APPENDIX 2

HISTORY AND CURRENT STATUS OF COMMODITY MARKET REGULATION

In the United States, the Commodity Exchange Act (CEA) is the primary Federal statute governing the purchase and sale of contracts for the future delivery of crude oil. Section I of this Appendix describes the legislative history and major provisions of the CEA as it relates to the trading of contracts for future delivery of crude oil. Section II describes the recent exclusions and exemptions for energy and crude oil contracts that are traded “over-the-counter.”

I. LEGISLATIVE HISTORY OF THE COMMODITY EXCHANGE ACT

“[The CFTC] chairman, William Bagley, was fond of reminding people that the CFTC had fewer ‘policemen’ than the Rockville, Maryland, Police Department—and this to monitor the commodity exchanges that are among the world’s most complex economic institutions.”

—Dan Morgan, Merchants of Grain (1980)

Summary: A fundamental purpose of the regulation of the commodities futures markets is to prevent manipulation.

A. Background on Commodities Exchanges and Need for Regulation

In 1848, as the industrial revolution was helping transform the American Midwest into productive farmland, 82 merchants founded the Chicago Board of Trade (CBOT) to be a central marketplace for producers, buyers, and sellers in the expanding grain trade. In 1865, the CBOT developed futures contracts for trading on the exchange. These standardized contracts, which provided for delivery of a standardized quantity of grain, at a specific location, on a fixed date in the future, at an agreed-upon price, afforded farmers with the price certainty and stability that enabled them to commit resources to the planting of wheat without knowing the specific prices the wheat would eventually obtain on the spot market. Similarly, these futures contracts allowed grain traders, processors, and merchandisers to protect themselves or “hedge” against price volatility while transporting, storing, and processing the grains. The trading of futures contracts attracted speculators who were willing to absorb some of these price risks in exchange for speculative gains, bringing “liquidity” to the market. This market innovation enabled American farmers and merchants to join in the mush-
rooming international trade in grains in the latter part of the 19th Century.

Hundreds of other agricultural exchanges soon sprouted across the country to participate in the domestic and international markets. In 1872 in New York, a group of dairy merchants organized the “Butter and Cheese Exchange of New York,” which also began trading in futures. The New York exchange soon grew to become the “Butter, Cheese and Egg Exchange,” and, in 1882, to reflect the inclusion trade of poultry, groceries, dried fruits, and other produce, became simply “the New York Mercantile Exchange.”

Over time, most of the smaller exchanges could not compete with the large exchanges in New York and Chicago, and have either folded or been consolidated into the major exchanges. The last major consolidation occurred in 1994, when the New York Mercantile Exchange merged with the Commodity Exchange (COMEX), which trades in items such as gold, copper, hides, rubber, silk, silver, and tin. A list of commodity exchanges in operation today is provided in Table A.2-1.1

