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Federal Regulation of Commodity Option Trading - Is the Customer Protected.

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COMMENTS

FEDERAL REGULATION OF COMMODITY OPTION TRADING—IS THE CUSTOMER PROTECTED?

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Trading in commodity options has been abused in recent years.[1] Although the Commodity Exchange Act of 1936[2] banned option trading in most domestic agricultural commodities, the Act failed to prohibit option trading in the unregulated world commodities.[3] The attractive lure of option trading coupled with insufficient customer protections has often resulted in significant losses for the unsophisticated investor.[4] In response to this, Congress enacted the Commodity Futures Trading Commission Act of 1974[5] in an effort to extend protection against trading abuse in the unregulated commodities.[6] The Act effectively expands the definition of "commodity" to include anything for which contracts for future delivery may be made.[7] It continues the ban on trading in options in the previously

1. The collapse of a California firm resulted in a $71 million loss to commodity customers. In Texas another firm engaged in nonregulated option trading failed, causing substantial losses to customers. H.R. REP. No. 93-975, 93d Cong., 2d Sess. 37 (1974).

2. Ch. 545, §§ 1-13, 49 Stat. 1491 (1936) (current version at 7 U.S.C. §§ 1-22 (1970 & Supp. V 1975)).

3. The ban extended only to those commodities regulated by the Act and did not restrict option trading in the unregulated commodities. The following commodities were regulated under the Act:

> wheat, cotton, rice, corn, oats, barley, rye, flaxseed, grain sorghums, mill feeds, butter, eggs, onions, 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. § 2 (1970) (current version at 7 U.S.C. § 2 (Supp. V 1975)). The "world" commodities, which are international market commodities such as cocoa, coffee, rubber, world sugar, silver, and most metals, were left unregulated. Clayton Brokerage Co. v. Mouer, 520 S.W.2d 802, 804 (Tex. Civ. App.—Austin), *dismissed as moot per curiam*, 531 S.W.2d 805 (Tex. 1975).

4. COMMODITY FUTURES TRADING COMMISSION ADVISORY COMM., RECOMMENDED POLICIES ON COMMODITY OPTION TRANSACTIONS (1976); *see* Hill, *The Ponzi Principal, Naked Commodity—Options Business, Now in Ruins*, Wall St. J., June 28, 1973, at 38, col. 2 (total losses to speculators in California alone could exceed $100 million).

5. 7 U.S.C. §§ 1-22 (1970 & Supp. V 1975).

6. CFTC v. J.S. Love & Assocs. Options, Ltd., No. 76-928, slip op. at 11 (S.D.N.Y. Aug. 12, 1976); *see* H.R. REP. No. 93-975, 93d Cong., 2d Sess. 62 (1974); S. REP. No. 93-1131, 93d Cong., 2d Sess. 19 (1974).

7. The expanded definition of commodity includes, in addition to the specific commodities, "all other goods and articles, except onions . . . and all services, rights, and interests in which contracts for future delivery are presently or in the future dealt in . . . ." 7 U.S.C. § 2 (Supp. V 1975).

regulated commodities but allows option trading in all other commodities if not contrary to any rules or regulations of the newly formed Commodity Futures Trading Commission[8] (CFTC). Thus the Commission was given the burden of determining whether commodity option trading will be permitted, and if so, under what conditions.[9] Rejecting the simpler solution of extending the statutory ban on option trading to the newly regulated commodities, the Commission adopted the more positive plan of permitting, for the first time, option trading in accordance with federal regulation.[10]

COMMODITY OPTION CONTRACTS

The traditional form of trading in commodities is the commodity futures contract.[11] A commodity futures contract is simply a contract to buy or sell a specified quantity of a particular commodity at a given date in the future.[12] Commodity futures contracts are useful because they provide a hedging mechanism which enables producers, dealers, and processors of various commodities to shift the risk of price fluctuations to speculators.[13] They also play an increasingly important role in the marketing of commodities by providing an immediate and continuous flow of competitively determined prices.[14]

Another method of dealing in commodities is through the commodity option contract. A commodity option gives the purchaser the option to buy from, or sell to, the grantor of the option a specific commodity futures contract at a definite price within a stipulated period of time.[15] The lifetime of the option generally ranges from two to fourteen months.[16] The purchaser obtains the option privilege by paying the grantor a sum of money called a premium.[17] An option to buy the underlying futures con-

8. *Id.* § 6c(b).

