be “removing any regulatory barriers that hamper these markets from fully exploiting innovations in technology.”¹³¹

The major futures exchanges chimed in. David Brennan, chairman of the CBOT, told the subcommittee that it “heartily endorses the concept of replacing inflexible, micromanaging

¹²⁵ See *Hearings Before the Subcomm. on General Farm Commodities and Risk of the House Comm. on Agriculture*, 108th Cong. 16 (2003) (statement of James Newsome, Chairman of the Commodity Futures Trading Commission, in response to question by the subcommittee).

¹²⁶ *Id.* Committee member and Representative from Kansas Jerry Moran said in a review of the CFMA two years after it was approved: “[W]e heard continually from the exchanges about the potential threat if we didn’t appropriately deregulate the industry, the threat from competition, foreign sources, from the ability of customers to utilize exchange service offshore.” *Id.*

¹²⁷ Commodity Futures Modernization Act of 2000, Pub. L. 106-554, 114 Stat. 2763 (2000) (amendments in scattered sections throughout 7 U.S.C.).

¹²⁸ 7 U.S.C. § 7(d) (2000).

¹²⁹ *Id.*

¹³⁰ *Hearing Before S. Subcomm. on Research, Nutrition and General Legis.*, *supra* note 124, at 1.

¹³¹ *Id.* at 2.

[sic], government mandates with core principles. The CFTC is right that exchanges and others are best able to design systems to achieve the desired and shared objectives of market integrity, financial integrity and preventing abuses."¹³²

At a hearing to discuss the CFMA two and a half years after it was approved, congressional members seemed unable to assess whether the new system had been an improvement or not. The CFTC defended the CFMA by saying trade volume in futures has increased by 50% since its passage, and that as it had predicted, the industry has become substantially more competitive.¹³³

But in the interim there had also been a series of market scandals, including the collapse of a major energy trader, Enron Corp., and several congressmen raised concerns about whether the CFTC was properly able to monitor the energy markets.¹³⁴ CFTC Chairman James Newsome also conceded that foreign exchanges had not followed suit with similar moves to liberalize their regulatory regimes.¹³⁵

III. DEMUTUALIZATION AND MODERN TRENDS

A. *Trend of For-Profit Exchanges*

The trend by the world's largest exchanges to demutualize has pushed the debate about self-regulation back to the forefront.¹³⁶ Demutualization in this context refers to the conversion of non-profit, membership-owned organizations into for-profit stock corporations. Demutualization among futures and securities exchanges has been driven by forces in the business environment, including advances in technology, globalization of markets, a concentration of investment capital, competitive pricing pressure and government deregulation.¹³⁷

¹³² *Id.* at 64.

¹³³ *Hearing Before House Subcomm. on General Farm Commodities, supra* note 125, at 16 (statement by James Newsome, Chairman of the Commodity Futures Trading Commission). Newsome said that during the prior one and a half years, the CFTC, which usually handles about 100 investigations concurrently, had conducted roughly 30 investigations in the energy sector. *Id.* at 27.

¹³⁴ *Id.* at 22.

¹³⁵ *Id.* at 16-17.

¹³⁶ *See generally* Karmel, *supra* note 1.

¹³⁷ *Id.* at 368.

A dramatic shift in the economic and power structure of the securities industry is currently in progress. Although competition to traditional markets from electronic trading markets may be the precipitating cause of this upheaval, more than technology is driving these changes. The worldwide

By demutualizing, management at the exchanges hope to be able to raise larger pools of money, which in turn would allow them to invest more in technology and grow their businesses. Proponents also believe that demutualization will create a fairer marketplace. The members who have traditionally run the exchanges have been driven by the profits earned from their own trading. The demutualized exchanges would in theory be directed by shareholders and experienced management teams who are more focused on the bottom line,¹³⁸ which in a competitive environment would mean there would be pressure to provide the best possible services.

There are concerns that demutualization creates new conflicts of interest. One concern is that an inherent conflict exists between the interests of the shareholders and the market users.¹³⁹ It has been suggested, for example, that a for-profit exchange would not rigorously undertake self-regulatory obligations if those obligations negatively affect profitability.¹⁴⁰ The issue is whether a commercial entity that is running an exchange and seeking to protect and promote its business can also support the integrity and efficiency of the trading markets by setting and enforcing regulations that are in the public interest.¹⁴¹

One must enter this debate with the understanding that the current structure has its own conflicts. Even traditional, not for profit exchanges are run by members interested in

rise in stock exchanges trading volume, global integration of the capital markets and competition for trading profits have triggered a disintermediation comparable to the unfixing of commission rates. Decimalization has cut the conventional trading increment, formerly twelve and a half cents, to a penny or less. Futures exchanges similarly have been buffeted by technological change, global competition and resulting cost pressures.

