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THE COMMODITY FUTURES TRADING COMMISSION AND THE RETURN OF THE BUCKETEERS: A LESSON IN REGULATORY FAILURE

M. VAN SMITH*

I. INTRODUCTION

In 1974, Congress enacted the Commodity Futures Trading Commission Act of 1974 (CFTCA). The CFTCA significantly amended the Commodity Exchange Act and was intended to strengthen and centralize federal commodities regulation. One of the specific purposes of the CFTCA was to end the fraudulent exploitation of the public by bucket shop operators, the "bucketeers" of the 1970s. Unfortunately, rather than putting an end to the bucketeers, there was a recrudescence of the bucketeers under the 1974 Act.

Partially in response to the resurgence of the bucketeers, Congress in 1978 passed the Futures Trading Act of 1978 (FTA). Nevertheless, the bucketeers have persevered and proliferated. This article will trace the emergence of the bucketeers under the Commodity Exchange Act, their adaptation to the restrictions of the CFTCA, and their perseverance under the FTA.

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II. REGULATION OF COMMODITY OPTIONS

A. REGULATION UNDER THE COMMODITY EXCHANGE ACT OF 1936

Commodity options are contracts by which one party purchases from another party the right to buy or sell a commodity at an agreed price and within an agreed time.[1] In 1936, Congress prohibited the trading of options on commodity futures by enacting the Commodity Exchange Act.[2] This prohibition was intended to protect commodity futures markets from the disruption caused by option dealers.[3]

The Commodity Exchange Act regulated only commodity futures specified by the Act.[4] Thus, the Act did not prohibit options on futures markets not regulated under the Act, commonly known as "world" commodities.[5] The lack of regulation under the Commodity Exchange Act of the so-called world commodities set the stage for the return of the bucketeers.

On April 28, 1971, Harold Goldstein opened an office in Los Angeles to sell options on commodity futures not regulated under the Commodity Exchange Act. Goldstein had stumbled onto a

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1. An option to buy is known as a "call," referring to a party's "calling" for the commodity from the other party; an option to sell is known as a "put," referring to a holder's "putting" the commodity to the other party. An option given the holder to either buy or sell is known as a "double" option, or "straddle"; a double option or straddle is a combination of a put and a call.

The price at which the holder of an option can either buy or sell the optioned commodity is the "striking price." When the striking price is the same as the market price of the commodity being optioned, the option is an "at market" option. If, for the holder, the striking price is better than the market price, the option is "in the money"; if the striking price is worse than the market price, the option is "out of the money." The money paid for an option is the "premium." The premium is paid to the "grantor," or "writer," of an option.

Commodity options specify a period, ranging from two to fourteen months, during which time the option may be exercised. The date and hour by which an option holder must state that he wants to exercise an option is the "declaration" date. If an option is not declared by the declaration date, it is "abandoned" and the premium is forfeited.

The "commission" on a commodity option is a fee for brokering the option. The "break even point" is how much the price of a commodity must change in favor of its holder to pay for the premium and the commission. Options which are traded on an exchange are called "exchange traded" options, and options which are not traded on exchanges are called "dealer" options.

For further explanation of these and other terms used in commodity options trading, see CFTC v. Crown Colony Commodity Options, Ltd., 434 F. Supp. 911 (S.D.N.Y. 1977); P. CRACRAFT, LONDON OPTIONS ON COMMODITIES 210 (1977); R. GIBSON-JARVIE, THE LONDON METAL EXCHANGE 134 (1976); S. KROLL & J. SHISHKO, THE COMMODITY FUTURES MARKET GUIDE 258-68 (1973); R. TEWELES, C. HARLOW & H. STONE, THE COMMODITY FUTURES GAME: WHO WINS? WHO LOSES? WHY? 227-29 (1974).

2. Pub. L. No. 74-675, ch. 545, 49 Stat. 1491 (1936) (current version at 7 U.S.C.A. §§ 1-24 (West 1980)).

3. H.R. REP. NO. 74-421, 74TH CONG., 1ST SESS. 5 (1935); *Hearings on H.R. 3009 Before the House Comm. on Agriculture,* 74th Cong., 1st Sess. at 94-95 (1935); P. MEHL, TRADING IN PRIVILEGES ON THE CHICAGO BOARD OF TRADE 75-78 (U.S. Dep't of Agriculture Cir. No. 232, 1934).

4. Commodity Exchange Act, Pub. L. No. 74-675, ch. 545, § 2, 49 Stat. 1491 (1936) (current version at 7 U.S.C.A. § 2 (West 1980)).

5. *See* Werst v. First Commodity Corp., [1977-1980 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 20,542 at 22,237 (D. Mass. 1978).

loadstone of public cupidity. In less than two years, he pyramided an $800 initial investment into Goldstein-Samuelson, Inc., a corporation with offices world-wide which had sold over 175,000 options valued at $88 million.[6] Goldstein-Samuelson represented that its options were backed by a computerized program to buy futures contracts for every option.[7] Goldstein also represented that it covered its obligations by matching every dollar of its customer's profit with a position in the futures markets.[8] Goldstein-Samuelson actually attempted to cover its options with positions in the futures markets only during its first few months in business; efforts to cover options ceased after six months.[9]

Although government officials were slow to realize it, Goldstein-Samuelson's selling of uncovered, or "naked," options was nothing more than the bucket shop under a new guise.[10] The quintessence of Goldstein-Samuelson's fraud was in representing that its options were bona fide transactions in which holders actually acquired a put or call for the commodities optioned. In truth, Goldstein-Samuelson's naked options were nothing more than bets which would be settled, if at all, according to fluctuations in commodity prices. Of 175,000 options it sold, Goldstein-Samuelson attempted to deliver the commodity optioned in only four instances, and actually purchased a futures contract in only one instance.[11] As sales of options increased, Goldstein-Samuelson had to take in an ever-increasing amount of new premium money from new investors in order to cover the increased value of the futures contracts previously optioned. Thus, the millions of dollars in sales which

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6. Stipulation of All Relevant Facts in Lieu of Trial on Preliminary Injunction for the Plaintiff at 7, SEC v. Goldstein- Samuelson, Inc., No. 73-472 (C.D. Cal., Oct. 11, 1973) [hereinafter cited as Goldstein-Samuelson Stipulation].

7. Wall St. J., June 28, 1973, at 38, col. 2.

8. Goldstein-Samuelson Stipulation, *supra* note 6, at 12.

9. *Id.* at 6.

10. *See* People v. Gardner, 72 Cal. App. 3d 641, 140 Cal. Rptr. 238 (1977). The term "bucket shop" originally described places on the east side of London where persons who had cadged leftover beer and liquor would gather together to drink. *See* J. HILL, GOLD BRICKS OF SPECULATION 39 (1904). Wychoff attributes the term to the practice of selling odd-lot grain "by the bucket." P. WYCHOFF, WALL STREET VENTURES AND ADVENTURES 264 (1968). In time, "bucket shop" came to be used as a term of derision to describe a place where persons placed bets on market quotations.

In executing a customer's order to buy or sell commodity futures or securities, a brokerage firm will execute its customer's orders by an exchange transaction. A customer's order to purchase or sell a commodity futures contract must be executed on a commodity futures exchange. A customer's order to buy or sell a security will be executed on a stock exchange or by a brokerage firm dealing with its customer from securities it owns. Bucket shops operate under the guise of being brokerage firms. However, instead of actually executing orders of their customers, bucket shops put orders down as bets. Bucket shops bet that their customers' margin will be lost before they can make a profit. To promote their customers' losing, bucket shops set margins so low that normal market fluctuations do not wipe out customers' margin. Bucket shops also manipulate market quotations so that customers' margins are lost. WYCHOFF, *supra,* at 33.

Should enough customers have winning positions, a bucket shop might arrange to have a market rigged. *See* E. LEFEVRE, REMINISCENSES OF A STOCK OPERATOR 12 (1923).

11. Goldstein-Samuelson Stipulation, *supra* note 6, at 11.

Goldstein represented as financial strength actually guaranteed that the scheme would eventually collapse.[12]

State and federal securities officials attacked the selling of naked options on the ground that they were unregistered securities,[13] since naked commodity options could be characterized as investment schemes. What a person who purchased an option invested in, albeit unknowingly, was a bucket shop operator's ability and willingness to keep a Ponzi fraud[14] afloat long enough to pay off on a winning bet. The value of the commodity option thus depended upon the ability of the operator to defraud new victims. Since the purchaser of a naked option risked the money he paid for the option in a "common enterprise," naked options came within the traditional definition of a security.[15]

As the fraudulent nature of naked options was exposed, courts began to hold that they were securities.[16] As securities, naked options could not be legally sold without being registered under state and federal securities laws. Furthermore, options dealers probably would not have been allowed to register had they attempted to comply with state securities laws. For example, the Georgia Securities Commission took the position that naked options violated statutes prohibiting bucket shops and could not be registered, even if all of the other registration requirements were met.[17] Other state officials took similar positions.[18]

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12. To allay a growing suspicion that his options were not covered, Goldstein forged a letter which he sent to customers stating that American Bankers Insurance Company of Miami had written a one-million-dollar performance bond to guarantee payment on Goldstein-Samuelson's options. *Id.* at 15. Goldstein pleaded guilty to three counts of mail fraud for his use of the forged letter. Wall St. J., Nov. 12, 1973, at 1, col. 2.

13. Long, *The Naked Commodity Option Contract As a Security,* 15 WM. & MARY L. REV. 211 (1973) [hereinafter cited as *The Naked Option*].

14. A Ponzi fraud is synonymous with a big store Peter-to-Paul confidence game in which investors are lured by the prospect of huge profits on investments. In reality, profits are paid from money taken in from later investors. The fraud is named after Charles Ponzi, who opened offices in 1919 in Boston and sold a scheme in which investors could double their money in 90 days by purchasing postal coupons in foreign countries at depressed rates which would then be redeemed in the United States at higher rates. Using payoffs to early investors to lure victims, Ponzi was besieged by eager investors. He soon became a millionaire, taking in $200,000 a day. In 1920, the scheme was exposed by the *Boston Globe.* Ponzi paid off $15 million of the $20 million he took in during his year of operation. He eventually was sentenced to four years in prison. *See* J. NASH, HUSTLERS AND CON MEN 311-12 (1976).

15. *See* Georgia Sec. Comm'r Release No. 1 (Sept. 18, 1973).

16. *E.g.,* People v. Puts and Calls, Inc., [1973] 3 BLUE SKY L. REP. (CCH) ¶ 71,090 (Cal. Super. Ct. Los Angeles 1973); King Commodity Co. v. State, 508 S.W.2d 439 (Tex. Civ. App. 1974); 1 A. BROMBERG, SECURITIES LAW: FRAUD ¶ 442 (1977); *see The Naked Option, supra* note 13, at 230-31. *See also* Glazer v. National Commodity Research and Statistical Serv., 388 F. Supp. 1341, 1343-45 (N.D. Ill. 1974).

17. *See* Georgia Sec. Comm'r Release No. 1 (Sept. 18, 1973).

18. California Securities Commissioner Brian Van Camp has stated that options violated California bucket shop laws. Barrows Nat'l Business and Financial Weekly, Mar. 5, 1973, at 21, col. 2. The securities administrators of Colorado and Utah announced similar positions. *In re* Commodity Options, [1973] 1 BLUE SKY L. REP. ¶ 9722 (Colo. Sec. Comm'n); *In re* Commodity Options, Notice and Order, [1973] 3 BLUE SKY L. REP. ¶ 47,656 (Utah Sec. Comm'n).