9. *Id.* § 6c(b).

10. *See* 41 Fed. Reg. 51,808, 51,814 (1976) (to be codified in 17 C.F.R. §§ 32.1-.10).

11. Note, *Federal Legislation for Commodity Option Trading: A Proposal,* 47 S. CALIF. L. REV. 1418, 1420 (1974).

12. Corn Prod. Ref. Co. v. Comm'r, 350 U.S. 46, 47 n.1 (1955); Clayton Brokerage Co. v. Mouer, 520 S.W.2d 802, 804 (Tex. Civ. App.—Austin), *dismissed as moot per curiam,* 531 S.W.2d 805 (Tex. 1975).

13. *See* Corn Prod. Ref. Co. v. Comm'r, 350 U.S. 46, 48-50 (1955); United States v. New York Coffee & Sugar Exch., 263 U.S. 611, 619 (1924); S. REP. No. 93-1131, 93d Cong., 2d Sess. 12 (1974).

14. S. REP. No. 93-1131, 93d Cong., 2d Sess. 12 (1974).

15. Stipulation of all Relevant Facts in Lieu of Trial on Preliminary and Permanent Injunction, SEC v. Goldstein Samuelson, Inc., Civ. App. No. 73-472 at 9 (C.D. Cal. Oct. 11, 1973) [hereinafter cited as Stipulation]. For a general discussion of commodity options see S. KROLL & I. SHISKO, THE COMMODITY FUTURES GUIDE 259-68 (1973).

16. S. KROLL & I.SHISKO, THE COMMODITY FUTURES GUIDE 259, 260 (1973).

17. Clayton Brokerage Co. v. Mouer, 520 S.W.2d 802, 807 (Tex. Civ. App.—Austin),

tract from the option grantor is a "call," while the option to sell the underlying futures contract is a "put."[18]

Trading in commodity options affords several advantages over trading in commodity futures. One advantage is that the risk of loss is limited to the premium paid for the option privilege.[19] Additionally, the purchaser of the commodity option is not subject to margin calls in the event of an adverse movement in the futures market.[20] Finally, an option allows the holder time to observe the price fluctuations in the market during the lifespan of the option and to exercise the option when the market is most advantageous to him.[21]

Trading in commodity options also provides many economic benefits to investors and producers not available through trading in straight commodity futures contracts. Because of the limited risks involved, trading in commodity options attracts a large number of investors to the commodities market who are unwilling to accept the risks connected with the traditional commodity futures contract. This in turn assures a more representative price since there is a larger number of participants expressing their opinions in the market.[22] Commodity options also tend to stabilize market

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dismissed as moot per curiam, 531 S.W.2d 805 (Tex. 1975); S. Kroll & I. Shisko, The Commodity Futures Guide 258, 259 (1973).

18. Clayton Brokerage Co. v. Mouer, 520 S.W.2d 802, 805 (Tex. Civ. App.—Austin) (defines "call"), *dismissed as moot per curiam*, 531 S.W.2d 805 (Tex. 1975). A call purchaser anticipates the price of the underlying futures contract will rise during the option period. If this happens, he exercises his option to buy the underlying futures contract at the lower price and then sells the futures contract at the current market price. His profit is the difference between the two prices minus the cost of the premium. The purchaser of a put option, on the other hand, anticipates the price of the underlying futures contract will decline during the option period. When this occurs he buys a futures contract at the lower market price and subsequently sells it to the grantor of his put at the higher price. *See* Laing, *New Game in Town? Commodity Markets May Soon Be Trading in Options in Futures*, Wall St. J., May 13, 1976, at 1, col. 6.

19. King Commodity Co. v. State, 508 S.W.2d 439, 442 (Tex. Civ. App.—Dallas 1974, no writ); *see Commodity Futures Trading Commission Act: Hearings on H.R. 11955 Before the House Comm. on Agriculture*, 93d Cong., 2d Sess. 174 (1974).