Id.

¹³⁸ Robert Wilmoth, President of the National Futures Association, Remarks at the IOSCO Conference (June 24, 2001), *available at* <http://www.nfa.futures.org/news/mewstestimony.asp?articleID=287> (last visited Mar. 19, 2005).

¹³⁹ See Erickson, *supra* note 2, at 5.

¹⁴⁰ *Id.* at 5-6.

¹⁴¹ Karmel, *supra* note 1, at 420. *But see* Erickson, *supra* note 2, at 6 n.9: [I]n a briefing of staff for the Senate Agriculture Committee, Robert Colby, Deputy Director of the SEC's Division of Market Regulation, raised the converse argument. Would a demutualized exchange have a perverse incentive to impose hefty fines for violative activity, thereby creating a profit center for the exchange? While this view might be a short-term profit maximization strategy, an exchange employing such a practice would quickly lose business in a competitive market where similar products are traded on many exchanges.

Id.

making money and enhancing value through trading and seat value.¹⁴² Furthermore, the current structure of exchange disciplinary programs, where members sanction fellow members, could arguably affect the rigor of an exchange's self-regulatory program. Therefore, to some extent, questioning the efficacy of a for-profit structure in fulfilling self-regulatory obligations is also questioning the current exchange structure.

According to a CFTC report on demutualization that was published by CFTC Commissioner Thomas Erickson in 2000, even if new conflicts arise under the for-profit context, exchanges would continue to have a self-interest in preserving their reputations for providing fair and efficient markets.¹⁴³

Exchanges like the CME, the New York Stock Exchange and the New York Mercantile Exchange aggressively market their records of regulatory enforcement to attract new business, and as more competitors enter the market place, the reputations of these exchanges will pay a heavier price when their regulatory systems fail.¹⁴⁴ During a Senate hearing in 2000, Thomas Donovan, the chief executive of the CBOT, told legislators that "the CFTC strictly should be an oversight agency, one that provides the flexibility for us to use our self—the regulatory structure as a marketing tool for people to want to come and trade"¹⁴⁵ At the same hearing, James McNulty, the CEO of the CME, concurred, saying that the exchange has built "a highly disciplined self-regulatory body in the CME, and we think that is one of the reasons people come to work with our exchange."¹⁴⁶

B. *Initial Reforms: Exchanges and Regulation Bodies React*

One issue that exchanges have been forced to address is the independence of boards of directors. A scandal over governance at the New York Stock Exchange led regulators to revisit issues surrounding exchanges' governance standards.¹⁴⁷ In September of 2003, NYSE Chairman and CEO Richard

¹⁴² Erickson, *supra* note 2, at 6.

¹⁴³ *Id.*

¹⁴⁴ *Id.*

¹⁴⁵ *Hearing Before S. Subcomm. on Research, Nutrition and General Legis., supra* note 124, at 20.

¹⁴⁶ *Id.* In the securities industry, the NYSE has a regulatory staff of 550 people and a budget of \$142 million annually. The NASD has a regulatory staff of 2100 people and an annual budget of \$500 million. *See* Cohen & Kelly, *supra* note 2.

¹⁴⁷ *See, e.g.,* Cohen & Kelly, *supra* note 2.

Grasso was pressured to resign after it was made public that he was entitled to close to \$140 million in compensation and deferred retirement benefits in 2003¹⁴⁸ (the NYSE as a whole made less than \$28.1 million in profits in 2002).¹⁴⁹ Much of the focus since has centered on the structure of the board, and claims that it did not receive enough information to gain a sufficient understanding of the pay package it was approving.¹⁵⁰

A review of the NYSE's approach is relevant to the study of futures exchanges because the futures industry has historically followed the lead of the securities industry.¹⁵¹ Grasso, a 35-year veteran at the NYSE, had been a respected figure in the debate over demutualization for both securities and futures exchanges. In a hearing before the Senate Banking Committee in September of 1999, Grasso said that the NYSE would need to demutualize, and possibly go public, in order to fend off competition from "electronic communications networks," commercially-owned electronic trading systems known as ECNs.¹⁵² Grasso argued that ECNs are not subject to cumbersome self-regulatory requirements, and are often owned by wealthy corporations that are willing to invest money to expand and enhance their businesses.¹⁵³ Demutualization would cause the members' interests to align with the success of the exchange as a whole, as opposed to being skewed toward the success of only the floor trading operations.¹⁵⁴ Under a for-profit structure the NYSE would also be able to raise money by

¹⁴⁸ Jake Keaveny & Brendan Intindola, *NYSE Chairman Grasso Resigns Under Pressure*, REUTERS NEWS, Sept. 17, 2003. It was later determined that Grasso's total compensation, including compensation and deferred benefits, was closer to \$190 million, when including an additional \$50 million he claimed to be owed. Ben White, *Former NYSE Chairman Grasso Sued Over Pay*, Washington Post, May 25, 2004.