The strategy of the states and the SEC in attacking the bucketeers under the securities laws succeeded.[19] By 1975, the states and the SEC had put the bucketeers out of business.[20]

B. REGULATION UNDER THE COMMODITY FUTURES TRADING COMMISSION ACT OF 1974

In 1974, Congress enacted the Commodity Futures Trading Commission Act.[21] One of the primary incentives for passage of the CFTCA was to bring options on previously unregulated commodities under the jurisdiction of the Commodity Exchange Act.[22] The CFTCA reflected the hostility of Congress toward the sale of commodity options, and bills introduced in the 93rd session prohibited all options.[23] However, under pressure from the proponents of commodity options, Congress compromised and delegated to the Commodity Futures Trading Commission (CFTC) the authority to decide whether options should be banned.[24] Thus, the CFTCA banned the sale of options contrary to regulations adopted by the CFTC within one year from the effective date of the Act, unless the CFTC notified Congress that it was unable to prescribe such regulations within one year.[25]

When the CFTC came into existence in April of 1975, it had the experience of state securities officials and the Securities and Exchange Commission (SEC) to draw on in deciding how to deal with commodity options. The basic problem was to allow option trading

19. *See* Long, *Commodity Options—Revisited,* 25 DRAKE L. REV. 75, 83 n.30 (1975) [hereinafter cited as *Options Revisited*]; *The Naked Option, supra* note 13, at 212-30.

20. *See Options Revisited, supra* note 19, at 131.

21. Pub. L. No. 93-463, 88 Stat. 1389 (1974) (amending the Commodity Exchange Act, Pub. L. No. 74-675, ch. 545, 49 Stat. 1941 (1936)) (current version at 7 U.S.C.A. §§ 1-24 (West 1980)).

22. British Am. Commodity Options Corp. v. Bagley, 552 F.2d 482, 485-86 (2d Cir.), *cert. denied,* 434 U.S. 938 (1977); CFTC v. J.S. LOVE & Assocs. Options, Ltd., 422 F. Supp. 652, 658-59 (S.D.N.Y. 1976).

The dichotomy between regulated and unregulated commodities was perpetuated under the CFTCA. The flat prohibition of options on domestically produced commodities specified by section 2(a) of the Act was continued in section 4c(a)B. 7 U.S.C.A. § 6c(a)B (West 1980). With respect to all other commodities regulated under the Act, Congress gave the Commodity Futures Trading Commission power to decide whether to prohibit or to permit option transactions and, if permitted, to set terms and conditions. Section 4c(b) provided in pertinent part: "No person shall offer to enter into, enter into, or confirm the execution of any [commodity option] transaction . . . contrary to any rule, regulation, or order of the Commission prohibiting any such transaction or allowing any such transaction under such terms and conditions as the Commission shall prescribe. . . ." 7 U.S.C.A. § 6c(b) (West 1980).

23. H.R. 13113, 93d Cong., 1st Sess. (1973) (addition of § 201 without altering 7 U.S.C. § 6c(a) (B) (1970); S. 2837, 93d Cong., 1st Sess. § 308(b)(2) (1973); S. 2485, 93d Cong., 1st Sess. § 6c(a)(B); S. 2578, 93d Cong., 1st Sess. (1973) (addition of § 7 without altering 7 U.S.C. § 6c(a)(B) (1970)). *See also* Note, *The Role of the Commodity Futures Trading Commission Under the Commodity Futures Act of 1974,* 73 MICH. L. REV. 710, 722 (1974) [hereinafter cited as *The Role.*].

24. *The Role, supra* note 23, at 722.

25. Commodity Futures Trading Commission Act, *supra* note 21, at § 402(c) (current version at 7 U.S.C.A. § 6c(b) (West 1980)).

by legitimate dealers, but at the same time keep the bucketeers from infiltrating the market. This had always been a difficult task.[26]

Outwardly, a bucket shop operation is similar to a brokerage. What differentiates the bucketeer from a legitimate dealer goes on behind closed doors. If a dealer spends premium money without regard to the obligations he has incurred, it is bucketing; if a dealer spends premium money to cover obligations he has incurred, it is legitimate options trading. There can be a considerable degree of variation in how a dealer covers an obligation. A dealer may cover his obligation by having an inventory of commodities to deliver on calls, or money to buy commodities to cover his puts. If a dealer does not want to keep an inventory, he may contract with someone who has the commodity for delivery to cover his obligation. A dealer may also cover his position by balancing his obligations against those of his customers who are on the opposite side of a market. Finally, a dealer may cover by a combination of the above methods. If a dealer can use premium money to cover options solely by speculating in the futures markets, the difference between covered and uncovered options is chimerical at best.

Because the line between a legitimate and a bucketed commodity option can be blurred, the difference will often depend upon the good faith of the dealer in meeting the obligations of his customers. For this reason, the regulator, in order to regulate commodity options, must have power over the premium; specifically, the power to keep an option dealer from disposing of premium money until after he has satisfied his obligations to his customer.[27]

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26. Bucket shops were prevalent in the United States from the 1880s until the 1920s. T. HIERONYMUS, ECONOMICS OF FUTURES TRADING 88 (1971); WYCHOFF, *supra* note 10, at 18, 33.

Although keeping a bucket shop was illegal, early bucket shops apparently were tolerated. The early bucket shops were patronized mostly by boys who worked as runners for brokerage firms, school boys, laborers, housewives, and others who had a predilection to gamble a few dollars. HIERONYMUS, *supra*, at 89; WYCHOFF, *supra* note 10, at 20.

The early bucket shops do not seem to have made much of a pretense of being brokerage operations. The line between a brokerage and a bucket shop was often a thin one. Before the federal securities laws, most securities transactions were on a ten percent margin. *See* R. SOBEL, THE CURBSTONE BROKERS 69 (1970). Margin transactions were financed by banks lending money to brokerage firms to buy or sell securities on margin for their customers. Wall Street banks refused to be associated with brokerages other than New York Stock Exchange member firms. *Id.* at 67. The refusal of banks to lend to brokerages other than members of the New York Stock Exchange forced members of the Curb Exchange, later to become the American Stock Exchange, and the Consolidated Exchange to either finance margin transactions with their own money or bucket their customer's orders.

In 1883, a committee of the Illinois House of Representatives was unable to discern a significant difference between the trades executed on the Chicago Board of Trade and those in bucket shops. *See* Irwin, *Legal Status of Trading in Futures*, 32 ILL. L. REV. 155 n.5 (1938). In 1891, a member of the Chicago Board of Trade wrote a pamphlet defending bucket shops. *Id.* at 156.

Left to their devices, the bucket shops extracted a tremendous amount of money from the public. *See* SOBEL, *supra*, at 71. The large bucket shops did more business than legitimate brokerage firms. LEFEVRE, *supra* note 10, at 7; WYCHOFF, *supra* note 10, at 264. The bucketeers had enough

The Goldstein-Samuelson era dealers could not live with regulations which forced them to cover their options. As with any Ponzi scheme, the operation of the naked option dealers depended upon a continual inflow of money from new investors to pay those few investors who had purchased profitable options. The illusion of successful investing is essential to the momentum of a Ponzi scheme. Money was also needed to pay sales commissions and overhead, which were quite high. Harold Goldstein testified at a bankruptcy hearing of Goldstein-Samuelson, Inc., that forty to fifty percent of the premium money was paid to customers whose options became profitable, and forty percent went to overhead, including sizable commissions to salesmen.[28] Because of the high cost of their fraudulent operations, naked option dealers could not have

influence in 1903 to kill bills against bucket shops in five of six state legislatures. *See* HILL, *supra* note 10, at 40. The Consolidated Exchange, the second largest stock exchange in New York City and at one time the most powerful rival of the New York Stock Exchange, came to be regarded as a den of bucketeers. The Chicago Open Board of Trade, the "Little Board" in Chicago, was captured by bucketeers in order to obtain commodity market quotations. HILL, *supra* note 10, at 466-67.

The business which bucketeers diverted from brokerage firms provoked campaigns against them by the exchanges. As bucket shops came under attack, they became adept at disguising their operations as brokerages. A bucket shop could escape detection by executing a customer's order on an exchange, but later, without the knowledge of a customer, the dealer would close out the transaction and carry it as a bet. *See* SOBEL, *supra*, at 69; Note, *Legislation Affecting Commodity and Stock Exchanges*, 45 HARV. L. REV. 912, 916 (1931) [hereinafter cited as *Legislation*].

The exchanges attempted to put the bucket shops out of business by depriving them of market quotations, and eventually established their legal right to prevent bucket shops from obtaining market quotations. *See, e.g.*, Board of Trade of Chicago v. Christie Grain & Stock Co., 198 U.S. 236 (1904). This did not, however, put the bucket shops out of business. SOBEL, *supra*, at 123. The bucket shops continued to operate, either by surreptitiously obtaining market quotations, or by simulating market quotations. WYCHOFF, *supra* note 10, at 262.

Bucketeers were prosecuted, but the sporadic enforcement of the laws, light sentences, and the ability of persons in the highest echelons to escape prosecution made it difficult to put the bucketeers out of business. HILL, *supra* note 10, at 39-40; WYCHOFF, *supra* note 10, at 266. Eventually bucket shops disappeared as a part of the investment scene, probably due to publicity campaigns against them more than as a result of state police action. WYCHOFF, *supra* note 10, at 262. In any event, whatever the reasons for the disappearance of bucketeering, by the 1970s the bucket shop was considered an anachronism. In February of 1973, the California Commissioner of Corporations characterized California's bucket shop law as an archaic criminal statute which regulatory agencies were reluctant to use. Wall St. J., Feb. 6, 1973, at 44, col. 2.

27. This was the thought behind regulations which were adopted by the California Commissioner of Corporations under the California Commodity Law. These regulations required that eighty percent of premium money be segregated, or one hundred percent of a dealer's obligations if greater, less the value of the equity of the commodity or futures contract used for cover. 8 CAL. ADMIN. CODE, tit. 10, § 350.545(a) (1974).

The California regulations also required a dealer to acquire the commodity contract underlying an option when the market price of a commodity was fifty percent or less of the premium received. Option dealers were further required to have a minimum adjusted working capital, as defined by the regulations, of $100,000, or more in some instances. *Id.* at § 350.537.4.

One must have doubts as to how effective the California regulations would have been. The California commodity bucket shops collapsed under the weight of their own corruption before the California regulations were tested. The $100,000 capital requirement for entry into the commodity option business was a nominal entrée. It would not have kept the bucketeers from infiltrating the ranks of the state-sanctioned dealers. Therein lies the problem. What could be a better front for a big-store confidence game than the great seal of California on a license? Thus, having put a number of potential bucketeers into business, the regulator must undertake the responsibility to keep them honest. Short of putting a keeper on the till of each dealer, how would a regulator know what a dealer takes in or what he does with what he takes in? Ultimately, the California regulations depended on the willingness of dealers to comply. The state would have been put in the position of sponsoring dealers without the ability to keep them honest.

28. Wall St. J., July 30, 1973, at 5, col. 2.

covered the options they sold, even if they had been inclined to do so.