20. King Commodity Co. v. State, 508 S.W.2d 439, 442 (Tex. Civ. App.—Dallas, 1974, no writ); *Commodity Futures Trading Commission Act: Hearings on H.R. 11955 Before the House Comm. on Agriculture*, 93d Cong., 2d Sess. 174 (1974). Unlike an investor in a commodity option, an investor who purchases a futures contract must advance an initial margin deposit with the exchange clearinghouse as evidence of his good faith and ability to perform the contract. If the market moves against him, he must deposit additional margin money. If he is unable to deposit the additional margin, all or part of the investor's position may be liquidated in order to maintain established margin requirements. Note, *Federal Legislation for Commodity Option Trading: A Proposal*, 47 S. Cal. L. Rev. 1418, 1424 (1974).

21. *Commodity Futures Trading Commission Act: Hearings on S. 2485, S. 2578, S. 2837, & H.R. 13113 Before the Senate Comm. on Agriculture and Forestry*, 93d Cong., 2d Sess. 827 (1974).

22. Note, *Federal Legislation for Commodity Option Trading: A Proposal*, 47 S. Cal. L. Rev. 1418, 1443 (1974).

prices, since, unlike a commodity futures contract, there are no margin requirements which may force an investor to unwillingly relinquish his position and thus create an artificial "supply" which increases the downward pull on prices and destroys the supply and demand balance for the underlying commodity.[23] More importantly, commodity options facilitate hedging by enabling producers, dealers, and processors to utilize the futures market more effectively in reducing risks.[24] Minimization of risk enables the producers, dealers, and processors to reduce their costs, thereby permitting customers to purchase their manufactured goods at lower prices.[25]

Abuse of Commodity Options and the Commodity Futures Trading Act of 1974

Although legitimate option dealing serves a variety of useful economic purposes, option trading has been criticized throughout its history.[26] The earliest criticism voiced against trading in option contracts was that they were merely wagering devices. In *Pearce v. Foote*[27] the Illinois Supreme Court found that persons entering into the option contract had no intent to enter the commodities market or purchase the underlying commodity, but were simply betting on the price fluctuations in the market.[28] Later, option contracts were also criticized as causing excessive price movements which resulted in the wheat market collapse of 1933.[29] Partially prompted by this disaster, the Commodity Exchange Act of 1936 banned option trading for all commodities regulated under the Act.[30] The prohibition,

23. *Id.* at 1443.

24. *Commodity Futures Trading Commission Act: Hearings on H.R. 11955 Before the House Comm. on Agriculture,* 93d Cong., 2d Sess. 179, 198-99 (1974).

25. *Id.* at 199.

26. Commodity Futures Trading Commission Advisory Comm., Recommended Policies on Commodity Option Transactions (1976) [hereinafter cited as Recommended Policies]. The Commodity Futures Trading Commission requested the Advisory Committee on Definition and Regulation of Market Instruments to report and recommend appropriate regulations or restrictions dealing with commodity options. 40 Fed. Reg. 32,866 (1975). The report was submitted to the Commission on July 6, 1976. *Id.* at 51,808, 51,809.

27. 113 Ill. 228 (1885).

28. *Id.* at 233-34.

29. Recommended Policies, *supra* note 26, at 93. The volume of options sold at that time was estimated as being equal to 15% of the total volume on the Chicago Board of Trade. These options were sold "naked," which means they were sold without a futures contract to support them. A rise in the price of grain caused many options holders to exercise their profitable calls at the dealer's expense. To reduce their losses by covering their option contracts, the dealers swarmed into the market frantically buying all available contracts. This caused the price of grain to rise rapidly overnight causing even more frantic buying. The sudden price movement, not connected with any actual change in supply and demand, subsequently led to the market collapse. Hill, *Gambler's Game: Commodity Options Are the Latest Way to Get Rich or Poor in a Hurry,* Wall St. J., Feb. 2, 1973, at 19, col. 2.