¹⁴⁹ NEW YORK STOCK EXCHANGE, 2002 ANNUAL REPORT 42 (2002), available at http://www.nyse.com/pdfs/2002ar_financial_review.pdf (last viewed Mar. 27, 2005).

¹⁵⁰ Andrew Countryman, *NYSE Chief Proposes Independent Board*, CHI. TRIB., Nov. 6, 2003, at 1. New York Attorney General Eliot Spitzer, whose office has jurisdiction over not-for-profit corporations like the NYSE, said his office "will probe the role of NYSE board members and others that helped create" Grasso's compensation package." Under New York not-for-profit laws directors can only approve compensation packages to executives that are commensurate with the benefits that the executives provide to the corporation. Jake Keaveny and Mark McSherry, *Spitzer Says Troubled by Report on Grasso Pay*, REUTERS NEWS, Jan. 13, 2004.

¹⁵¹ See Karmel, *supra* note 1, at 402 ("To a large extent the CFTC is an analogue to the SEC . . .").

¹⁵² PUBLIC OWNERSHIP OF THE U.S. STOCK MARKETS: HEARING BEFORE THE SENATE COMM. ON BANKING, HOUSING AND URBAN AFFAIRS, 106th Cong. 3-4 (Sept. 28, 1999) (statement of Richard A. Grasso, CEO, New York Stock Exchange) [hereinafter Grasso, *Hearing*]

¹⁵³ *Id.*

¹⁵⁴ *Id.*

selling stock, either publicly or to private investors. Grasso also argued that greater competition in the market place would strengthen the NYSE's commitment to regulation.¹⁵⁵ At the time he made that statement, the exchange had no intentions of altering the compensation of its board—then made up of 50% industry representatives and 50% public directors unaffiliated with its members—as a way to eliminate conflicts.¹⁵⁶

The public outcry surrounding Grasso's ouster has since led the 211-year old exchange to dramatically alter its course. John Reed, the former co-CEO of Citigroup Inc. who was brought in as interim NYSE chairman, orchestrated a series of reforms.¹⁵⁷ NYSE members approved a plan that the board be cut down to 8 members, less than a third of its present size, and not include any representatives of the financial firms that are members of the exchange.¹⁵⁸ Under the new structure, the board is responsible for such issues as compensation, independent audits, and self-regulation, while a separate advisory committee that would include member firms would be created to help oversee issues that are strategic to the exchange's business.¹⁵⁹ The Securities and Exchange Commission has approved the proposal.¹⁶⁰

Such corporate governance initiatives are implemented on securities markets sooner than on futures markets because of the public nature of the companies that are listed on them. The latest board proposal at the NYSE is an extension to a similar shake-up some 31 years earlier. In 1972, significant changes were made to the NYSE constitution after release of the Martin Report, a congressionally commissioned study that

¹⁵⁵ *Id.*

¹⁵⁶ *Id.* at 5.

¹⁵⁷ See Phyllis Plitch, *Reed Keeps SRO Status, But Adds Independent Board*, DOW JONES NEWSWIRE, Nov. 5, 2003.

¹⁵⁸ See Greg Farrell, *Reed Proposes Cutting NYSE Board to Eight*, USA TODAY, Nov. 6, 2003. Several State treasurers and large public pension officials, some of whom publicly pushed for Grasso's ouster, felt that Reed's plan was just more of the status quo. Sean Harrigan, president of the nation's largest public pension fund, the \$145 billion California Public Employee's Retirement System, said "Investors were expecting a home run proposal to reform the New York Stock Exchange. What we got . . . is not even a base hit." Arden Dale, *Pension Funds See Flaws in NYSE Reform Plan*, DOW JONES NEWSWIRE, Nov. 5, 2003.

¹⁵⁹ See Plitch, *supra* note 157.

¹⁶⁰ Ken Hoover, *SEC Approves NYSE's Reform Proposals, But Critics Will Press for More Change*, INVESTOR'S BUS. DAILY, Dec. 18, 2003. While SEC commissioners unanimously approved the proposals, "[SEC Chairman] William Donaldson said further change may come as the SEC undertakes a broad review of market self-regulation in 2004." *Id.*

was critical of the exchange.¹⁶¹ The report had recommended that the NYSE reduce the number of board seats to twenty-one from thirty-three, and that the number of members representing the public be increased to ten from three.¹⁶² Prior to the reforms half of the NYSE's board had been composed of public directors.