<table>
<thead>
<tr>
<th>Exchange</th>
<th>Major Commodities</th>
<th>Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td>The COMEX Division (COMEX)</td>
<td>Metals</td>
<td>Founded in 1933 from the merger of the National Metal Exchange, the Rubber Exchange of New York, the National Raw Silk Exchange, and the New York Hide Exchange. Since 1994 a subsidiary of NYMEX.</td>
</tr>
<tr>
<td>Chicago Board of Trade (CBOT)</td>
<td>Grain, U.S. Treasury notes and bonds, interest rates, and stock indexes</td>
<td>First exchange, established in 1848; began futures trading for agricultural commodities in 1865.</td>
</tr>
<tr>
<td>Midamerica Exchange (MIDAM)</td>
<td>Soybeans, wheat, and corn</td>
<td>Subsidiary of CBOT; trades in same contracts as CBOT, but in smaller sizes.</td>
</tr>
<tr>
<td>Chicago Mercantile Exchange (CME)</td>
<td>Livestock, dairy products, stock indexes, interest rates, futures and other currencies</td>
<td>Originally formed in 1848 as the Chicago Butter and Egg Board, became the CME in 1910.</td>
</tr>
<tr>
<td>Kansas City Board of Trade (KCBT)</td>
<td>Wheat, natural gas, and stock indexes</td>
<td>Established in 1858; began futures trading for grains in 1876.</td>
</tr>
<tr>
<td>Minneapolis Grain Exchange (MGRE)</td>
<td>Spring wheat</td>
<td>Established in 1881 by Minneapolis Chamber of Commerce to prevent abuses.</td>
</tr>
<tr>
<td>New York Board of Trade (NYBGT)</td>
<td>Coffee, cocoa, sugar, frozen concentrated orange juice, cotton, currencies, and stock indexes</td>
<td>Formed in 1868 by merger of CSGE and NYCE.</td>
</tr>
<tr>
<td>Coffee, Sugar &amp; Cocoa Exchange (CSGE)</td>
<td>Coffee, sugar, and cocoa</td>
<td>Part of NYBOT.</td>
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<tr>
<td>New York Cotton Exchange (NYCE)</td>
<td>Cotton and frozen concentrated orange juice</td>
<td>Part of NYBOT.</td>
</tr>
<tr>
<td>Merchants’ Exchange (ME)</td>
<td>Barge freight rates and energy products</td>
<td>Established in 1836 as a cash exchange; in 2000 it became the ME and is now an electronic exchange.</td>
</tr>
<tr>
<td>Cantor Financial Futures Exchange (CX)</td>
<td>US Treasury and Agency notes</td>
<td>Proprietary electronic trading platform; joint venture between NY Board of Trade &amp; Cantor Fitzgerald.</td>
</tr>
<tr>
<td>New York Futures Exchange (NYFE)</td>
<td>Currencies and stock indexes</td>
<td>Owned by NYCE.</td>
</tr>
</tbody>
</table>

In the late 19th Century, the commodities markets were self-regulated and rife with manipulation. To many, the commodities markets did not reflect natural forces of supply and demand or perform a valuable economic function, but rather were corrupt institutions that enabled unscrupulous speculators to control the price of basic commodities. "[T]he frequent picture of commodity exchanges was one of unbridled speculation, recurrent market manipulations, and spectacular price fluctuations. Indeed, it was a serious question with many whether the economic services of the system in the 1870's and 1880's were not outweighed by speculative excesses and abuses of the system." 2 The "shenanigans that took place year in and year out at the Chicago Board of Trade" fed into the populist resentment against the trusts, banks, and other large corporate interests toward the end of the century:

The Board of Trade, which was created in 1848 at the instigation of Chicago's merchants, soon became a sort of international symbol of the worst elements of American free enterprise: greed; the cycle of riches and ruin, boom and bust; corruption. There was an orgy of speculation and market manipulation during the Civil War. The Board printed rules governing trading in 1869, but abuses of all kinds continued—fraud, bribery of telegraph operators to obtain confidential information (until coded messages were used), and the spreading of false rumors to influence prices. Outside the trading floor at Jackson and La Salle streets, bucket shops, not much different from bookie joints or other gambling establishments, flourished. 3

Most attempts at cornering the market did not succeed, mainly because the markets were too large. "Memoirs of the markets are full of stories about attempted corners, and they usually have two things in common: greed and failure." 4 "Squeezes made some rich, and bankrupted others. The more severe episodes placed enormous strains on the nation's financial system. . . . Indeed, the gold corner shook the administration of Ulysses S. Grant (who was indirectly linked to the scheme) to its core and largely foreshadowed its litany of scandal." 5 The rampant corruption and manipulations undermined confidence in the futures markets. "The irresponsible trading and lack of effective market regulation in the early period stirred farm resentment and opposition to futures trading that still exist to a limited extent." 6

B. The Commodity Exchange Act
1. Grain Futures Act of 1922

"The abuses of futures trading in this early period resulted in repeated efforts of various State legislatures, from the late 1860's on-

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3 Dan Morgan, Merchants of Grain, at 95 (Penguin, 1980).
4 Stephen Fay, Beyond Greed, at 69 (1982).
ward, to abolish futures trading.”

In 1892–93 both houses of Congress passed bills that would have imposed a prohibitive tax on futures trading; final legislation was narrowly defeated on a procedural motion. As farm prices rose and stabilized in the ensuing years, however, legislative efforts focused on regulation of the markets rather than their abolition.