Because of the difficulty of monitoring cover, licensing is crucial. Josef Rotter, one of the pioneers in the naked option business, stated that fifty to sixty percent of the individuals who were option dealers could not have been registered under state and federal securities laws because of past felonies or securities law violations.[29] Stringent fitness and large capital requirements undoubtedly would have kept most of the bucketeers from being licensed. The traditional integrity of options dealers in London was due to the considerable finances required for membership on the London exchanges. An analogous incentive for compliance would have been achieved if dealers had been required to put up funds sufficient to guarantee compliance with regulations before being allowed to sell options to the public.

It is now apparent, however, that whatever regulations the CFTC could have adopted would not have made much difference. Although it was unthinkable that the CFTC would do nothing — neither ban nor regulate — that is, in effect, what the CFTC did. The CFTC did no more than adopt a general rule prohibiting the fraudulent selling of options.[30] This was tantamount to granting a franchise to any charlatan to sell naked options. In setting its regulatory priorities, the CFTC simply overlooked commodity options.[31] The CFTC's oversight thus initiated another naked commodity option era. But this time the SEC and the states could not go after the bucketeers, as their laws had been preempted by the agency charged with such regulation — the CFTC.

The preemption of state and federal securities regulation by the CFTCA was an historic event. Although federal legislation had comprehensively regulated the field of commodity futures since 1922, state law had never been preempted. In 1922, Congress enacted the Grain Futures Act.[32] The Grain Futures Act established requirements for the validity of grain futures contracts and subjected grain exchanges to federal supervision and control. The recognition of the legality of commodity futures trading implicit in the Act should have immunized commodity futures trading from attack under state bucket shop laws. In 1933, however, the United

29. Wall St. J., Feb. 2, 1973, at 1, col. 1.

30. 40 Fed. Reg. 26,504 (1974), *proposed codification redesignated by* 41 Fed. Reg. 51,817 (1976) (currently codified in 17 C.F.R. § 32.9 (1980)).

31. *See generally* H.R. REP. No. 95-1181, 95th Cong., 2d Sess. (1978).

32. Pub. L. No. 67-331, ch. 369, 42 Stat. 998 (1922). The Grain Futures Act was amended in 1936 and renamed the Commodity Exchange Act, Pub. L. No. 74-675, ch. 545, 49 Stat. 1491 (1936) (current version at 7 U.S.C.A. §§ 1-24 (West 1980)).

States Supreme Court, in *Dickson v. Uhlmann Grain Co.*,[33] held that the Missouri bucket shop law, under which commodity futures transactions had been found to be illegal, was not preempted by the Grain Futures Act.[34] Thus, even though commodity futures trading was sanctioned by the regulatory effect of federal law, and even though the states undoubtedly did not have the power to directly declare commodity futures trading to be illegal, states still had the power to indirectly make it illegal by prohibiting certain trading practices.[35]

That states had the power to make illegal an activity sanctioned by federal law was an anomaly.[36] In 1936, commodity exchanges sought to nullify the *Dickson* decision by proposing an amendment to the Commodity Exchange Act which declared the validity of commodity futures contracts.[37] This attempt failed. The anomaly of the states having the power to make commodity futures trading illegal was incorporated into the Commodity Exchange Act.[38]

Although it may have been an anomaly for the states to retain the authority to make commodity futures trading illegal, Congress structured the Act in such a way that the states and the federal government were able to avoid conflict. In *Rice v. Board of Trade of Chicago*,[39] the plaintiff contended that the Chicago Board of Trade had adopted various unreasonable and discriminatory rules which were invalid, in part, because the Board had failed to seek approval by the Illinois Commerce Commission in accordance with Illinois law.[40] The Board argued that the state statute which required Commission approval was preempted by the Commodity Exchange Act and therefore void.[41] The Supreme Court, after considering the language and legislative purpose of the Act, stated:

> [S]ection 4c provides that "nothing in this section or Section 4b shall be construed to impair any state law ap-

33. 288 U.S. 188 (1933).
34. Dickson v. Uhlmann Grain Co., 288 U.S. 188, 200 (1933).
35. *See* Taylor, *Trading in Commodity Futures — A New Standard of Legality?*, 43 YALE L.J. 63, 88 (1933).
36. Bachrach, *The Cloverleaf Case, and Suspension of State Gambling Statutes as Applied to Commodity Futures Transactions*, 7 J. MAR. L.Q. 457 (1941); Taylor, *supra* note 35, at 100-02.
37. *Proposed Amendments to the Commodity Exchange Act: Hearings on H.R. 5772 Before the Senate Comm. on Agriculture and Forestry*, 74th Cong., 2d Sess. 112 (1936).
38. "Nothing in this section or section 6b of this title shall be construed to impair any State law applicable to any transaction enumerated or described in such sections." 7 U.S.C. § 6c (1970). This language was deleted by the CFTCA. Pub. L. No. 93-463, § 402(a), 88 Stat. 1369 (1974) (current codification at 7 U.S.C.A. § 6c (West 1980)).
39. 331 U.S. 247 (1947).
40. Rice v. Board of Trade of Chicago, 331 U.S. 247, 249 (1947) (construing ILL. REV. STAT. ch. 114, § 1946 (1945)).
41. 331 U.S. at 249.

> plicable to any transaction enumerated or described in such sections.". . . Thus the provision in § 4c serves the function of preventing supersedure and preserving state control in two areas where state and federal laws overlap.[42]

Thus, the trend was set for state legislatures and the courts to recognize the validity of commodity futures contracts executed on organized exchanges.[43]

C. THE REGULATORY GAP

In the aftermath of the Goldstein-Samuelson era fraud, it was popularly believed that the fraud had come about because of a regulatory gap. This gap was supposed to have been located somewhere between the laws governing commodity futures and the securities laws. It was thought that the Goldstein-Samuelson era commodity option dealers fell outside of the 1936 Commodity Exchange Act because there was no jurisdiction over world commodities, and that they also fell outside of the securities laws because commodity options were not within the ambit of securities.[44]

In truth, there was a plethora of laws which could have been invoked against the Goldstein-Samuelson era bucketeers. Every state had bucket shop laws or laws against gambling under which the bucketeers could have been criminally prosecuted.[45] In addition to laws against gambling and bucket shops, state and federal securities laws could have been used to attack the selling of naked options. Indeed, as we have already seen, state securities officials

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42. *Id.* at 255.

43. *See, e.g.*, Merrill Lynch, Pierce, Fenner, & Smith, Inc. v. Schriver, [1975-1977 Transfer Binder] COMM. FUT. L. REP. ¶ 20,172 (Tenn. Ct. App. 1976). *See Legislation, supra* note 27, at 920; Comment, *Federal Regulation of Commodity Futures Trading*, 60 YALE L.J. 822, 831-32 (1951).

44. *See* Johnson, *The Commodity Futures Trading Commission Act; Preemption As Public Policy*, 29 VAND. L. REV. 1, 4 (1976); Rainbolt, *Regulating The Grain Gambler and His Successors*, 6 HOFSTRA L. REV. 1, 14 (1977); Russo & Lyon, *The Exclusive Jurisdiction of the Commodity Futures Trading Commission*, 6 HOFSTRA L. REV. 57, 59 (1977).

45. *See, e.g.*, CAL. CORP. CODE § 29100 (West 1977) (making bucketing a felony). Section 29008(a) defines "bucketing" to include:

> Making or offering to make any contract respecting the purchase or sale of any securities or commodities, wherein both parties intend, or the keeper [of the place where the bucketing is done] intends, that the contract shall be, or may be, terminated, closed, or settled according to or upon the basis of the public market quotations or prices made on any board of trade or exchange upon which the securities or commodities are dealt in, without a bona fide purchase or sale of the securities or commodities.

CAL. CORP. CODE § 29008(a) (West 1977).

and the SEC invoked securities laws in their successful campaign against the Goldstein-Samuelson era dealers.

The Goldstein-Samuelson phenomenon did not occur because of a gap in the law, but because of a lag in enforcement by state and federal officials. Despite early warnings, the SEC acted slowly because it was reluctant to extend its jurisdiction into an area which it had not recently regulated.[46] As the commodity options fraud grew to monstrous proportions, however, it became embarrassingly evident that someone had to do something.[47] By the time the SEC and state officials decided to shut the naked option dealers down, the commodity "scandal," as the phenomenon had come to be known, had already been perpetrated. Even though the SEC and state securities officials were able to put the bucketeers out of business under federal and state securities laws, it was the scandal itself which was remembered, and not that the states and the SEC had been able to deal with it effectively. Thus, it was presumed that the CFTC needed exclusive jurisdiction over commodity options to fill the regulatory gap.[48] The misconception that the Goldstein-Samuelson phenomenon had occurred because of a gap in the law was to bring the long dormant issue of preemption to life.

D. THE EXCLUSIVE JURISDICTION CONTROVERSY

Several commentators have traced the issue of preemption of securities regulation as it evolved during the consideration of the CFTCA.[49] Perhaps the most startling revelation is the polar vacillation of legislative intent as to the degree of exclusivity of the jurisdiction of the CFTC.[50] The lack of direction may be partially explained by Congress's trepidation to realign any jurisdiction within the federal bureaucracy.[51] In addition, pressure from in-

46. The Associaton of Commodity Exchange Firms complained of options sales before the United States Senate Committee on Agriculture and Forestry. S. REP. No. 93-1131, 93d Cong., 2d Sess., *reprinted in* [1974] U.S. CODE CONG. & AD. NEWS 5843, 5860-67. Similarly, Henry Jarecki, president of Mocatta Metals, complained to various officials that the new option dealers were defrauding the public because the premiums being charged were too low for the options to be legitimate. *See* Jarecki, *Mocatta Options: Forerunner of a Boom Market?*, COMMODITIES, Apr. 1977, at 31, 35.

47. The first attack against Goldstein-Samuelson's options was in October of 1972 by the Oklahoma Securities Commissioner, who served notice of an intent to issue a cease and desist order against the firm's violations of the state securities law. *See Notice of Intent to Issue Cease and Desist Order*, Okla. Sec. Comm'n (Oct. 26, 1972). Hearings were conducted in November, 1972, and an order prohibiting further sales of naked options was issued in February, 1973. Also in February, Washington, Oregon, California, and Maryland moved against options. *See The Naked Option*, *supra* note 13, at 215-16.

48. *See* H.R. REP. No. 93-975, 93d Cong., 2d Sess. 36-53 (1974).

49. *See* Johnson, *supra* note 44. *See also* 1 A. BROMBERG, *supra* note 16, ¶ 471, at 82.383-.388.

50. *See* Johnson, *supra* note 44, at 8-19.

dustry groups and trade organizations supplemented the expected bureaucratic infighting.[52] The jurisdictional fate of several commodity-related securities hinged on the outcome.[53] Justification for the exercise of exclusive jurisdiction by the CFTC varied with regard to each different type of transaction.

In one of these areas, discretionary accounts, there was ample justification for the exclusive jurisdiction of the CFTC. This was particularly true because the application of securities laws to discretionary commodity futures accounts had always been controversial and confusing.[54] Similarly, there was good reason for the CFTC's exclusive jurisdiction over exchange-traded commodity options. The CFTC had always regulated the trading on commodity exchanges, and there was no need to impose additional securities regulations on these comprehensively regulated exchanges.

While there was ample justification for the CFTC's exclusive jurisdiction over these transactions, this was not true for naked options.[55] Naked commodity options were simply the tools chosen by bucket shop operators. Commodities were involved only insofar as they provided the underlying subject matter upon whose price fluctuations the outcome could be determined. As Henry Jarecki observed, naked options "could as well have involved wagers on the temperature in Los Angeles or the whereabouts of Secretary Kissinger."[56] Whatever justification there was for exclusive regulation of naked options by the CFTC, it could not have been logically based upon the connection of the devices to commodity futures. Rather, the only logical justification had to rest on the premise that the CFTC could do a better job of regulating such transactions than the states or the SEC.