30. Commodity Exchange Act, ch. 545, § 4c(B), 49 Stat. 1491, 1494 (1936) (current

however, did not apply to world commodities, leaving the door open for continued abuses in this area. The latest abuses occurred in the 1970's when commodity options were used to attract unsophisticated investors into the market.[31] The dealers offering the options defrauded the customers by not utilizing the commodity market properly;[32] rather than settling option contracts by actual exchanges of the underlying contract, these option firms paid profitable option holders with the premiums of new investors.[33] The operations of the dealers finally collapsed when net winners outnumbered net losers.[34] One company's collapse resulted in a customer loss of seventy-one million dollars.[35] As a result of these scandals, Congress enacted the Commodity Futures Trading Commission Act of 1974[36] giving the new Commission jurisdiction over all commodity futures sold in the United States, as well as the authority to decide if and under what circumstances option trading in the newly regulated commodities would be permitted.[37]

REGULATION

The Commission responded to its congressionally imposed duty by recognizing the beneficial uses of commodity options and determining that option trading in general should not be banned.[38] The Commission plans to regulate commodity options by implementing a two-stage procedure resulting in comprehensive regulations for a three year test program.[39] The program will ultimately limit the purchase and sale of commodity options to Commission-designated boards of trade and recognized foreign commodity exchange systems.[40] Based on the results of the test program, the Commission will develop a permanent regulatory program or, if necessary,

version at 7 U.S.C. 6c(b) (Supp. V 1975).

31. *See* King Commodity Co. v. State, 508 S.W.2d 439, 444 (Tex. Civ. App.—Dallas 1974, no writ) (advertising literature boasting that option customers need not watch market quotations). *See also* Clayton Brokerage Co. v. Mouer, 520 S.W.2d 802, 809 (Tex. Civ. App.—Austin) (investment customers unfamiliar with commodity trading solicited), *dismissed as moot per curiam*, 531 S.W.2d 805 (Tex. 1975); Stipulation, *supra* note 15, at 21 (target customers, small investors disillusioned with stock market).

32. *See* Stipulation, *supra* note 15, at 11, 26; *Commodity Futures Trading Commission Act: Hearings on H.R. 11955 Before the House Comm. on Agriculture*, 93d Cong., 2d Sess. 194 (1974).

33. Stipulation, *supra* note 15, at 16, 25, 26; H.R. REP. No. 93-975, 93d Cong., 2d Sess. 38 (1974).

34. H.R. REP. No. 93-975, 93d Cong., 2d Sess. 38 (1974).

35. *Id.* at 37.

36. 7 U.S.C. §§ 1-22 (1970 & Supp. V 1975).

37. 7 U.S.C. § 6c(b) (Supp. V 1975).

38. *See* RECOMMENDED POLICIES, *supra* note 26, at 1.

39. 41 Fed. Reg. 51,808 (1976).

40. *Id.*

prohibit trading in the United States.[41]

In effecting the regulatory scheme, the Commission has temporarily prohibited all commodity option transactions involving domestically traded futures contracts—including those traded on contract markets[42]—and has implemented Stage One which seeks to regulate London options[43] as they are currently sold in the United States.[44] Stage Two will ultimately allow both domestic and London option trading on designated organized exchanges in the United States and recognized foreign commodity exchange systems.[45]

The regulatory scheme created by the Commission is designed to provide necessary customer protections which would assure the financial integrity of option transactions and prevent fraud.[46] Protection of both customers and the underlying markets against manipulation is an essential consideration in the development of a realistic commodity option policy.[47] The Commission's Advisory Committee on Definition and Regulation of Market Instruments[48] determined that in order to adequately protect customers, ensure the financial solvency of option transactions, and prevent fraudulent practices, three basic safeguards are needed: (1) segregation of funds; (2) a sufficient guarantee of performance of the option obligation; and (3) adequate regulation of trading practices.[49] The Commission's regulatory program will be analyzed in light of these customer safeguards. It will be shown that the regulations in Stage One, which seek to regulate London options as they are currently sold in the United States, fail to effectively provide a number of essential protections. The general scheme of Stage Two can provide many of these missing protections although inherent problems surround the regulation of foreign commodity exchange systems.

Specific Regulations of Stage One

London options, as opposed to domestically traded options, are those

41. *Id.* at 44,560.

42. *Id.* at 51,808, 51,514 (to be codified in 17 C.F.R. § 32.2(b)) (effective Dec. 9, 1976).