Traditionally, outside directors representing the public had only a token representation on futures exchanges.¹⁶³ In 1989, the Federal Bureau of Investigation ran an undercover sting at the CME and CBOT that resulted in the indictment of forty-eight individuals for various trading practice violations on commodity exchange floors.¹⁶⁴ The controversy surrounding the arrests led Congress to amend the Commodity Futures Act in 1992, including a provision which had previously failed that required at least 20% of the regular voting members of the exchanges' boards be independent, non-member directors.¹⁶⁵ Other provisions required that a diversity of interests be represented by including the principal groups of the commodities being traded, floor brokers and at least 10% from a group that included farmers, merchants, and exporters.¹⁶⁶

¹⁶¹ See Karmel, *supra* note 1, at 405.

¹⁶² *Id.* at 405-06.

These changes occurred in the context of uncertainty about the immunity of stock exchanges from the anti-trust laws, pressures to unfix commission rates and the financial and operational back office crisis of the securities industry. These developments ultimately led to the enactment of the 1975 Act that restructured the regulatory relationship between the SEC and SROs and stripped stock exchanges of some of their former autonomy. The Martin Report was intended to compel the NYSE to discard what vestiges of a private club atmosphere then remained and to become a quasi-public organization.

Id. (citing *House Subcomm. on Interstate and Foreign Commerce*, 92d Cong., 1st Sess., Securities Industry Study, Fed. Sec. L. Rep. (CCH) Spec. Rep. 438, at 3-13, 131-46, 155-68 (Aug. 25, 1972)). In 1971 the NYSE was incorporated, and initially the SEC had some doubts about whether this would hurt its ability to be a self-regulator. See Comments on NYSE Incorporation, Exchange Act Rel. No. 9112, 1971 WL 1717 (SEC) (Mar. 17, 1971).

¹⁶³ See Joseph Weber, *Red Flags Rising at the Merc*, BUSINESS WEEK, Oct. 20, 2003.

¹⁶⁴ See Karmel, *supra* note 1, at 408 (citing JERRY W. MARKHAM, COMMODITIES REGULATION: FRAUD, MANIPULATION AND OTHER CLAIMS § 14.10 (1998)).

¹⁶⁵ See *id.*

These criminal indictments were upheld, although the trials had mixed results. In response to the sting operations Congress passed legislation to strengthen trading in the pits . . . audit trails were strengthened, there was increased regulation of floor broker associations, and more outsiders were required to be included on exchange boards and disciplinary committees.

Id. at 408-09 (citing MARKHAM, *supra* note 164, at § 14.10).

¹⁶⁶ Karmel, *supra* note 1, at 409.

A major futures exchange to come under scrutiny following the NYSE scandal was the CME.¹⁶⁷ In 2000 the CME was the first exchange to demutualize¹⁶⁸ (preceding plans by the CBOT and the New York Mercantile Exchange),¹⁶⁹ and in 2002 it became the only major U.S. exchange to go public.¹⁷⁰ In an October, 2003 article, *Business Week* reporter Joseph Weber questioned the independence of the CME's board, and said that the CFTC is scrutinizing its corporate governance policies.¹⁷¹ At the time only four of the 105-year old exchange's twenty directors do not have ties to the CME or its trading floor, while fifteen were long time exchange members.¹⁷²

In November, 2003 the CME announced that it planned to make a number of changes to its Board that would enhance the independent oversight of key corporate governance issues.¹⁷³ As part of the plan, the CME would create a new board level committee in 2004, comprised solely of independent, non-member directors.¹⁷⁴ The committee would conduct an annual review of issues that include the independence of the CME's regulatory functions from its business operations; the CME's compliance with its statutory self-regulatory responsibilities; the funding of the CME's self-regulatory responsibilities; and

¹⁶⁷ Weber, *supra* note 163.

¹⁶⁸ *Chicago Mercantile Exchange to Dual List on Nasdaq Stock Market*, NASDAQ PRESS RELEASE, April 27, 2005, at http://www.nasdaq.com/newsroom/news/pr2005/ne_section05_047.stm. See Erickson, *supra* note 2, at 4. At the time that the CME demutualized is set in motion a two year plan to reduce its existing 39-member board to 19 members, with the exchange run by a chief executive officer hired by the board. *Id.*

¹⁶⁹ Peter McKay, *SEC Clears CBOT Reorganization*, WALL ST. J., Feb. 15, 2005, at C4.

¹⁷⁰ *Chicago Merc Nets About \$117.8 Million in IPO*, REUTERS NEWS, Dec. 12, 2002.