It should have been obvious that the CFTC could not do the job the states and the SEC had done. Commodity options presented

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51. *Id.*

52. *Id.*

53. These were discretionary commodity futures accounts, gold and silver margin contracts, commodity forward contracts, naked options, and covered commodity options. 1 A. BROMBERG, *supra* note 16, ¶ 400, at 82.101; Russo & Lyon, *supra* note 44, at 78-80.

54. Hodes & Dreyfos, *Discretionary Trading Accounts In Commodity Futures—Are they Securities?*, 30 BUS. LAW. 99 (1974); Russo & Lyon, *supra* note 44, at 78-79; Comment, *Regulation of Commodity Related Abuses*, 22 WAYNE L. REV. 137, 159 (1975).

55. This was also true for sales of gold and silver on margin, or "leverage contracts." Leverage contracts came into vogue soon after naked options flourished. Leverage contracts can be used with the same felicity as naked options to fleece the public, although with less notoriety. *See* 1 A. BROMBERG, *supra* note 16, ¶ 415, at 82.141-.161.

56. *Commodity Futures Trading Commission Act, Hearings on S.2485, S.2578, S.2837, and H.R. 13,113, Before the Senate Comm. on Agriculture and Forestry*, 93d Cong., 2d Sess., pt. 3, at 800 (1974) [hereinafter cited as *1974 Senate Hearings*].

a regulatory problem which the federal commodity futures regulator had never faced before. Federal regulation of commodity futures markets has always been accomplished via commodity exchanges. Under the Commodity Exchange Act's scheme of self-regulation, the role of federal regulation was to assure that the commodity exchanges adopted and enforced rules and regulations to carry out the policies of the Commodity Exchange Act.[57] Thus, commodity exchanges were in essence the regulatory agencies by which the law was administered. In contrast, commodity options dealers have never really been a part of the commodity futures community in the United States. In 1892, the Chicago Board of Trade prohibited options.[58] By the time commodity options were banned by the Commodity Exchange Act in 1936, options were already prohibited by the rules of many of the major exchanges.[59] Because the naked option dealers were outside the exchange community, they were also outside the regulatory mechanism of the Commodity Exchange Act. This meant that the generally passive role of market surveillance and overseeing the exchanges, which had always been ensconced in Chicago, New York, and Kansas City, could not do the regulatory job. The commodity option bucketeers were spread all over the country, in such exotic places as California, Nevada, Arizona, Utah, Texas, and Michigan. If the CFTC was to succeed in regulating options, it would have to go out into the field, aggressively and without trade organization support. This was a radical change from the federal commodity regulator's traditionally passive role. Thus, while the regulation of naked commodity options may have seemed to dovetail with the CFTC's regulation of the commodity futures markets, the success of the CFTC in dealing with these devices depended heavily upon a radical change in policy and logistics. Considering the aversion in human nature to radical change, it was questionable how soon an agency fettered with fifty years of inertia would be able to adjust.

There was little in the history of federal regulation of the commodity futures markets by the Commodity Exchange Authority, the predecessor of the CFTC, to inspire confidence that naked options would be effectively regulated. The Commodity Exchange Authority was a small, timorous, and ineffective agency,

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57. *See* Ricci v. Chicago Merchantile Exchange, 409 U.S. 289, 293-97 (1973) (outline of regulatory scheme under the Commodity Exchange Act).

58. *Hearings on Futures Trading Before the House Comm. on Agriculture,* 66th Cong., 3d Sess. 945, 949 (1921).

59. *Hearings on H.R. 6772 Before the Senate Comm. on Agriculture and Forestry,* 74th Cong., 2d Sess. 220-21 (1936).

even within its narrowly self-defined jurisdiction.[60] During the Goldstein-Samuelson era, the naked option fraud had spread with a virulence which the combined efforts of the states and the SEC had barely been able to arrest.[61] If commodity options had been a difficult problem for the states and the SEC, a fortiori it would be a difficult one for the CFTC.

The states and the SEC had demonstrated, although belatedly, the ability to put the naked option bucketeers out of business. This should have been sufficient reason to leave well enough alone. Despite the reasons for leaving the jurisdiction of the states and the SEC over naked commodity options undisturbed, those who participated in the Congressional hearings on the CFTCA were oblivious to them. Early in the hearings, the emphasis was on filling the regulatory gap by creating a strong regulatory agency comparable to the SEC.[62] Exclusive jurisdiction was considered essential to the CFTC's strength as an agency.

In subsequent hearings, the reason advanced for the CFTC's need for exclusive jurisdiction was to avoid duplication and potential conflict, particularly with the SEC.[63] Had the regulation of naked options been considered as a separate problem, it would have been obvious that there would have been no conflict in keeping bucketeers out of business, since all governmental agencies would have had the same objective. There is no evidence that the legislative committees appreciated that they were tinkering with the state-federal system of regulation which had worked for over fifty years, much less realized the consequences of freeing the naked option bucketeers from the control of the securities laws.

The only controversy which preemption generated centered around the concerns of the SEC to preserve its jurisdiction. Although concerned about the direction the legislation was taking, the SEC never made a public presentation before the committees which considered the various bills to amend the Act. Instead, the SEC preferred to lobby behind the scenes.[64] The jousting of the

60. See N. MILLER, THE GREAT SALAD OIL SWINDLE 68 (1965), for a criticism of the Commodity Exchange Authority for its passive role in the DeAngelis oil fraud. One of the main reasons for the 1974 amendments to create a strong federal regulatory agency was to remedy ineffectual regulation which confidential governmental investigations had reported for years. In 1971, the Office of the Inspector General of the Department of Agriculture had made an audit of the Commodity Exchange Authority. This report analyzed the ineffectiveness of the agency in market surveillance. The report was kept, as were others, for "official use only." [1971] OFFICE OF THE INSPECTOR GENERAL, U.S. DEP'T AGRIC., *Audit Report No. 5110-1-C.*

61. *Options Revisited, supra* note 19, at 131.

62. *1974 Senate Hearings, supra* note 56. These hearings took place in May, 1974.

63. *Commodity Futures Trading Commission Act, Hearings on H.R. 13,113, Before the Senate Comm. on Agriculture and Forestry,* 93d Cong., 2d Sess. (1974). These hearings took place in September, 1974.

64. *See* 1 A. BROMBERG, *supra* note 16, ¶ 471, at 82.386.

SEC and industry proponents manifested itself in a curious logomachy between committee bills which preserved the jurisdiction of the SEC and other bills which subordinated the jurisdiction of the SEC to that of the CFTC.[65]

Provisions in the final version of the CFTCA grant the CFTC exclusive jurisdiction over all of the commodity related securities, including naked options.[66] Thus, in an attempt to fill a regulatory gap, which for naked options did not exist, Congress preempted the states and the SEC and substituted the CFTC. As subsequent events indicated, this substitution carved out the very gap which Congress thought it had filled with regard to the sale of naked options.

Although the CFTC did not regulate or ban options when it came into existence, it lost no time in guarding its exclusive jurisdiction to do so. In *SEC v. American Commodity Exchange,*[67] the SEC brought an action to enjoin violations of securities laws by dealers in options, contending that commodity options were investment contracts, and therefore securities. In a brief as *amicus curiae,* the CFTC argued that the CFTCA did not preclude action by the SEC for violations which occurred before its enactment, but implied that the SEC had no jurisdiction for violations occurring after the 1974 legislation.[68] The CFTC announced a similar position in its interpretative letters.[69]

In the courts, defendants successfully contended that the exclusive jurisdiction of the CFTC precluded actions under the securities laws. In *Texas v. Monex International, Ltd.,*[70] the Court of Civil Appeals of Texas upheld the dismissal of an action which had been brought by the state securities commissioner to enjoin the selling of leverage or margin contracts, on the ground that the CFTC had exclusive jurisdiction.[71] Similarly, in *SEC v. Univest, Inc.,*[72] the United States District Court for the Northern District of

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65. *See* Johnson, *supra* note 44, at 7-26.

66. *See* 7 U.S.C.A. § 4a(a)-(j) (West 1980).

67. [1975-1977 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 20,063 (W.D. Okla. 1975).

68. SEC v. American Commodity Exchange, [1975-1977 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 20,063, at 20,680 (W.D. Okla. 1975).

69. Letter of CFTC Deputy to Central Security Administrator's Counsel, [1977-1980 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 20,445 (1977) (expressing preemption of federal jurisdiction over state jurisdiction in the regulation of commodity pool operators); CFTC Interpretative Letter No. 76-20, [1975-1977 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 20,214 (1976) (expressing preemption of federal jurisdiction over state jurisdiction in the regulation of trading advisor); CFTC Interpretative Letter No. 76-19, [1975-1977 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 20,213 (1976) (expressing preemption of federal jurisdiction over state jurisdiction in the regulation of sale of commodities).

70. 527 S.W.2d 804 (Tex. Civ. App. 1975).

71. Texas v. Monex Int'l, Ltd., 527 S.W.2d 804, 806 (Tex. Civ. App. 1975); *accord,* International Trading Ltd. v. Bell, [1977-1980 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 20,495 (Ark. 1977); Clayton Brokerage Co. v. Mouer, 531 S.W.2d 805 (Tex. 1975).

72. 405 F. Supp. 1057 (N.D. Ill. 1975).

Illinois dismissed a complaint by the SEC against a dealer in commodity options, concluding that the CFTC had exclusive jurisdiction.[73]

Even as the CFTC was protecting its exclusive jurisdiction, CFTC officials realized that they could use the help of state securities officials. CFTC officials attempted to woo back state officials, contending that states were not preempted in applying their general anti-fraud statutes.[74] CFTC officials, however, continued their refusal to acknowledge that the states and the SEC had jurisdiction under securities laws over naked commodity options. Although state officials may have been able to prosecute naked option dealers under general criminal laws, the time and expense involved in this type of prosecution, as opposed to prosecuting the sale of unregistered securities, made state participation unlikely.[75]

E. RETURN OF THE BUCKETEERS

Because of the lack of regulations, the selling of options went unregulated for seventeen months following the enactment of the CFTCA. It was not until November of 1976, when the CFTC adopted interim regulations, that sales of commodity options were again regulated.[77] During this seventeen-month hiatus a new breed of option dealers arose, whose fraudulent exploits far exceeded those of the bucketeers of the Goldstein-Samuelson era.

The new option dealers were not only bucketeers, but were "boiler room" bucketeers. "Boiler room" describes fraudulent, high-pressure selling over the telephone by batteries of salespersons in which random members of the public are pressured into making hasty decisions to invest in obscure, speculative investments, without regard to the suitability of the investment.[78] Boiler rooms tend to flourish in speculative periods, such as the stock market in

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73. SEC v. Univest, Inc., 405 F. Supp. 1057, 1059-60 (N.D. Ill. 1975).

74. In an address in September, 1975, CFTC Vice-Chairman John Rainbolt stated, "We do not believe that the states are preempted from prosecuting fraud under state laws of general application. The important concept is that the fraud statute must be of general application and is not part of some narrower state regulatory scheme." [1975-1977 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 20,075, at 20,707. This position had also been stated in a Congressional report. *See* S. REP. No. 73, 94th Cong., 1st Sess. (1975).

75. *See* Russo & Lyon, *supra* note 44, at 71.