It was not until grain prices collapsed after the First World War that Federal legislation was passed to regulate the futures markets. During the First World War, the disruption of European grain production and markets drove up prices for American grain, providing handsome profits for entrepreneurial merchants and speculators. After the War ended, the high levels of production in the United States and the resumption of grain production in Europe caused wheat prices to plummet. At the same time, the overall U.S. economy had fallen into a depression. American farmers blamed their post-war plight on the excesses of the speculators, particularly the short sellers, whose speculative selling, they believed, had driven down the price of grains.

At Congressional hearings, farm witnesses “attacked speculators as ‘predatory parasites,’ thieves, gamblers, and wealthy individuals who ‘live like lords and ride in high-powered automobiles and live in great residences.’” The farmers clamored for either outright abolition of the trading of futures or, at the very least, stringent linkages between contracts for futures and the physical market.

Largely as a result of the agitation from the farmers, in 1922, the Congress passed the Grain Futures Act to prevent excessive speculation and manipulation. Congress set forth in the statute itself the purpose of the futures markets—for hedging, price discovery, and price dissemination; the importance of these markets to the national and international commerce; and the public interest in preventing excessive speculation and manipulation:

The prices involved in such transactions are generally quoted and disseminated throughout the United States and in foreign countries as a basis for determining the prices to the producer and the consumer of commodities and the products and byproducts thereof and to facilitate the movements thereof in interstate commerce. Such transactions are utilized by shippers, dealers, millers, and others engaged in handling commodities and the products and byproducts thereof in interstate commerce as a means of hedging themselves against possible loss through fluctuations in price. The transactions and prices of commod-

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7 S. Rept. 97–384, supra at 11; Dan Morgan, Merchants of Grain, at 97 (Penguin, 1980).
8 S. Rept. 97–384, supra at 11.
10 Id. at 292.
11 Id., at 291–294.
12 The Future Trading Act, 42 Stat. 187 (1921), imposed a tax on all grain futures contracts that were not traded on a designated contract market. In Hill v. Wallace, 269 U.S. 44, 42 S.Ct. 458, 66 L.Ed. 822 (1922), the Supreme Court held this Act to be an unconstitutional violation of the taxing power. To remedy this constitutional defect, the next year the Congress passed the Grain Futures Act, 42 Stat. 908 (1922), with virtually the same provisions as the overturned law, but without the offending tax provision. The Grain Futures Act simply made it illegal to trade in futures contracts off a designated contract market. The Supreme Court upheld the Grain Futures Act as a constitutional exercise of the power to regulate interstate commerce in Board of Trade v. Olsen, 262 U.S. 1, 43 S.Ct. 479, 67 L.Ed. 829 (1923).
ities on such boards of trade are susceptible to excessive speculation and can be manipulated, controlled, cornered or squeezed to the detriment of the producer or the consumer and the persons handling commodities and the products and byproducts thereof in interstate commerce, rendering regulation imperative for the protection of such commerce and the national public interest therein.\textsuperscript{13}

The 1922 Act established much of the framework for the regulation of the commodities exchanges in effect today. The Act required all grain futures contracts to be traded on a designated contract market,\textsuperscript{14} and authorized the Secretary of Agriculture to designate a board of trade as a “contract market” if the board satisfied a number of conditions set forth in the statute. Among these conditions were for the board of trade to require members of the exchange to keep records of their transactions, to prevent “false or misleading or knowingly inaccurate reports concerning crop or market information,” and to prevent the “manipulation of prices and the cornering of any commodity.”\textsuperscript{15} The Act provided the government—a commission made up of the Secretary of Agriculture, the Secretary of Commerce, and the Attorney General—with the authority to revoke the designation of any board that failed to comply with the conditions of its designation as a contract market.

2. Commodity Exchange Act

In 1936, Congress enacted the Commodity Exchange Act (CEA) to rename and expand the scope of the original Grain Futures Act to include not only grain but various other commodities, including cotton, butter, and eggs.\textsuperscript{16} The exchanges that traded these commodities opposed the regulation of their markets as unnecessary, and, in what became a typical objection to the various proposed expansions of the markets regulated by the CEA, predicted dire consequences if these markets were regulated. Experience, however, proved such fears to be unfounded.