43. London options, as opposed to domestically traded commodity options, represent those options which are originally traded on organized exchanges in London. Clayton Brokerage Co. v. Mouer, 520 S.W.2d 802, 804 (Tex. Civ. App.—Austin), *dismissed as moot per curiam*, 531 S.W.2d 805, 806 (Tex. 1975).

44. 41 Fed. Reg. 51,808 (1976).

45. *Id.*

46. *Id.* at 51,809.

47. *See* Recommended Policies, *supra* note 26, at 18.

48. The Advisory Committee on Definition and Regulation of Market Instruments was requested by the Commodity Futures Trading Commission to report and recommend appropriate regulations or restrictions dealing with commodity options. 40 Fed. Reg. 32,866 (1975).

49. Recommended Policies, *supra* note 26, at 18.

options which are originally traded on organized exchanges in London.[50] As subsequently retailed in this country, these options lack several essential customer protections.

There are three basic exchange groups in London which trade commodity options.[51] In all three groups, exchange contracts extend only to members of the exchange.[52] Thus, any clearinghouse guarantee of the option obligation or any segregation of premiums does not extend to the ultimate customer in the United States but merely runs to another exchange member.[53] Also, funds received by the London seller from a United States retailer are aggregated in a single general account irrespective of whether the funds concern the retail dealer's house trades or United States customer transactions.[54] As a result of the general account, funds received from United States customers are subject to any right of setoff the London seller may have against the United States retailer.[55] These factors, coupled with the lack of control of the United States market for foreign options and the absence of financial standards for United States option dealers,[56] make customer protection virtually nonexistent. The first stage of the Commission's two-stage procedure attempts to fill this gap in customer protection.

Segregation of Premium Funds

The most important customer protection provided by the regulations is the segregation of premium funds.[57] A minimum of ninety percent of the funds or property received from an option customer as payment of the purchase price for a commodity option must be segregated from all other assets and treated as belonging to the option customer.[58] The funds must

50. Clayton Brokerage Co. v. Mouer, 520 S.W.2d 802, 804 (Tex. Civ. App.—Austin), *dismissed as moot per curiam,* 531 S.W.2d 805 (Tex. 1975).

51. Long, *Commodity Options—Revisited,* 25 DRAKE L. REV. 75, 112 (1975).

52. *Id.* at 124.

53. CFTC v. J.S. Love Assocs. Options, Ltd., No. 76-928, slip op. at 5 (S.D.N.Y. Aug. 12, 1976). *See generally* Long, *Commodity Options—Revisited,* 25 DRAKE L. REV. 75, 111-28 (1975) (thorough discussion of three London trading groups and their trading operations).

54. CFTC v. J.S. Love Assocs. Options, Ltd., No. 76-928, slip op. at 9 (S.D.N.Y. Aug. 12, 1976); RECOMMENDED POLICIES, *supra* note 26, at 135. London options are generally sold in the United States in the following manner: A person or firm in London contacts a member on a London exchange and sells him an option. The exchange member then sells the option to another exchange member. The second exchange member resells the option through a firm in the United States rewriting the option in his own name as grantor. This firm will then retail to another firm who may retail to another firm and so forth until the option is ultimately sold to a United States customer. As the option changes hands, each firm will charge a markup for participation in the transaction. RECOMMENDED POLICIES, *supra* note 26, at 135. *See also* Long, *Commodity Options—Revisited,* 25 DRAKE L. REV. 75, 124-28 (1975).

55. RECOMMENDED POLICIES, *supra* note 26, at 137-38.

56. *Id.* at 42.

57. 41 Fed. Reg. 51,808, 51,815-16 (1976) (to be codified in 17 C.F.R. § 32.6(a)) (effective Dec. 27, 1976).