76. The only regulation adopted during this period was the general antifraud provision which became effective in June, 1975. 17 C.F.R. § 30.02 (1980).

77. 41 Fed. Reg. 51,808-09. For the restrictions which currently apply to the sale of commodity options, see 7 U.S.C.A. § 6c(c) (West 1980).

78. *See* SEC v. R.J. Allen & Associates, 386 F. Supp. 866, 874 (S.D. Fla. 1974); CONFERENCE ON SECURITIES REGULATION 8, 69 (R. Mundheim ed. 1965) [hereinafter cited as Mundheim].

the late 1950s and early 1960s.[79] Securities sold by boiler rooms are often obscure securities which are difficult to verify and which can be acquired in large quantity.[80] Penny mining and uranium stocks, oil and gas promotions, companies with new inventions, and securities which catch the public fancy have traditionally been good boiler room merchandise.[81] Thus, commodity options were the ideal merchandise for boiler room operators. Commodity futures markets and commodity options were unknown to the general public. The average person had no experience by which he could evaluate what a salesman told him.

The new generation of option dealers began to emerge soon after the CFTCA took effect in April, 1975.[82] The matrix from which boiler-room operators spawned was Miami, long notorious as the confidence man's capital.[83] Some of the boiler-room operators were known to have been associated with persons in organized crime.[84]

Crown Colony Options typified the new generation of commodity option dealers. The principals of Crown Colony, one of whom was a three-time felon, had been running a land-sale racket based in Miami under the name Property Resale Service, Inc.[85] After the land-sale racket had been shut down by an injunction, Property Resale Service, Inc., changed its name to Crown Colony Options Ltd., and became a London options firm.[86]

Crown Colony operated out of offices which were used to sell wigs and chemicals over the telephone during the day. The building had as many as eighty telephones tied to a long distance WATS facility, and a central monitoring system that allowed supervisors to listen in on conversations or to broadcast such conversations to other salesmen over a speaker system.[87]

Crown Colony made no attempt to hire sales persons with any knowledge of commodity markets. The objective of the boiler-room operators was to sell options and not to give customers investment advice. Crown Colony paid its salesmen a commission of ten percent of the amount paid by a customer for an option. Supervisors received a commission of ten percent on their own sales

79. Mundheim, *supra* note 78, at 8.
80. J. HAZARD & M. CHRISTIE, THE INVESTMENT BUSINESS, A CONDENSATION OF THE SEC REPORT 62 (1964).
81. *Id.*
82. *Options Revisited, supra* note 19, at 131.
83. J. KWITNY, THE FOUNDATION PEN CONSPIRACY 286 (1973).
84. Kwitny, *Commodity Options Sold by Phone Often Fail to Ring True,* Wall St. J., Nov. 18, 1977, at 1, col. 4.
85. *Id.* at 41, col. 1.
86. *Id.*
87. *Id.* at col. 3.

and an override of one-half percent on the sales of their salesmen. Crown Colony pressured its salesmen to produce sales of $5,000 per week; salesmen who could not meet this quota were often fired.[88] As was typical of the boiler-room operators, Crown Colony's sales campaign was "cold canvass"; salesmen solicited strangers who had expressed no prior interest in purchasing options. Lists of names and telephone numbers of prospective customers were purchased from persons who specialized in selling mailing lists.[89]

While bucketeers were busily plying their fraudulent wares to the public, the CFTC was investigating the situation. In October of 1975, the CFTC established an advisory committee to study whether options should be banned or allowed.[90] The chairman of the advisory committee was John V. Rainbolt II, Vice-Chairman of the CFTC. On the seventeen-member committee were "various industry leaders, exchange officials, economists, attorneys, a state securities commissioner, a farmer-rancher, and a customer representative."[91] There were more persons from "industry than the public, although the vast preponderance of members were not from the option industry *per se*."[92]

The report of the advisory committee was submitted on July 6, 1976. Initially, the members were divided over allowing options trading.[93] When the report was submitted, however, only one member dissented from the committee's recommendation that options trading be allowed.[94]

The advisory committee reasoned that the "key to solving customer protection problems on options offered in the country was to move such options to organized exchanges designated by the Commission. Segregation of premiums, clearing mechanisms, government and exchange surveillance and auditing procedures, and competitive execution of transactions would, it was generally felt, 'clean up' the industry and solve the problem."[95] Standing in the way of this solution, however, was the concern that it would have been anti-competitive to ban dealer options and restrict trading to a "handful of contract markets designated by the

88. *Id.* at col. 2-3.
89. *Id.*
90. *See Recommended Policies On Commodity Option Transactions,* COMM. FUT. L. REP. CCH Report No. 26, July 1976, at vii.
91. *Id.* at viii.
92. *Id.* at xiii.
93. *Id.* at viii.
94. *Id.* at 56.
95. *Id.* at xviii.

Commission.''[96] If dealer options were banned, the committee was concerned that this might be construed as prohibiting trading by domestic dealers while allowing foreign offerings.[97]

Because of what was viewed as the anti-competitiveness of prohibiting dealer options but allowing exchange-traded options, the committee concluded that off-exchange options had to be allowed. In so doing, the advisory committee assumed that the CFTC would be able to afford protections to customers equivalent to those provided to futures customers on contract markets. These protections included segregation of funds, a mechanism guaranteeing performance of the transaction, and adequate supervision and control of trading practices.[98] The advisory committee envisioned that bank guarantees could be an adequate substitute for segregation of funds and performance of the transactions, and that a self-regulatory organization could fulfill a supervisory role. The committee also suggested that account insurance would help in protecting customers who purchased off-market options.[99] Primarily because of its faith in regulatory safeguards,[100] the committee concluded by recommending strict regulatory control, rather than the more authoritarian approach of a complete ban on options trading.

The one member who dissented from the committee's

96. *Id.* at xxiii.
97. *Id.* at xxiv.
98. *Id.* at xxv.
99. *Id.*
100. The committee concluded by stating:

> In dealing with the commodity option issue the Commission could find precedent in the statutory ban on options on the "previously regulated" commodities and, citing the various problems associated with options through the years, extend that ban to the "new" commodities brought under federal regulation by the CFTC Act. No doubt there are those who would approve such a ban and, admittedly, it would require considerably fewer Commission resources to police than would a regulatory system allowing option trading.
>
> However, before we exercise a natural desire to look for simple solutions, such as banning options, the Commission should be mindful of the success of those who have used such solutions in the past. The authoritarian approach (*i.e.*, banning one or another aspect of legitimate economic behavior) has not necessarily proven, in every case, to be the most successful or correct course when interpreted in the light of history. Properly enforced, with intelligent interpretation of the structure envisioned by the Committee for off-contract market trading, the requirements recommended offer a positive plan that represents a substantial step forward from past governmental approaches regarding commodity option trading.
>
> It is probably time to see if we can bring commodity options in from the cold. If applied through a designation process, and interpreted in the light of the Commission's "public interest" test currently applied to futures contracts, and implemented initially in the form of a pilot program for exchange options, the Committee's recommendations for strict regulation should provide an adequate structure to support trading in a market instrument that in one form or another has been seeking the favor of commercial and speculative interests over a hundred years.

Id. at xxviii.

recommendation, Rodney E. Leonard, criticized the committee for having decided the regulatory terms and conditions under which options trading should be allowed before deciding whether option trading, as a whole, served any beneficial function.[101] Leonard correctly assessed the industry bias of the advisory committee's report. The report could have been paraphrased from the statement committee member Henry Jarecki had made before the Committee on Agriculture and Forestry during its hearings on the Commodity Exchange Act.[102]

In November of 1976, the CFTC adopted interim rules for the

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101. Mr. Leonard stated:

> What the Committee has done is recommend the conditions under which dealers in commodity options must operate, whether on or off a regulated exchange. The Committee argues that these safeguards are adequate to protect those who deal with commodity option traders. These conditions, however, are porous safeguards, since the Commission is going to have a difficult time with its limited staff in policing these transactions where they occur away from a regulated exchange. The standards are not safeguards as they are an attempt to assure competitive parity to futures merchants who fear that option trading will compete unfairly with the more conventional futures trading.

Id. at 57-58.

102. The following quote from Dr. Jarecki's statement before the United States Senate Committee on Agriculture and Forestry expresses the same ideas as the advisory committee report:

> It has been argued that, in view of the severe losses suffered by members of the public resulting from the failures of numerous commodity option issuers in recent years, commodity options should be prohibited as clearly and swiftly as possible to avoid further such frauds. According to this theory, the evils of commodity option dealing have been shown to be so severe that the burden of justifying the existence of commodity options should now be shifted; that is, outlaw them until somebody can prove to Congress that the business can be done legitimately. This position is tempting in its simplicity but it is very incorrect.
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> . . . .
>
> The Honorable Brian Van Camp, Commissioner of Corporations of the State of California, is perhaps the man whose regulatory objectives have been most upset by the spate of fraudulent commodity option dealing in recent years, and the man who has demonstrated the most constructive and realistic approach to solving the problems of this kind of dealing. I offer his words in closing:
>
>> I do have a philosophical persuasion which would lead me to be slow to outlaw any business operation which is basically fair and which fully discloses the risks involved to the customers.
>>
>> To do otherwise, I am afraid, that is to outlaw a legitimate activity simply because another investment opportunity would be more prudent to society, I am afraid goes too far. Going to the logical extreme, I am afraid this kind of prohibition could conceivably give justification for prohibiting investment in all but the bluest of blue chip corporate securities in this country.
>>
>> Therefore, I think our only basis for outlawing the commodity option is a finding of inherent fraud; that is, a finding that there is no way to operate this kind of program for the long pull and still pay off the option holders on exercise. As of this date, . . . I am afraid I haven't seen the proof in this industry of this kind of inherent fraud or inherent inability to pay off. Therefore, I could not recommend at this time a total prohibition of the commodities option activity.

Transcript of Testimony before the United States Department of Agriculture in the Matter of Trading of Puts and Calls on Non-Regulated Commodities, Feb. 14, 1973, at 22. *See Hearings on S. 2485, S. 2578, S. 2837 and H.R. 13113, Before the Comm. on Agriculture and Forestry,* 93d Cong., 2d Sess., pt. 3, at 801, 807 (1974) (statement of Dr. Henry J. Jarecki).

regulation of commodity options.[103] In the words of the CFTC, the interim regulations were intended to allow legitimate enterprises to write options with certain protection to customers until a comprehensive regulatory structure for all commodity options could be developed and implemented.[104] The interim regulations prohibited an option dealer from doing business after January 17, 1977, unless the dealer was registered as a futures commission merchant under the Act.[105] To be registered, a dealer had to maintain minimum capital which was the greater of either $50,000 or a mathematical formula specified in the regulation.[106]

The interim regulations required that a customer be given a "summary disclosure statement" before a commodity option transaction.[107] The statement had to disclose the total quantity and quality of the commodity under option, its duration, the elements of the purchase price, the method used to arrive at the striking price, the amount of commission charged, a statement that the price rise (for a call) or price fall (for a put) must exceed the premium amount plus fees if the holder is to make money, and a clear explanation of the possible effects of currency fluxuation on options executed on foreign facilities.[108] The interim regulations required the segregation in a domestic bank of ninety percent of the payment received from a customer until exercise or expiration of an option.[109] The regulations also required that records of each transaction be kept.[110]

Although the interim regulations were similar in effect to the registration and disclosure requirements of the securities laws, there was a fundamental difference between the Goldstein-Samuelson era bucket shops and those which prospered under the interim regulations. The Goldstein-Samuelson era dealers had always been outlaws; once it became recognized that commodity options were securities, they were forced to halt their operations. The Goldstein-Samuelson era dealers knew that it was either stop selling options or go to jail.