¹⁷¹ Weber, *supra* note 163 ("The Merc board—including its compensation committee—remains controlled by traders and floor brokers who are regulated by the exchange. Indeed, the Merc [CME] seems rife with the same conflicts of interest that tarnished the Big Board [NYSE] before CEO Richard A. Grasso self destructed.")

¹⁷² *Id.*

¹⁷³ Peter A. McKay, *CME Alters Governance in Step That May Help Avert Criticism*, WALL ST. J., Nov. 12, 2003, at C16.

Market-structure experts were quick to say the changes . . . are mild compared with the plan put out by Big Board [NYSE] interim Chairman John Reed. . . . Still, the plan will have some immediate results . . . trader William R. Shepard, longtime chairman of the Merc's compensation committee, will leave that position. Also, the plan, which came out of the governance committee now led by trader Jack Sandner, will require him to give up that position.

Id.

¹⁷⁴ *Id.*

the compensation of exchange employees involved in regulatory activities.¹⁷⁵

By making its boards more independent, the NYSE and the CME hope to preserve its regulatory roles from encroachment by the government. Critics have suggested that self-regulatory bodies should be completely separate from the exchanges' business operations.¹⁷⁶ The NYSE has publicly opposed suggestions that it should either spin its regulatory unit off into a subsidiary, or that the industry should move towards a single self-regulatory organization (SRO) for the entire securities industry, such as the National Association of Securities Dealers, a NYSE competitor.¹⁷⁷ In the futures industry, the National Futures Association (NFA) has aggressively marketed itself as a third party provider of regulatory services to other exchanges, though with limited success.¹⁷⁸

Regulatory authorities have been a step slower, but are moving ahead with comprehensive groups of proposals. The SEC, which saw nearly all of the major scandals of the last several years come under its watch, has opened a series of governance and regulatory related proposals for public comment.¹⁷⁹ Some of the proposals mimic those made by securities industry. The SEC would call for securities exchanges and registered securities associations to require a majority of board members to be independent, and certain board committees would be required to be composed solely of independent directors.¹⁸⁰ There would also be requirements that a separation be maintained between regulatory functions and

¹⁷⁵ *Id.*

¹⁷⁶ See Karmel, *supra* note 1, at 424-26.

¹⁷⁷ Grasso, *Hearing, supra* at note 152, at 3-4. "John Reed, the interim NYSE chairman brought in after the Grasso uproar, is seeking to preserve self-regulation." Cohen & Kelly, *supra* note 2.

¹⁷⁸ See *Hearing Before Senate Subcomm. on Research, Nutrition and General Legislation, supra* note 124, 11 (statement of Robert Wilmoth, Chief Executive, NFA).

From 1977 to 1999 there were no new futures exchanges formed. In the last six months, at least six different enterprises have stated their interest in creating new electronic futures exchanges. All of them are dedicated to using effective self-regulation . . . but none . . . are really shackled by the past. Everyone is looking for more efficient ways to perform their self-regulatory functions, and everyone has contracted NFA to discuss outsourcing that function to us.

Id. at 12.

¹⁷⁹ Fair Administration and Governance of Self-Regulatory Organizations, 70 Fed. Reg. 11 (Proposed Jan. 8, 2005) (to be codified at 17 C.F.R. at pt. 240, 242, and 249) [hereinafter Fair Administration and Governance].

¹⁸⁰ *Id.*

market operations, and that funds brought in from regulatory fines, fees and penalties be used for regulatory purposes.¹⁸¹

Further, the proposals would prohibit members that are brokers or dealers from owning or voting more than 20% of the ownership interest in the exchange.¹⁸² Among other proposals, the SEC would require exchanges to maintain their books and records in the U.S. and add reporting requirements by the exchanges to enhance transparency.¹⁸³ Exchanges that go public, and whose shares trade on their own exchange, would have a separate group of requirements to help supervise trading and enforce listing standards.¹⁸⁴

For its part, CFTC Chairman James Newsome opened a review of self-regulation in May of 2003.¹⁸⁵ The review revolves around an analysis of regulation under the Commodity Futures Modernization Act.¹⁸⁶ As of April, 2003, it had opened a formal request for commentary from futures market participants that includes: board composition, regulatory structure, forms of ownership of the exchanges, the structure of disciplinary committees, and other issues.¹⁸⁷

C. *Potential Alternatives: the NFA model and Market Competition*

The nature of the SRO structure makes the potential for conflicts almost inherent. Under the 1934 Commodities Exchange Act, SROs are required to act as quasi-governmental bodies in implementing federal laws as their own. Yet SROs are also membership organizations that represent the economic interests of their partners.¹⁸⁸ In addition, SROs are marketplaces concerned with preserving and enhancing their competitive positions.¹⁸⁹ As competition grows among marketplaces and SROs, it seems that the relationship that SROs have with their members inevitably will strain the SROs' ability to carry out their regulatory duties impartially.¹⁹⁰

¹⁸¹ *Id.*

¹⁸² *Id.*

¹⁸³ *Id.*

¹⁸⁴ Fair Administration and Governance, *supra* note 179.