58. *Id.* at 51,816.

be segregated in the United States until the option expires, or if the customer exercises the option, until the customer's rights under the option are satisfied.[59]

Segregation of premium funds is necessary to at least protect the initial investment of the customer.[60] Prior to this regulation, neither London nor United States option dealers were required to segregate funds received from United States customers. As a result, these funds could be invested in the general business operations of the dealer or could be subjected to the general claims of his creditors.[61] Furthermore, segregation of premiums encourages the legitimate use of the option transaction while ensuring its financial integrity. Since the dealer is prevented from financing his activities with customer premiums, he will be more inclined to properly participate in the commodities market.[62] Also, segregating the premiums in the United States guards against the commingling of funds, which occurs in London where funds of the option dealer's house trades and funds of his United States customer are aggregated in a single general account. Segregation further protects United States customer's funds from losses occurring should the London dealer set off a claim he might have against the option dealer from this account. At the very least, segregation of premiums assures the customer that his initial investment can be refunded if he exercises the option but cannot obtain performance of the obligation because the option dealer is insolvent.[63]

Registration

The registration requirement[64] is a substantive regulation promulgated by the Commission, which facilitates control over persons dealing in commodity option transactions. Any person who now accepts premiums paid by an option customer to secure the purchase of an option privilege must be registered with the Commission as a futures commission merchant.[65] Any person who solicits or accepts orders for commodity options must also be registered as a futures commission merchant or as an associate of a specified futures commission merchant.[66] This in effect means that options can be offered and sold in the United States only through registered future

59. *Id.* at 51,815-16.

60. *Id.* at 51,812.

61. RECOMMENDED POLICIES, *supra* note 26, at 47-48.

62. Segregation of premiums will help guard against the abusive use of option contracts which occurred in the 1970's. No segregation of funds was required and option dealers were using premiums paid by new customers to pay profitable option holders rather than settling the contract through actual exchange of the underlying futures contract. See text accompanying notes 31-35 *supra*.

63. 41 Fed. Reg. 51,808, 51,812 (1976).

64. *Id.* at 51,808, 51,814 (to be codified in 17 C.F.R. § 32.3) (effective Jan. 17, 1977).

65. *Id.* at 51,814.

66. *Id.* at 51,814.

commission merchants and their associates.[67] Registration is required regardless of whether or not the futures commission merchant receives the option order directly from the option customer.[68] An option customer is defined as "any person who, directly or indirectly, purchases . . . for value any interest in a commodity option . . ." but excludes a person registered as a futures commission merchant.[69]

The registration requirement is significant because it subjects persons dealing in options to the same careful screening process which applies to those dealing in futures contracts and requires them to meet established standards.[70] In addition to registering, a futures commission merchant engaged in commodity transactions must also have an adjusted working capital which at a minimum exceeds fifty thousand dollars or satisfy other requirements set out in the regulations.[71] This requirement prevents fraudulent practices and ensures the financial solvency of the option transaction by effectively excluding "fly-by-night" option dealers while also providing customer protection against losses resulting from such factors as fraudulent business operations or inadequate segregation.[72]

The requirement that future commission merchants who engage in commodity option transactions must maintain an adjusted working capital of not less than fifty thousand dollars has been criticized as being anticompetitive, especially since future commission merchants who engage in commodity futures transactions need only maintain an adjusted working capital of ten thousand dollars.[73] It is asserted that the requirement violates section 19 of the Commodity Futures Trading Commission Act,[74] which requires the Commission to consider the least anticompetitive means of achieving its objectives.[75] Although the Commission is charged with this responsibility, it believes that the public interest in customer protection against abuses connected with commodity options outweighs any anticompetitive effect of the financial requirement.[76] This stand taken by the Commission is sound since the most recent abuses concerning commodity options stem from inadequate capitalization.[77] A firm capitalization basis is

67. *Id.* at 44,560, 44,562.

68. *Id.* at 44,562.

69. *Id.* at 51,808, 51,814 (to be codified in 17 C.F.R. § 32.1(c)).

70. *See* 17 C.F.R. § 1.17 (1976).

71. 41 Fed. Reg. 51,808, 51,814 (1976) (to be codified in 17 C.F.R. § 1.17(b)(1)).

72. RECOMMENDED POLICIES, *supra* note 26, at 45.

73. 41 Fed. Reg. 51,808, 51,809 (1976).

74. 7 U.S.C. § 19 (Supp. V 1975).

75. 41 Fed. Reg. 51,809 (1976).

76. *Id.* at 51,809-10.