The new generation of federally allowed options dealers, however, had never been outlaws. Moreover, by the time the CFTC adopted the interim regulations, the options dealers had

103. 41 Fed. Reg. 51,808 (1976).
104. 41 Fed. Reg. 51,808-09 (1976).
105. 41 Fed. Reg. 51,814-15 (1976) (codified at 17 C.F.R. § 32.2 (1976)).
106. 41 Fed. Reg. 3194 (1976) (codified at 17 C.F.R. § 1.17 (1976)).
107. 41 Fed. Reg. 51,815-16 (1976) (codified at 17 C.F.R. § 32.5 (1976)).
108. *Id.*
109. 41 Fed. Reg. 51,815-16 (1976) (codified at 17 C.F.R. § 32.6 (1976)).
110. 41 Fed. Reg. 51,815-16 (1976) (codified at 17 C.F.R. § 32.7 (1976)).

been lawfully ensconced in business for over seventeen months. When the CFTC began enforcing the interim regulations, it faced well-entrenched adversaries who were not about to fold up their tents and slink off into the night. With the largest dealers reportedly taking in as much as two million dollars per month, the option dealers had the finances to wage a war of dilatory litigation.

The bucketeers wasted little time in attacking the CFTC's attempts at regulation. In *Citadel Trading Co. v. Bagley,*[111] a dealer brought an action to enjoin the CFTC from investigating its activities, claiming that the appointment of the acting executive director of the CFTC had not been submitted to the Senate for confirmation.[112] In *Lucas v. Commodity Futures Trading Commission,*[113] a registered, associated employee of Lloyd, Carr & Co., one of the most notorious "boiler room" operations, brought an action contending that the CFTC had been responsible for an erroneous news report.[114] The report indicated that the CFTC had taken official action against registered associates, such as the plaintiff, who continued their affiliation with unregistered futures commission merchants, such as Lloyd, Carr & Co. Although the report was in error, the court dismissed the action, finding no evidence that the CFTC had been responsible for the report.[115] Although these brabbles could hardly have been taken seriously, they helped in the bucketeers' war of attrition against the CFTC.

The option dealers also made concerted attacks on the enforcement of the interim regulations, especially the regulation requiring the segregation of ninety percent of the money received from customers, artfully labeled "double segregation." Displaying the American propensity for organized groups, the option dealers formed the National Association of Commodity Options Dealers (N.A.C.O.D.) late in 1976.[116] N.A.C.O.D. and nine individual dealers brought an action in the United States District Court for the Southern District of New York to enjoin the CTFC from enforcing the interim regulations.[117] The court enjoined the enforcement of the segregation regulation,[118] finding that the interim regulations as

111. 440 F. Supp. 925 (E.D. Mo. 1977).
112. Citadel Trading Co. v. Bagley, 440 F. Supp. 925, 926 (E.D. Mo. 1977).
113. [1977-1980 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 20,493 (E.D. Mo. 1977).
114. Lucas v. CFTC, [1977-1980 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 20,493, at 21,989 (E.D. Mo. 1977).
115. *Id.*
116. *Evaluating Commodity Options Terms — Some Views On Trading Approaches,* COMMODITIES, Dec. 1976, at 22.
117. British Am. Commodity Options Corp. v. Bagley, [1975-1977 Transfer Binder] COMM. FUT. L. REP. ¶ 20,245 (S.D. N.Y. 1976).
118. *Id.* at 21,334.

originally proposed had no segregation requirement and that there was no reason for the hasty addition of the segregation rule.[119] The court therefore concluded that the plaintiffs had a reasonable likelihood of success in establishing that the CFTC had acted arbitrarily and capriciously in imposing the segregation requirement.[120] Although the decision invalidating the segregation regulation was a dysnomy, the decision nevertheless caused the CFTC to publicly announce that it did not intend to enforce the regulation pending the outcome of a motion for reconsideration.[121]

On appeal, the United States Court of Appeals for the Second Circuit reversed the district court decision granting the injunction against the segregation regulation.[122] The court concluded that the segregation regulation had not been adopted hastily and was not unreasonable.[123] In view of the CFTC's power to ban option trading altogether,[124] the court decided that the segregation requirement was a reasonable exercise of discretion,[125] even if it did "restrict participation in the industry to soundly capitalized firms."[126]

A substantial amount of the CFTC's resources were exhausted in actions to enforce the interim regulations.[127] The efforts spent in regulating options so debilitated the CFTC that it was unable to effectively carry out many of its other regulatory duties.[128]

Most of the option dealers simply ignored the regulations. As the CFTC sought to enforce the interim rules, the agency found

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119. *Id.* at 21,331-32.

120. *Id.* at 21,332.

121. CFTC Release No. 232-76 (Dec. 22, 1976).

122. British Am. Commodity Options Corp. v. Bagley, 552 F.2d 482 (2d Cir.), *cert. denied,* 434 U.S. 938 (1977).

123. *Id.* at 490-91.

124. 7 U.S.C.A. § 6c(b) (West 1980).

125. 552 F.2d at 490-91.

126. *Id.* at 490.

127. *See* 43 Fed. Reg. 16,155 (1978).

128. At a seminar at the University of Santa Clara in July of 1977, CFTC Chairman Bagley stated:

> CFTC computations show that work in the options field, occupied by an inordinate number of fly-by-night hustlers, is now consuming about 20 percent (18.9 percent to be exact) of our operating time and personnel. We simply can't swallow that and at the same time properly regulate trading in the futures markets — our primary duty and concern.
>
> We are, for example, almost one year behind in auditing brokers. We are months behind in exchange contract review and exchange rule review. We are weeks behind in processing salesperson registration. And we can barely keep up with the daily surveillance of the trading in half a hundred commodities on the ten domestic exchanges.
>
> Additionally, we have deferred or dropped a large number of customer fraud, fictitious trading, and potential manipulation investigations, because we have only 26 professional investigators nationwide.

CFTC Release No. 316-77 (July 27, 1977).

itself sinking deeper and deeper into a morass of litigation. By the spring of 1978, the agency had instituted thirteen formal administrative actions and fifteen injunctive actions against commodity option dealers.[129] The CFTC had obtained injunctions against sixty firms and individuals.[130] At least forty of these injunctions were to enjoin further violations of the anti-fraud rule governing options. Yet, despite these efforts, thirty of the thirty-eight firms which were selling options in the spring of 1978 were under investigation for violation of the interim regulations.[131] The frustration of the CFTC is evidenced by the following statement of a CFTC official:

> How far can Big Brother government go in protecting somebody who gets a phone call from somebody he never heard of halfway across the country who says, "Send me a check tonight and I'll quadruple your money," and he sends it and never hears from his money again? Is it right to charge some farmer in Fergus Falls, Minnesota, $8,900 for a London option that sells for $2,200? It isn't against the law.[132]

CFTC officials blamed the courts for the agency's inability to enforce the regulations.[133] But the difficulties the CFTC had in enforcement were brought on itself. The CFTC expected the courts to immediately close down what the CFTC belatedly recognized as criminal operations. The federal judges who rebuffed the CFTC enforcement efforts, however, did not see the boiler room operators as criminals. They viewed the options dealers as the CFTC had initially protrayed them — as businessmen who were recalcitrant to comply with burdensome regulations.

F. SELLING OF DEALER OPTIONS BANNED

The more effort the CFTC directed toward enforcement of the

129. 43 Fed. Reg. 16,154 (1978).
130. *Id.*
131. *Id.*
132. Kwitny, *supra* note 84, at 41, col. 4.
133. In May of 1978, CFTC Chairman William T. Bagley stated:

> We have helped establish a "public institution" atmosphere and have helped bring true self-regulation nearer to reality. Even in the options area, with our hands tied behind our backs by Congress and the Courts, we have done our share to stop burgeoning customer fraud and to ready a new and innovative exchange-traded options program.

interim regulations, the more the futility of these efforts became apparent. For example, after the CFTC had labored in court for a year to put the Miami office of British American Commodity Options Corporation out of business, its phone operation was simply sold to First Regal Commodities, Inc. First Regal's salesmen immediately began calling the victims of British American to con them into buying new options to recoup their losses.[134]

In the beginning, the CFTC had justified its decision not to ban commodity options on the grounds that an outright prohibition would have been the epitome of government overregulation.[135] By mid-1977, the CFTC indicated that continued regulation depended upon Congress's willingness to increase the CFTC budget by one-and-a-half million dollars, enough for fifty to sixty additional employees.[136] When Congress mercifully denied the request for additional money, it could be remembered that Congress and not the CFTC had been responsible for a policy which eventually resulted in a complete ban. However, any hope the CFTC had of gracefully extricating itself from its initial decision to regulate, rather than prohibit, options trading ended in frustration and national attention. In addition to the frustration the CFTC was suffering in the courts, the public was rapidly becoming aware of the massive frauds involving the option dealers. The improprieties of the bucketeers and the failure of the CFTC to curtail them was widely and derisively reported in the newspapers and on the nationally televised program "60 Minutes."[137]

On February 6, 1978, the CFTC published its proposal to suspend any further sale of options.[138] After conducting the necessary hearings, the CFTC, on April 17, 1978, issued a regulation banning the sale of options.[139] In its report accompanying the regulations, the CFTC admitted: "The Commission has invested a substantial portion of its resources in an

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Letter to John V. Rainbolt from William T. Bagley upon Mr. Rainbolt's resignation from the CFTC (May 8, 1978).

134. Kwitny, *supra* note 84, at 41, col. 3.

135. When the CFTC directed its staff to draft the interim regulations in September of 1976, CFTC Chairman Bagley stated, "The easy way would have been to ban the trading of options and not to regulate them at all, but that would have been the epitome of over-regulation." CFTC Release No. 198-76 (Sept. 13, 1976).

136. *See* CFTC Release No. 316-77 (July 27, 1977).

137. Schneider, *The Carr Case: The Straw That Broke the Camel's Back*, COMMODITIES, Mar. 1978, at 37.

138. 43 Fed. Reg. 16,161 (1978) (currently codified at 17 C.F.R. § 32.11 (1980)). The validity of section 32.11 has been upheld on at least two occasions. Rosenthal & Co. v. Bagley, 581 F.2d 1258 (7th Cir. 1978); Chartered Systems of N.Y., Ltd. v. Seevers, [1977-1980 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 20,682 (D.D.C. 1978).

139. 43 Fed. Reg. 16,161 (currently codified at 17 C.F.R. § 32.11 (1980)).

attempt to control dealer and foreign option sales under the interim regulations. The adoption of a suspension has been necessary because the Commission has been unable to do so."[140] Thus came the ignominious end to the CFTC's efforts to regulate the sale of commodity options to the general public.