Congress also strengthened the anti-manipulation provisions of the Act. In response to the 1936 Supreme Court decision in \textit{Wallace v. Cutter} \textsuperscript{17}, in which the Court held the Grain Futures Act did not permit after-the-fact criminal prosecutions for violations of the anti-manipulation provisions, Congress made manipulation a misdemeanor punishable by a fine of $10,000 and imprisonment of up to 1 year.\textsuperscript{18}

\textsuperscript{14}In making off-exchange transactions in futures illegal, Congress intended to stop the “bucketing” of orders in “bucket shops.” A “bucket shop” would take a customer order for a futures transaction but not place the order on the exchange; as the counter-party to the customer’s transaction the bucket shop would attempt to profit from price movements adverse to the customer. Bucket shops also would offset orders from customers with opposing positions against each other, thereby short-circuiting the open outcry price discovery mechanism of the exchange. Both practices exposed the customers to additional costs and risks of default. See, e.g., Markham, supra at n139 and accompanying text.
\textsuperscript{15}7 U.S.C.A. § 7 (1999).
\textsuperscript{16}49 Stat. 1491 (1936).
\textsuperscript{17}258 U.S. 229 (1936).
\textsuperscript{18}49 Stat. 1498, 1499 (1936)
Butter & Eggs and Cotton Exchanges Opposed
Regulation under the CEA

Although farmers and dairy producers supported the
regulation of butter and egg futures, the butter and egg
exchanges opposed it. Romano, supra. The President of the
Chicago Mercantile Exchange testified the legislation was
not needed to “insure the free flow of butter and eggs from
the farm to the table of the consumer.” The President of
the New York Mercantile Exchange predicted the bill
would “undoubtedly curtail trading in futures to such an
extent that future boards on commodity exchanges han-
dling butter and eggs will practically become useless.” The
exchanges requested further study before legislation was
enacted. Hearings before the Senate Committee on Agri-
culture and Forestry, To Amend the Grain Futures Act,
74th Cong., 2nd Sess., April 21, 22, and 23 (1936).

Phelan Beale, General Counsel for the Cotton Exchange,
testified “it would be a grievous error to include cotton in
a bill that primarily was drawn to apply to grain.” He
asked the Committee to further study the issue so that
“through no inadvertence nor sins of omission or commis-
sion may the greatest commodity in the United States and
the greatest export of the United States be impaired.”
Hearings before the House Committee on Agriculture, Reg-
ulation of Commodity Exchanges, 74th Cong., 1st Sess.,
45–46, February 5, 7, and 8, 1935.

The Congress also added an anti-fraud provision, which to this
date has remained essentially unchanged.\textsuperscript{19}

The CEA Anti-Fraud Provision

Section 4b of the CEA makes it unlawful for any person,
in connection with the sale of or order for any contract for
future delivery that is used for hedging, price discovery, or
actual delivery of such commodity, to: (i) cheat or defraud,
or attempt to cheat or defraud, another person; (ii) will-
fully make any false statement to another person or create
a false record; (iii) willfully deceive or attempt to deceive
another person; or (iv) to bucket any such orders, offset
such orders against orders of other persons, or willfully
and knowingly become the buyer or seller of sell or buy or-
ders without the consent of the other party.

3. 1968 Amendments

In 1968, Congress again expanded the Act and strengthened the
anti-manipulation and anti-fraud provisions.\textsuperscript{20} The 1968 amend-
ments brought several additional commodities, such as live cattle
and pork bellies, within the scope of the Act. It empowered the Sec-
retary of Agriculture to disapprove rules adopted by a contract
market that would violate the Act or the regulations established
thereunder, and also required the contract markets to enforce all

\textsuperscript{20} 82 Stat. 26 (1968).
of its rules that were not disapproved by the Secretary of Agriculture. The amendments made a violation of the anti-manipulation and anti-fraud provisions a felony rather than a misdemeanor, with a maximum prison term of 5 years.