77. Harold Goldstein, who led the abusive use of options contracts in the 1970's, started with capital of $800. Stipulation, *supra* note 15, at 3. Because $800 was inadequate to meet obligations to customers or to pay business expenses, Goldstein used premium funds for these purposes. He justifies the abusive use of the premium funds by contending that the funds

also necessary to afford minimum protection to the customer trading in commodity options because of the market's high volatility and the lack of essential customer protections afforded those dealing in the regular futures transaction.

Books and Recordkeeping

The books and recordkeeping requirement is a further regulation which can assist the Commission in customer protection through the surveillance of trading practices.[78] Persons accepting payment or orders from option customers are required to maintain complete records of the transaction.[79] When an order is accepted from a customer, it is to be immediately recorded and assigned both an account identification and an order number.[80] The time the order is accepted, transmitted for execution, and executed is to be recorded to the nearest minute.[81] A permanent record containing the true name and address of the person assuming financial responsibility for the option must also be maintained to the extent possible.[82] The records are to be maintained for five years and are to be available to the Commission upon request.[83]

Disclosure

In an effort to provide further customer protection, the Commission has also promulgated disclosure requirements.[84] Before an option customer or prospective option customer enters into a commodity option contract, he must be given a summary disclosure statement. The statement must briefly describe the commodity option transaction, including the lifespan of the option and the amount and quality of the underlying commodity which may be bought or sold when the option is exercised.[85] A breakdown

became business property upon receipt. *See id.* at 9, 16. Proper capitalization will eliminate the need to reinvest premium funds in the firm or to use the funds to pay profitable customers.

78. *Id.* at 51,808, 51,816 (1976) (to be codified in 17 C.F.R. § 32.7) (effective Dec. 9, 1976).

79. *Id.* at 51,816. The records are to at least include:

> all orders (filled, unfilled or cancelled), signature cards, books or records, journals, ledgers, cancelled checks, copies of all statements of purchase, exercise or lapse, and reports, letters, disclosure statements, and confirmation statements . . . solicitation or advertising material (including the texts of standardized oral presentations, and of radio, television, seminar or similar mass media presentations), circulars, memoranda, publications, writings, and all other literature or written advice distributed to option customers or prospective option customers.

Id. at 51,816.

80. *Id.* at 51,816.

81. *Id.* at 51,816.

82. *Id.* at 51,816.

83. *Id.* at 51,816.

84. *Id.* at 51,815 (to be codified in 17 C.F.R. § 32.5) (effective Dec. 9, 1976).

85. *Id.* at 51,815.

of all the elements comprising the total purchase price must also be given, including the premium and the manner in which it is determined, the striking price, mark-up, costs, fees, and other charges.[86] An explanation of what must occur before the option becomes profitable must also accompany the summary disclosure.[87] The first page of the disclosure must contain a statement which warns the customer in boldfaced type that he risks losing the entire purchase price and that he should not enter into the transaction unless he is fully aware of the rights and obligations involved.[88] Finally, the disclosure must state the difficulty in predicting price movements of the underlying commodity and the inability to resell the option.[89] Within twenty-four hours of the execution of the option transaction, the customer must receive a confirmation statement containing the actual amounts of the price items disclosed in the summary statement plus the date by which the option transaction must be exercised and the date on which the option transaction was executed.[90]

Antifraud Provision

As an additional customer protection, the Commission incorporated into the regulations an antifraud provision governing commodity options.[91] The antifraud provision, which in broad terms prohibits deceptive acts or practices in connection with commodity option transactions, was originally adopted by the Commission on June 24, 1975.[92] It represented the Commission's first promulgation concerning commodity options.[93] This provision is particularly significant because it gives a private right of action under general state criminal fraud provisions.[94]