At about the same time as the CFTC was adopting a regulation to suspend the further sale of options,[141] a CFTC reauthorization bill was being reported out of committees of the House and the Senate.[142] This bill provided an exemption for options granted by trade dealers who were in the business of buying, selling, or using the commodity underlying the option.[143]

On May 11, 1978, Mocatta Metals Corporation and Metals Quality Corporation petitioned the CFTC to amend section 32.11 of the Code of Federal Regulations to allow firms which could meet conditions for the protection of the public to continue to offer and sell options on physical commodities, the so-called dealer options.[144] They proposed regulations to exempt dealer options which were similar in substance to exemptions in the bill pending in Congress.[145] Anticipating that Congress would adopt legislation to exempt dealer options from the ban on options trading, the CFTC adopted section 32.12.[146] Section 32.12 generally provided that the ban on options under section 32.11 did not apply to the purchase or sale of any commodity option on a physical commodity granted by a dealer in the business of granting options on a physical commodity, and in the business of buying, selling, producing, or otherwise using that commodity. A dealer approved under this exemption was required to have a net worth of ten million dollars.[147] To screen out the bucketeers, section 32.12 provided that persons convicted of crimes involving securities or commodities within the previous ten years, or who had been enjoined from engaging in securities or commodities activity, could not sell options.[148] Other requirements of section 32.12 included segregation of profits over premiums, account identification,

140. 43 Fed. Reg. 16,159 (1978).

141. 43 Fed. Reg. 21,022 (1978).

142. S. 2391, 95th Cong., 2d Sess. (1978). The bill was eventually passed. Futures Trading Act of 1978, Pub. L. No. 95-405, 92 Stat. 865 (currently codified in scattered sections of 7, 18 U.S.C.).

143. S. 2391, 95th Cong., 2d Sess. (1978).

144. 43 Fed. Reg. 21,023 (1978). The petition was filed under a Commission regulation which provides that any person may file a petition with the Commission for the issuance, amendment, or repeal of a rule of general application. 17 C.F.R. § 13.2 (1980).

145. 43 Fed. Reg. 21,023-25. *See supra* note 142 and accompanying text.

146. 43 Fed. Reg. 23,704-08 (1978) (currently codified at 17 C.F.R. § 32.12 (1980)).

147. The current code calls only for a net worth of one million dollars. *See* 17 C.F.R. § 32.12(a)(1) (1980).

148. 17 C.F.R. § 32.12(a)(7)(i)-(ii) (1980).

confirmations, and various other reports.[149]

On October 1, 1978, the Futures Trading Act of 1978 became effective.[150] The 1978 Act bears the scars of the CFTC's defeat by the bucketeers. Section 3 of the Act amended section 4c of the Commodity Exchange Act to ban the sale of options other than those sold by dealers in the trade, thereby making the CFTC's regulatory exception a permanent statutory fixture.[151]

III. FEDERAL REGULATION OF LEVERAGE CONTRACTS

The ban on the sale of commodity options, except by dealers of a prescribed net worth, ended the options scandal. But this did not put an end to the bucketeers. After the CFTC banned the sale of options in 1977, the bucketeers merely altered their operations and began selling leverage contracts.[152]

Leverage contracts are contracts in which a customer buys a commodity by paying to a dealer a percentage of the full contract value, termed "margin", in consideration for an agreement by a dealer to sell and deliver the commodity at the contracted price. Although the form and terminology of leverage contracts differs from options, there is not much difference in substance between commodity options and leverage contracts. In both transactions the customer pays a sum of money for the chance to profit from a change in price during the term of the contract. It is understood that a customer does not have to accept delivery but can close out the transaction for the difference between the contract price and the future market price of the commodity. In both options and leverage contracts, dealers need not actually purchase the commodity contracted for, but supposedly cover their obligations by hedging on the futures market or by contracting with others. Because parties to leverage contracts generally do not intend to perform by delivery, leverage contracts are illegal under state bucket shop and gambling statutes.[153]

Leverage contracts are also securities under state and federal

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149. *See* 17 C.F.R. § 32.12(a)-(h) (1980).

150. Futures Trading Act of 1978, Pub. L. No. 95-405, 92 Stat. 865 (currently codified in scattered sections of 7, 18 U.S.C.).

151. 7 U.S.C.A. § 6c(c) (West 1980).

152. Letter from William T. Bagley, Chairman of CFTC, to Harold M. Williams, Chairman of SEC (May 24, 1978), *reprinted in* CFTC Release No. 406-78 (May 25, 1978); Letter from William T. Bagley, Chairman of CFTC, to State Attorneys General and Securities Commissioners (May 25, 1978), *reprinted in* CFTC Release No. 406-78 (May 25, 1978).

153. *See supra* note 1 and sources cited therein.

law. As with commodity options, the value of a leverage contract depends upon whether the dealer has covered his obligation. This in turn ultimately depends upon whether the obligations of other customers have been covered, since the margin money is treated as belonging to the dealer to spend at his discretion. Thus, leverage contracts are just as susceptible to fraudulent practice as commodity options.[154] The SEC and state securities officials had previously regulated leverage contracts under the securities laws.[155] Congress, however, put an end to the campaign of the SEC and state officials by granting exclusive jurisdiction to the CFTC.[156]

The sale of leverage contracts was not one of the problems which had attracted the attention of those who were behind the 1974 legislation.[157] Leverage contracts would not even have been covered by the CFTCA if it had not been for the testimony of Martin Rom, Chairman of the Board of International Precious Metals Corporation, a leverage contract dealer. He was the last witness to testify before the Senate Committee on Agriculture and Forestry.[158] Describing leverage contracts as a "form of contract for future delivery" of a commodity, Rom urged that all such contracts be governed exclusively under the CFTCA rather than by other federal and state agencies.[159] A few days later, International Precious Metals submitted a proposal to the Senate Committee which, with a few changes, became section 217 of the CFTCA.[160]

Although the CFTCA gave the CFTC exclusive jurisdiction over leverage contracts, the CFTC never attempted to regulate

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154. *See supra* note 1 and sources cited therein.

155. *See, e.g.*, Jenson v. Continental Financial Corp., 404 F. Supp. 792 (D. Minn. 1975); People v. Monex Int'l, Ltd., 86 Misc. 2d 820, 380 N.Y.S.2d 504 (1975); Note, *Securities Regulation: Coin and Bullion Investment Programs — The Newest Security?*, 28 OKLA. L. REV. 433 (1975).

156. 7 U.S.C.A. § 6a(1)-(4) (West 1980).

157. H.R. REP. No. 93-975, 93d Cong., 2d Sess. 39-40 (1974).

158. *Commodity Futures Trading Commission Act: Hearings on S. 2485, S. 2578, S. 2837 and H.R. 13113 Before the Senate Comm. on Agriculture and Forestry*, 93d Cong., 2d Sess., pt. 3, at 748-54 (1974) (statement of M. Martin Rom).

159. *Id.* at 751-52.

160. 7 U.S.C. § 15a (1976) (originally enacted as Commodity Futures Trading Commission Act of 1974, Pub. L. No. 93-463, § 217, 88 Stat. 1389) (currently codified at 7 U.S.C.A. § 23 (West 1980)). *See infra* notes 161-97 and accompanying text for a discussion of the evolution of this statute. Section 217 provided in pertinent part:

> No person shall offer to enter into, enter into, or confirm the execution of any transaction for the delivery of silver bullion, gold bullion, or bulk silver coins or bulk gold coins, pursuant to the standardized contract commonly known to trade as a margin account, margin contract, leverage account, or leverage contract contrary to any rule of the Commodity Futures Trading Commission designed to insure the financial solvency of the transaction or prevent manipulation or fraud: Provided, ... If the Commission determines that any such transaction is a contract for future delivery within the meaning of the Commodity Exchange Act, as amended, such transaction shall be regulated in accordance with the provisions of such Act.

Id. See Greenstone, *Leverage Transactions: On Creating a Regulatory Theme*, 27 EMORY L.J. 909, 917 (1978).

them. On June 17, 1975, the CFTC adopted section 30.02 of the Code of Federal Regulations,[161] a general anti-fraud rule copied from rule 10-b5[162] under the Securities Exchange Act. An advisory committee chaired by CFTC Vice-Chairman Rainbolt was formed to study, among other things, the prohibition of regulation of leverage contracts.[163] On August 20, 1975, the CFTC proposed an interim regulation to require persons selling leverage contracts, as described in section 217, to comply with a business plan submitted to and approved by the CFTC. The business plan would have required dealers to disclose their identities, background, finances, the payment necessary to maintain a customer's interest, and procedures for covering obligations, including insurance and depository used.[164] The CFTC never acted on this proposal.[165]

On July 16, 1976, the advisory committee submitted a report to the Commission. With one dissent, the committee recommended that leverage contracts should not be prohibited, that they should not be treated as futures contracts nor regulated as such, and that the CFTC should adopt regulations to govern leverage contracts.[166] Rodney E. Leonard dissented on the ground that leverage contracts were inherently fraudulent because they served no economic purpose.[167] The advisory committee recommended dealer registration, minimum net worth and working capital requirements, segregation of funds, and one hundred percent coverage in futures of the actual commodity.[168] A month after receiving this report, the CFTC recommended to Congress that section 217 of the CFTCA be incorporated into the Commodity Exchange Act so that the enforcement provisions of the Act would be fully applicable to leverage transactions.[169]

On October 12, 1976, the CFTC, by a three-to-two vote, decided that leverage contracts were not futures contracts, and directed the staff to draft interim regulations.[170] Being preoccupied with the commodity option bucketeers, the CFTC did nothing about leverage contracts until November 8, 1977, when it established a task force to study the leverage contract business and

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161. 17 C.F.R. § 30.02 (1980).
162. 17 C.F.R. § 240.10b-5 (1980).
163. 40 Fed. Reg. 26,504 (1975); 40 Fed. Reg. 32,866 (1975).
164. Proposed Section 30.00, *reprinted in* COMM. FUT. L. REP. (CCH) ¶ 3425 (1975).
165. Greenstone, *supra* note 160, at 929.
166. *Report of the Advisory Committee on Market Instruments to the CFTC, Recommended Policies on Futures, Forward and Leverage Contracts and Transactions* 23-49 (July 16, 1976).
167. *Id.* at 50-52.
168. *Id.* at 23-49.
169. COMM. FUT. L. REP. (CCH) Report No. 29, Aug. 20, 1976, at 3.
170. COMM. FUT. L. REP. (CCH) Report No. 33, Oct. 22, 1976, at 2.

report its finding.[171]

The year of reckoning for the CFTC was 1978. Section 12(d) of the Commodity Exchange Act, a "sunset" provision included in the CFTCA, authorized Congress to appropriate funds only through fiscal year 1978. Without legislative reauthorization, the CFTC would cease to exist. Public criticism of the CFTC's inability to deal with the commodity option scandals had also been building.[172] During hearings of a Senate subcommittee on appropriations in 1977, after CFTC Chairman Bagley explained that the Commission had decided not to ban commodity options because that would have been the "epitome of over-regulation," Senator Eagleton replied: "Would the vitals of democracy be violated if we outlaw options? What worthwhile humanitarian civilized purpose do options serve if they are subject to manipulation; if there has been shystering, the democracy won't crumble without them."[173] Senator Bellmon warned: "Why sit around and wait until we have a scandal before we do something? I agree with our chairman, if you can't properly regulate options, I say put them out of business until you can."[174]

The reauthorization hearings began on February 12, 1978, before a House subcommittee.[175] During the hearings, the CFTC revealed that it had reversed its earlier position and had decided to recommend that Congress repeal section 217.[176] The CFTC's position was based on the differing function of exchange and leverage transactions, the absence of exchange control over leverage contracts, and the move of option bucketeers into leverage contracts following the 1978 ban on the sale of commodity options.[177] The CFTC argued that leverage transactions would be better regulated by agencies administering securities laws because those agencies already had standards applicable to off-exchange transactions.[178]

During the hearings, however, the position stated by the CFTC's report was undermined by testimony of commissioners. CFTC Chairman Bagley alternatively suggested that leverage

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171. COMM. FUT. L. REP. (CCH) Report No. 61, Nov. 21, 1977, at 3.