¹⁸⁵ Commodity Futures Trading Commission: Governance of Self-Regulatory Organizations, 69 Fed. Reg. 111 (request for comments made June 9, 2004).

¹⁸⁶ *Id.*

¹⁸⁷ *Id.*

¹⁸⁸ See WHITE PAPER, *supra* note 6, at 8-9.

¹⁸⁹ See *id.* at 9.

¹⁹⁰ See *id.*

In a recently updated study, the Securities Industry Association (SIA), an industry group, evaluated six potential models for self-regulation.¹⁹¹ In evaluating the models the SIA echoed the original argument that the SRO model puts regulatory decisions in the hands of people familiar with the relevant facts, and that any regulatory change should not abandon the system in favor of a distant, generalist regulator that is not as deeply familiar with the markets it regulates.¹⁹² The study outlined a series of possible alternative structures that include the splitting off of SRO functions into subsidiaries of the exchanges; creation of a single SRO to audit and monitor all broker dealers; or putting all of the regulatory responsibility into the hands of the SEC (or CFTC).¹⁹³

Proponents of a single SRO system argue that the transition could be made relatively easily in the futures industry because the NFA has already been sanctioned by, and works closely with, the CFTC.¹⁹⁴ The NFA, which is similar to the National Association of Securities Dealers in the securities industry, began as a regulator for trading participants that were not registered with exchanges, but has moved into the business of outsourcing its regulation services. The NFA can avoid some of the criticisms arising from the demutualization of SROs because it is a non-profit organization.¹⁹⁵ Its board is made up of representatives from the industry, though it is not controlled by any one entity.¹⁹⁶

The economic inefficiencies that come with operating multiple SROs could also help to promote a single SRO system. The NFA has marketed itself as an outsourcing facility for self-regulatory functions.¹⁹⁷ By regulating numerous exchanges, the NRA (or another comparable outsourcer to enter the market)

¹⁹¹ See generally *id.*

¹⁹² *Id.* at 6.

¹⁹³ See WHITE PAPER, *supra* note 6, at 2-12.

¹⁹⁴ *Id.*

¹⁹⁵ See Natasha de Teran, *Eurex Signs Up National Futures Association for US Exchange*, FIN. NEWS, Nov. 6, 2003. Rudolf Ferscha, Eurex CEO, said of an agreement to farm out its regulatory services to NFA: "We have agreed on initial plans of a three-year contract, with automatic one-year renewal contracts thereafter. The NFA will ensure that Eurex US's customers are protected at all times, and that business will be fair, orderly and transparent." *Id.*

¹⁹⁶ See Board of Directors at the National Futures Association website, at <http://www.nfa.futures.org/aboutnfa/board.asp>.

¹⁹⁷ See *Hearing Before Senate Subcomm. on Research, Nutrition and General Legislation*, *supra* note 124, at 11 (statement of Robert Wilmouth, Chief Executive, NFA).

would benefit from efficiencies of scale.¹⁹⁸ Several newer exchanges have contracted the NFA in hopes of finding a cost effective means to regulate their trading operations. If pressure on expenditures continues then traditional exchanges like the CBOT and the CME could be pressured to reduce regulatory expenditures,¹⁹⁹ which in turn could diminish the quality of regulation. Traditional exchanges are already being squeezed by the trend towards lower trading fees. However, the NFA's outsourcing model is not free of potential conflicts either. As the practice becomes more prevalent, issues could be raised regarding the exchange's continuing responsibility over its contractor and the relationship of both entities to the overseeing government regulator.²⁰⁰

The NFA entered into an agreement with Merchants Exchange and BrokerTech, two small U.S. futures exchanges, to perform market surveillance, conduct background checks, investigate and litigate disciplinary matters, and perform audits and financial surveillance.²⁰¹ This led to a break through deal that could give the NFA new credibility as a third party regulator. In November of 2003, it signed a three-year contract with Eurex US, the U.S. arm of Eurex, to be its regulator.²⁰² Frankfurt-based Eurex, which in recent years surpassed the CBOT as the world's largest futures exchange in terms of volume traded, received approval from the CFTC to set up a U.S. exchange in 2004.²⁰³

Detractors of the single SRO model say that it would weaken self-regulation. Broker-dealer regulation has its roots in efforts to assure creditworthiness of exchange members.²⁰⁴ In that regard, the big exchanges have spent hundreds of millions of dollars setting up self-regulatory systems to stand behind assurances that large member firms are financially viable.²⁰⁵ A

¹⁹⁸ *Id.*

¹⁹⁹ *Id.*

²⁰⁰ See Int'l Org. of Sec. Communications Technical Comm., Discussion Paper on Stock Exchange Demutualization, at 8 (Dec. 2000), available at <http://www.iosco.org/pubdocs/pdf/IOSCOPD112.pdf>.