4. 1974 Amendments: Creation of CFTC

Initially, jurisdiction over the commodities markets was provided to the Department of Agriculture because the commodities markets were centered around a limited number of agricultural products. By the 1970's, a number of futures markets in other products had developed, such as coffee, sugar, cocoa, lumber, and plywood, plus various metals, including the volatile silver market, and foreign currencies. In 1974, Congress concluded the need to regulate these commodity markets was no less than the need to regulate the agricultural markets already within the Act:

A person trading in one of the then unregulated futures markets needed the same protection afforded to those trading in the regulated markets. Whether a commodity was grown, mined, or created, or whether it was produced in the United States or outside the United States made little difference to those in this country who bought, sold, processed, or used the commodity, or to the United States consumers whose prices were affected by the futures market in that commodity.21

Accordingly, Congress overhauled the CEA and expanded its coverage to include a broad range of futures contracts, not just the agricultural commodities already specified in the statute.22

Coffee & Sugar and Cocoa Exchanges and Silver Companies Opposed Regulation Under the CEA

The New York Coffee and Sugar Exchange and the New York Cocoa Exchange (both are now part of the New York Board of Trade) opposed the regulation of their markets. One representative testified these exchanges were "more than adequately regulated" under their own rules and the "good sound judgment" of their officers and governing boards. He perceived "no reason" for regulation under the CEA. The exchanges predicted that regulation would drive these futures markets overseas, causing the United States and the City of New York "to lose substantial employment opportunities and taxable revenues," and "would increase the volatility of commodity prices passed on to consumers in the United States." Commodity Futures Trading Commission Act, Hearings before the Senate Committee on Ag-

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21 S. Rept. 97-384, supra at 13.
22 The commodities listed in the statute are wheat, cotton, rice, corn, oats, barley, rye, flaxseed, grain sorghums, mill feeds, butter, eggs, Solanum tuberosum (Irish potatoes), wool, wool tops, fats and oils (including lard, tallow, cottonseed oil, peanut oil, soybean oil, and all other fats and oils), cottonseed meal, cottonseed, peanuts, soybeans, soybean meal, livestock, livestock products, and frozen concentrated orange juice, 7 U.S.C.A. §§ 1a(4) (West Supp. 2002). In 1968, as a result of the numerous manipulations of the onion market, the Congress prohibited all futures in onions. Pub. L. 90-839, § 1, Aug. 28, 1968, 72 Stat. 1018; 7 U.S.C.A. §§ 13-1 (West 1999). See Markham, supra at 318 ("Perhaps the most manipulated market of all was onions.").

Today, the New York Board of Trade states it is “the world’s premier futures and options markets” for cocoa, coffee, cotton, frozen concentrated orange juice, and sugar. New York Board of Trade, Agricultural Futures & Options.

Several companies trading in silver opposed the regulation of futures contracts for silver. Even as the Hunt brothers were active in the silver market, the Chairman of Mocatta Metals, the largest U.S. silver bullion dealer, testified there were “no major scandals or improprieties affecting trading on the major international commodity exchanges necessitating emergency amelioration,” and urged more study of the issue. Mocatta predicted full CFTC regulation “could upset the markets for international commodities and materially reduce the vitality of U.S. participation in those markets, thereby causing those commodities to flow away from our shores and to be most costly to acquire for consumption in the U.S.” 1974 Senate Hearings, supra, at Part. 3, 797 (Statement of Dr. Henry G. Jarecki).

The 1974 Amendments expanded the Act to include “all other goods and articles . . . . and all services, rights, and interests in which contracts for future delivery are presently or in the future dealt in.”

In expanding the scope of the Act, Congress reiterated the purpose of the Act to prevent fraud, manipulation, and control speculation in the commodity markets:

The fundamental purpose of the Commodity Exchange Act is to ensure fair practice and honest dealing on the commodity exchange and to provide a measure of control over those forms of speculative activity which too often demoralize markets to the injury of producers and consumers and the exchanges themselves.23

The legislation transferred the authority of the Secretary of Agriculture to the new Commodity Futures Trading Commission (CFTC), an independent five-member regulatory agency. The 1974 Amendments increased the maximum fine for a violation of the anti-manipulation prohibition from $10,000 to $100,000.24