172. *See* Young, *A Test of Federal Sunset: Congressional Reauthorization of the Commodity Futures Trading Commission*, 27 EMORY L.J. 854, 864 (1978).

173. *Agriculture and Related Agencies Appropriations: Hearings Before the Subcomm. on Agriculture and Related Agencies of the Senate Comm. on Appropriations*, 95th Cong., 1st Sess., pt. 2, 1262 (1977).

174. *Id.* at 1263.

175. *See Extended Commodity Exchange Act: Hearings on H.R. 10285 Before the Subcomm. on Conservation and Credit of the House Comm. on Agriculture*, 95th Cong., 2d Sess. (1978).

176. *Id.* at 69-71.

177. *Id.* at 69.

178. *Id.* at 70.

contracts be banned or that the jurisdiction of the CFTC be expanded to adequately regulate them.[179] The CFTC Chairman indicated that his preference was for an expansion of Commission activity in the area.[180]

Following these comments, Vice-Chairman Rainbolt concluded with an appeal which was realistic but not likely to have gained the sympathy of exasperated Congressmen:

> Making a judgment between the nine firms or so that are trading this type of instrument and the overall responsibilities that the Commission has — our problems with jurisdictional issues, the reauthorization issue, the question of futures, the question of options — frankly, I think the judgment was made by the Commission that leverage was not worth the trouble we were going through in trying to define it. Therefore, I think we are coming back to you and asking you to take us off the hook.[181]

The CFTC's position that its jurisdiction over leverage contracts should be repealed aroused the wrath of International Precious Metals Corporation, the firm which had been responsible for the adoption of section 217. To repeal section 217, the firm argued, would have reopened the federal regulatory gap which existed prior to the enactment of the 1974 Act. If section 217 were repealed, the leverage contract industry would be subject to fifty different state securities regulations, as well as federal regulation: the proposed solution was to expand the scope of section 217 to cover all leverage contracts.[182]

State securities officials testified that the exclusive jurisdiction of the CFTC inhibited their ability to deal with the commodity options fraud which was allowed to exist in principle through leverage contracts.[183] The Committee reacted to this testimony by granting state officials the authority to bring civil actions for violations of section 217 or CFTC regulations concerning off-exchange transactions.[184]

The Senate Subcommittee on Agriculture, Nutrition, and Forestry had been considering the CFTC's initial recommendation that section 217 be incorporated into the Commodity Exchange Act

179. *Id.* at 654.
180. *Id.*
181. *Id.* at 656.
182. *Id.* at 728-29.
183. H.R. REP. No. 95-1181, 95th Cong., 2d Sess. 37 (1978).
184. *Id.* at 136-37.

as a new section.[185] The bill reported out of this committee prohibited leverage contracts on commodities regulated under the Commodity Exchange Act before the CFTCA, and authorized the CFTC to prohibit or regulate leverage transactions for all other commodities by October 1, 1979.[186] The overriding concern of the committee was to fill in the gaps in the regulation of commodity options. The committee cited the CFTC's warning that leverage contracts could become a "new field of speculative activity and deceptive sales practices."[187] The Senate considered and rejected an amendment proposed by Senator Bellmon to ban all leverage transactions.[188]

During the hearings before various committees, Congress was moving toward expanding the jurisdiction of the CFTC over all leverage contracts, while the CFTC was retracting toward the position that leverage contracts were futures contracts which should only be traded on designated contract markets.[189] The CFTC was too late, however, to influence the legislation. The Futures Trading Act of 1978 (FTA) combined the Senate and House bills into a new section 19, which expanded the CFTC's jurisdiction over all leverage transactions. Section 19 prohibited leverage transactions on commodities described in section 2(a) of the Commodity Exchange Act before 1974, required the CFTC to regulate gold and silver bullion and bulk coins, authorized the CFTC to prohibit or regulate all other leverage transactions by October 1, 1979, and authorized the CFTC to regulate leverage contracts as futures contracts under the Commodity Exchange Act.[190]

The CFTC has in fact done little to deal with the problem of leverage contracts since passage of the FTA. On March 12, 1979, the CFTC published a proposal to either classify leverage contracts as futures contracts or adopt comprehensive regulations.[191] The comprehensive regulations would include registration, net working capital requirements, segregation of customer's funds, disclosure, and record-keeping requirements.[192] On July 10, 1979, the

185. *Reauthorization of the Commodity Futures Trading Commission: Hearings on S. 2391 Before the Subcomm. on Agricultural Research and General Legislation of the Senate Comm. on Agriculture, Nutrition, and Forestry*, 95th Cong., 2d Sess., pt. 2, 627 (1978).

186. S. 2391, 95th Cong., 2d Sess. § 19, 124 CONG. REC. 10 533 (1978).

187. S. REP. No. 850, 95th Cong., 2d Sess. 15, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS 3817, 3823.

188. *Id.* at 27, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS 3817, 3845.

189. *See* Greenstone, *supra* note 160, at 941-46.

190. *See* H.R. REP. NO. 1678, 95th Cong., 2d Sess. 28, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS 3906, 3918.

191. *Proposed Statute 44 Fed. Reg. 13494 (Mar. 12, 1979): Regulation of Leverage Transactions as Contracts for Future Delivery*, [1977-1980 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 20,772 (1979).

192. *Id.* at 23,162-63.

CFTC announced that leverage transactions for the delivery of silver bullion, gold bullion, bulk silver coins, or bulk gold coins which were being offered to the public for future delivery were contracts for future delivery and were to be regulated as such.[193] This regulation took effect on June 30, 1980.[194]

The CFTC's approach to the problem may well lead to a dead end. It is difficult to view leverage contracts as equivalents of futures contracts. Although leverage and futures contracts are alike in having a futurity of delivery, this general characteristic does not justify similar regulatory treatment. Commodity futures trading is distinguished by exchange procedures which assure that commodity futures contracts will be performed. The performance of commodity futures contracts is guaranteed by margin, which must be deposited and maintained by parties to commodity futures contracts. Margin is administered by clearinghouses. This elaborate system for guaranteeing performance imparts a validity to commodity futures trading which is unique. This is the reason courts and state legislatures exempted commodity futures trading from the application of statutes prohibiting bucketing and gambling.[195] Even with these special circumstances, commodity futures trading was only grudgingly excepted from the general prohibition of wagers. Indeed, the exception of commodity futures trading from the general rule against wagers was never completely resolved until the CFTCA preempted state law.[196]

The CFTC's classification of leverage contracts as futures contracts rests solely on administrative expediency. Clearly this was not the intent behind the passage of the FTA, as Congress granted the CFTC authority to classify leverage contracts as futures contracts only if the Commission determined that leverage transactions were in fact contracts for future delivery.[197]

The situation is ironic. After five years of dealing with commodity options and leverage contracts, the CFTC has finally learned the bitter lesson that these transactions are not worth regulating. But by its ineptitude in attempting to do so, the CFTC has so destroyed its credibility with Congress that it dare not do what it knows should be done, for fear of being viewed as shirking

193. 44 Fed. Reg. 44,177 (1979).

194. 44 Fed. Reg. 69,304 (1979); *Postponement of Effective Date of Regulation of Leverage Transactions as Futures Contracts (Dec. 3, 1979),* [1977-1980 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 20,929 (1980).

195. *See* Comment, *Legislation Affecting Commodity and Stock Exchanges,* 45 HARV. L. REV. 912 (1932).

196. *See supra* note 35.

197. 7 U.S.C.A. § 23(d) (West 1980). For a statement on congressional intent, see H.R. REP. No. 1628, 95th Cong., 2d Sess. 28, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS 3906, 3919.

its duty.

Even if the CFTC is able to prevail in classifying leverage contracts as futures contracts, it still will not have dealt with the basic problem — what to do about the bucketeers. As in the past, the bucketeers will fade into other types of merchandise if leverage contracts become too difficult to sell, or will continue their bucketeering under the guise of complying with whatever regulations the CFTC chooses to promulgate.

IV. CONCLUSION

The federal government has failed to deal with the problem of the bucketeers because federal officials have not seen commodity options, leverage contracts, and other such contracts for what they are — bucket shop merchandise. It does not matter by what name this merchandise is called, whether it be commodity options, leverage contracts, margin contracts, or forward contracts. Regardless of the name, the substance of the transaction is the same: a bet on the future price of a commodity.

The elementary lore of regulation teaches that one should deal with bucket shops by eradication.[198] This is only common sense. Regulation must depend on those who are regulated having some incentive to comply. A legitimate brokerage has the incentive of being able to continue as a lawful business enterprise. The principals of a legitimate brokerage will have too much invested to jeopardize their investment by running a bucket shop or boiler room. This is why members of an organization such as the London Metals Exchange will adhere to a code of ethics even though it is unwritten.[199]

But a bucketeer is beyond regulatory redemption. A bucket shop is a fraud which will run its course, either because the police are willing and able to close it down, or because its victims eventually discover its true nature. Bucketeers have no incentive to comply with regulations; indeed, they have every incentive not to comply. There is no reason to assume that the bucketeers will cease defrauding the public by becoming part of the system for regulating commodity futures contracts.

The CFTC still suffers from a lack of ensynopticity which it has labored under from the beginning. Instead of doing something about the bucketeers which have proliferated under the aegis of

198. *See* HAZARD & CHRISTIE, *supra* note 80, at 63.
199. GIBSON-JARVIE, *supra* note 1, at 22.

federal law, the CFTC is nibbling away with its shilpit proposal to treat leverage contracts as futures contracts. If the leverage contract problem is understood for what it is — a problem of dealing with bucketeers — the policy becomes self-evident. There can be only one policy — to eliminate the bucket shops. For the present, the CFTC should adopt regulations aimed at impeding bucket shop operations. These regulations should include stringent fitness and financial requirements. Above all, the CFTC should make it unlawful for those selling bucket shop merchandise to receive money paid by customers before obligations to customers have been met. These anti-bucketeering regulations should apply universally to leverage contracts, margin contracts, forward contracts, or any other transaction which is susceptible to bucketeering. Finally, these regulations should be enforceable by criminal prosecutions.

Looking beyond an immediate attack on bucketeers, Congress should divest the CFTC of its exclusive jurisdiction over off-exchange transactions. This would return the regulatory scheme to its state before the enactment of the CFTCA. This was the direction in which Congress was leaning when it gave the states jurisdiction to prosecute violations of the Commodity Exchange Act. Although the grant to the states of jurisdiction over the bucketeers is a step in the right direction, the Act's delegation of authority to state officials may be an unconstitiutional delegation of executive authority.[200]

Congress should clear up the disorder it has created by restoring the law to its pre-CFTCA state. It was a mistake to grant the CFTC exclusive jurisdiction over off-exchange transactions, and the last five years have evidenced the enormity of that mistake. And, with all that has happened, Harold Goldstein, the man who started it all, is back at the same old scam.[201]

200. *See* Lower, *State Enforcement of the Commodity Exchange Act*, 27 EMORY L.J. 1057, 1080 (1978).

201. Goldstein was selling "cash-forward" contracts for the future delivery of gasoline in Los Angeles. Goldstein stated, "we've been doing this for eight months and we're still doing it. I'm sure we'd be out of business if it wasn't legal. I found the loophole I was looking for." San Jose Mercury News, Mar. 9, 1980, at 4e.