²⁰¹ Ros Krasny, *Eurex US in Deal With Regulatory Services Provider*, REUTERS NEWS, Nov. 5, 2003.

²⁰² Jeremy Grant, *Eurex US Unveils Governance Structure*, FIN. TIMES, Nov. 6, 2003.

²⁰³ *Eurex US Launch Date Moved to Feb 8 Pending CFTC Approval*, MARKET NEWS INT'L, Jan. 28, 2004.

²⁰⁴ See HISTORY OF COMMODITY FUTURES, *supra* note 1, at 86.

²⁰⁵ See Cohen & Kelly, *supra* note 2. In the securities industry, the NYSE has a regulatory staff of 550 people and a budget of \$142 million annually. The NASD has a regulatory staff of 2,100 people and an annual budget of \$500 million.

single SRO based in a separate location from the exchange and indirectly run by the CFTC or SEC may never be able to attain the same level of intimacy with a particular exchange. Not surprisingly, major exchanges like the NYSE, the CME and the CBOT have sought to preserve their regulatory duties by publicly opposing a single SRO model.²⁰⁶

Ultimately, competition in the market place may dictate the future model. If choice and competition are important in how financial products are offered, perhaps there are analogous benefits in terms of how exchanges are self-regulated.²⁰⁷ Just as the NFA has offered its services as third party regulator, the CME or CBOT also may decide to compete by also farming out their regulatory services.²⁰⁸ Thomas Erickson, the former CFTC commissioner, indicated there is talk that the CME has studied such an initiative. The NASD has taken similar initiatives in the securities business, and could also work toward offering a similar service to futures exchanges, according to Erickson.²⁰⁹ Such a scenario opens up the specter of further conflicts. For instance, the CME could create a structure where it acted as regulator to itself and a competitor. A third party SRO could be acquired by a large financial firm like Citigroup Inc. or J.P. Morgan Chase & Co., which also operate FCMs. Will the quality of self-regulation diminish amid the pressure to cut costs?²¹⁰

Competitive forces among futures exchanges may also give way to new incentives to uphold regulatory standards.²¹¹

²⁰⁶ See *House Subcomm. Hearing on General Farm Commodities and Risk Management*, *supra* note 125, at 61. (statement of Terrence A. Duffy, Chairman Chicago Mercantile Exchange) ("Rather than detracting from our ability as a self regulator, the CME's incentives and capability to maintain an effective program of self-regulation have been enhanced by its reorganization as a for-profit company.")

²⁰⁷ See Erickson, *supra* note 2, at 8. Moreover, to require exchanges to contract with a super self-regulator would appear to be inconsistent with the CFTC's role as an oversight agency, especially if regulatory concerns do not outweigh the benefits of the current SRO structure. *Id.*

²⁰⁸ Telephone interview with Thomas Erickson, former CFTC Commissioner and Vice-President, Bunge Ltd., Washington, D.C. (Nov. 7, 2003).

²⁰⁹ *Id.* The NASD has been pushing for a single SRO model and the former Chairman of the SEC, Arthur Levitt, briefly embraced this model. See Jeffrey E. Garten, *Manager's Journal: How to Keep NYSE's Stock High*, WALL ST. J. Sept. 13, 1999, at A44. The main barrier has been that the NYSE opposes the single SRO model. Grasso, *Hearing*, *supra* note 152.

²¹⁰ Telephone interview with Thomas Erickson, former CFTC Commissioner and Vice-President, Bunge Ltd., Washington, D.C. (Nov. 7, 2003).

²¹¹ Karmel, *supra* note 1, at 370.