Congress also clarified that this expansion of CEA coverage did not extend to certain financial transactions. During the debate over the 1974 amendments, the Treasury Department had expressed concern that the proposed language to broaden the Act could be read to encompass the existing trade in currency futures between large banks and other sophisticated institutions. Congress responded by enacting the “Treasury Amendment,” which exempted from the Act “transactions in foreign currency, security warrants, security rights, resales of installment loan contracts, repurchase options, government securities, or mortgages and mortgage pur-

chase commitments, unless such transactions involve the sale thereof for future delivery conducted on a board of trade.\textsuperscript{25}

The Senate report on the 1974 legislation explained the rationale underlying the Treasury Amendment:

[T]he Committee included an amendment to clarify that the provisions of the bill are not applicable to trading in foreign currencies and certain enumerated financial instruments unless such trading is conducted on a formally organized futures exchange. A great deal of the trading in foreign currency in the United States is carried out through an informal network of banks and tellers. The Committee believes that this market is more properly supervised by the bank regulatory agencies and that, therefore, regulation under this legislation is unnecessary.\textsuperscript{26}

In the mid-1970's, following the extreme price volatility in the energy sector resulting from the Arab oil embargo, a new market for energy futures emerged. In 1978, NYMEX offered futures contracts in heating oil, and over the next several years NYMEX proposed a variety of futures contracts in other petroleum products. In 1983, NYMEX began trading in the WTI futures contract.\textsuperscript{27}

Today, the vast majority of futures contracts traded on the exchange are unrelated to agriculture. Whereas as recently as the early 1970's, most of the approximately 13 million futures contracts traded annually on domestic boards of trade involved agricultural commodities, in 1999, nearly 600 million futures contracts were traded annually in the United States, but with only a small fraction—about 11 percent—related to agriculture.\textsuperscript{28}

In 1980, in a case involving the question of whether the CEA provided a private right of action, the U.S. Court of Appeals for the Second Circuit traced the history of the CEA and observed how the Act had been strengthened over the years to match the needs of the evolving futures markets:

The history of congressional concern with commodity futures trading has thus been one of steady expansion in coverage and strengthening of regulation. In 1936, 1968, and 1974 new commodities came under the CEA. In each of these years the power of the regulatory authority were augmented, and penalties were either extended, increased, or both. The question of Congressional intent with respect to private sanctions under the Act must be considered against this background of increasingly strong regulation designed to insure the existence of fair and orderly markets.\textsuperscript{29}

Although one of the main purposes of the CEA was to discourage and punish market manipulation, manipulations and attempts at manipulation of the commodity markets have continued. In 1982,
following the Hunt brothers' attempts to corner the silver market, one observer commented:

The 19th Century grain market in Chicago was littered with examples of attempted squeezes and corners; to a lesser extent it still is. Rings and corners in the stock market ended with the Great Crash and the establishment of the Securities and Exchange Commission in 1934. But commodities remained a temptation to the corner men. In the last generation corners were attempted in eggs, onions, vegetable oil, soybeans, and potatoes. The fact that market manipulation is now illegal does not stop people trying.  

More recent history demonstrates that manipulations are not "simply relics of the distant past." 21 Allegedly, the Hunt brothers squeezed the soybean market in 1977, as well as the silver market a couple of years later. The Peruzzis allegedly squeezed the CBOT soybean market in the late 1980's. "In 1991, the eminent investment bank and primary government securities dealer Salomon Brothers successfully cornered several issues of Treasury notes, thereby causing huge disruptions in the world's financial market and throwing a cloud of suspicion over it that has yet to dissipate completely." 22 As discussed in Appendix 1, the Sumitomo Corporation manipulated the price of copper in the mid-1990's, causing as much as a 30 percent rise in copper prices. And as discussed in the main section of this report, in 2000, a U.S. refiner obtained a large financial settlement from Arcadia, a crude oil trading company, in a lawsuit over alleged manipulation of the crude oil market.

20 Stephen Fay, Beyond Greed, at 60 (1989). For a list of Federal manipulation cases decided between 1949 and 1989, see Markham, Manipulation of Commodity Futures Prices—The Unprosecutable Crime, 8 Yale J. on Reg. 281 (1991) ("The commodity futures market has been beset by large-scale manipulations since its beginning.").
22 Id. See also Nicholas Dunbar, Inventing Money 109–112 (2001).