An interesting and relevant question is whether current trading technologies and the competition these technologies have engendered should lead to a reduction of SEC market regulation, rather than increase in regulation

Currently, exchanges like the CBOT and CME say that the integrity of their market place is the biggest incentive to uphold such standards. But that argument has weaknesses because for many futures products those exchanges offer the only liquid markets for particular contracts, and thus they enjoy *de facto* monopolies.²¹² If, for instance, the Eurex's U.S. exchange gains market share, and also offers a more transparent, and fair trading operation, then regulation issues could become more prevalent in traders' decisions over where they do business. In at least one instance, competitive pressures have already had an impact. In 2003 the SEC issued a report that said the American Stock Exchange had massive shortcomings in its regulation of options trading and that it had attempted to cover up its deficiencies.²¹³ In October of 2003 board members from the NASD, which holds a majority stake in the American Stock Exchange, and the American Stock Exchange voted to have the NASD take over its self-regulation.²¹⁴ In making the decision, the directors at both boards considered the American Stock Exchange's poor performance in the regulatory arena and the high cost of regulation.²¹⁵

IV. CONCLUSION

Critics have questioned the SROs' ability to maintain fair and transparent trading, but as this Note has demonstrated, failures in government oversight have also been pervasive. It seems unlikely that the government could operate more efficiently as a sole regulator.²¹⁶ If pure government

envisioned by current SEC concept and rulemaking releases, so that competition rather than regulation can determine outcomes.

Id. at 369-70.

²¹² Stephen Craig Pirrong, *The Self-Regulation of Commodity Exchanges: The Case of Market Manipulation*, 38 J.L. & ECON. 141, 154 (1995) ("As the advocates of self-regulation suggest, competition from other exchanges could mitigate, and perhaps eliminate, these problems. Unfortunately, it is by no means clear that competition between exchanges in a particular contract is especially acute.").

²¹³ Jed Horowitz et al., *SEC Says Amex Had 'Serious Failure' in Enforcing Regulations*, BLOOMBERG NEWS, Sept. 29, 2003.

²¹⁴ Jenny Anderson, *NASD May Take Over Regulation of Exchange*, N.Y. POST, Oct. 21, 2003, at 31.

²¹⁵ *Id.*

²¹⁶ Markham, *supra* note 9, at 405.

[W]e must be careful of what we wish for in life. A single regulator may also seek to expand its powers after a scandal. A single regulator will also undoubtedly use bad judgment in times of crisis. A single regulator could also stifle competition, over-regulate, and cause a loss of competitive position in

regulation were a preferable alternative, the system of self-regulation would have been scrapped years ago amid the government's many trials and errors.²¹⁷ The SRO system is preferable to a pure government regulatory scheme because it defrays much of the costs onto the market users, and makes efficient use of the expertise at the exchanges.

The role and duties of SROs vis a vis government regulation has steadily evolved since adoption of the Commodity Exchange Act and the Securities Exchange Act, with the government approving legislation throughout the years to increase its oversight authority and impose stricter standards. While the government initially sought to micro-manage regulation at the exchanges, it more recently determined that giving SROs more autonomy is more effective.

Thomas Erickson, who spoke regularly about the future of SROs during his tenure as a CFTC Commissioner, said in an interview that from a political standpoint the SRO system has too much history to ever be scrapped altogether.²¹⁸ There will be conflicts of interest in any system, and so the challenge is to create a system with the right oversight and incentives so that as many conflicts as possible are eliminated.²¹⁹ In that regard, self-regulation is a preferable system to pure government regulation, and the question becomes one of balance.

The CFTC should take several steps to eliminate the specter of conflicts of interest within exchanges. It should implement a model for independent boards similar to that adopted by the NYSE, or the rules that the SEC has proposed. These rules would ensure that exchange members are separated from regulation related decisions. Secondly, the CFTC should facilitate competition in the marketplace to the extent possible. For example, the Eurex's entrance into the U.S. could spark the beginning of a period of a competition driven regulation market, where market participants themselves go far in determining what the most effective SROs,

international markets. It could even try to become a Japanese MoF [Ministry of Finance] that seeks to manage the economy by bureaucratic fiat.

Id.

²¹⁷ Karmel, *supra* note 1, at 401. The 1975 Act sought to preserve and reinforce the concept of industry self-regulation. *Id.*

²¹⁸ Telephone interview with Thomas Erickson, former CFTC Commissioner and Vice-President, Bunge Ltd., Washington, D.C. (Nov. 7, 2003). Self-regulation is so enshrined in U.S. securities regulation that it is unlikely and probably not in the public interest for it to be supplanted by government regulation. Karmel, *supra* note 1, at 427.

²¹⁹ *Id.*

or self-regulatory model, will be. Finally, the CFTC needs to establish a formal structure that facilitates regular dialogue with exchanges and other market participants. The resulting effects of demutualization, electronic trading, and the globalization of marketplaces have yet to be fully realized. In this way, the CFTC would be able to react in a steady and effective manner to conflicts or other issues that arise from demutualization and other forces in the marketplace.

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