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86. *Id.* at 51,815.
87. *Id.* at 51,815.
88. *Id.* at 51,815.
89. *Id.* at 51,815.
90. *Id.* at 51,815.
91. *Id.* at 51,817 (to be codified in 17 C.F.R. § 32.9).
92. *Id.* at 51,808, 51,809.
93. *See id.* at 51,808, 51,809.
94. 7 U.S.C. § 2 (Supp. V 1975) gives the Commission exclusive jurisdiction over option trading. By this provision state jurisdiction of commodity option transactions is superseded. *See* Clayton Brokerage Co. v. Mouer, 531 S.W.2d 805, 806 (Tex. 1975); Texas v. Monex Int'l, Ltd., 527 S.W.2d 804, 806-07 (Tex. Civ. App.—Eastland 1975, writ ref'd n.r.e.). In *Clayton Brokerage Co.* the Texas Supreme Court dismissed as moot a suit by the state to enjoin the sale of London commodity options. Referring to the *Monex* decision, the court stated that the Commodity Futures Trading Commission Act of 1974 preempts state regulation of commodity options and thus prevents any injunctive state action. 531 S.W.2d at 806. By utilizing their general antifraud provisions, however, states may now bring suit. The antifraud provision gives customers a further remedy previously not available to them. *See* [1974] COMM. FUT. L. REP. (CCH) ¶ 20,213 (CFTC Interpretative Letter No. 76-19).

EFFECTIVENESS OF THE REGULATIONS

Although the first stage in the Commission's two-stage procedure consists of carefully drafted and potentially effective regulations, they fall short of providing many basic customer protections. The regulations do provide for segregation of funds[95] and some supervision over trading practices.[96] They do not, however, provide any guarantee of performance of the option obligation.[97] While a futures commission merchant may accept premiums and solicit and accept orders from option customers,[98] he is prohibited from assuming financial responsibility for a commodity option transaction.[99] In effect, he cannot guarantee performance of the London option. Since any London exchange guarantee extends only to exchange members, nonmember United States option purchasers are without any mechanism guaranteeing performance. The unsupported promise of the dealer to perform is the only customer safeguard.

Performance of the option transaction could be guaranteed to United States customers by allowing the futures commission merchant to assume financial responsibility for the option. In order to assure financial responsibility of the futures commission merchant, substantial revisions in regulation 1.17[100] governing activities of future commission merchants would be necessary. As a result, the Commission has not repealed regulation 1.19.[101] The Commission is, however, currently considering the repeal of regulation 1.19 when the more comprehensive plan of Stage Two is implemented.[102] A London exchange has also suggested that London options could be more readily guaranteed to United States customers by requiring option dealers in the United States to become members of the exchange, thus extending the exchange guarantee directly to the dealer.[103]

Although the performance of the option transaction is not guaranteed, the segregation requirement affords United States customers a minimum protection that their initial investment will not be lost. Segregation of the funds is considered by the Commission as the cardinal tenet of customer protection.[104] This segregation requirement, however, has recently been

95. 41 Fed. Reg. 51,808, 51,815 (1976) (to be codified in 17 C.F.R. § 32.6).

96. *Id.* at 51,814 (to be codified in 17 C.F.R. § 32.3) (registration requirement); *id.* at 51,815 (to be codified in 17 C.F.R. § 32.5) (disclosure requirement); *id.* at 51,816 (to be codified in 17 C.F.R. § 32.7) (books and record keeping requirement).

97. Thus, the regulations also fall short of the Congressional intent that option contracts be guaranteed. *See* H.R. REP. No. 93-975, 93d Cong., 2d Sess. 31 (1974).

98. 41 Fed. Reg. 51,808, 51,814 (to be codified in 17 C.F.R. § 32.3(a)(1)(i)).

99. 17 C.F.R. § 1.19 (1976); 41 Fed. Reg. 44,560, 44,561 (1976).

100. 17 C.F.R. § 1.17 (1976).

101. *Id.* § 1.19.

102. 41 Fed. Reg. 44,561 (1976).

103. [1974] COMM. FUT. L. REP. (CCH) No. 35 Other Developments at 4.

104. 41 Fed. Reg. 44,560, 44,564 (1976).

challenged. A preliminary injunction has been issued barring the Commission from enforcing its segregation requirements against the British American Commodity Options Corporation, a firm retailing London options in the United States for its London principals.[105] British American Commodity Options Corporation contends that the Commission acted arbitrarily and capriciously in imposing the sergregation requirement.[106] The Commission has requested a reconsideration of the ruling, but in the meantime has decided not to enforce the segregation regulation against any option dealer retailing London options in the United States.[107] Absent segregation and guarantee of performance, the United States customer is without any substantial protection. The Commission has indicated that unfavorable review of its motion to reconsider will cause the Commission to reevaluate its present decisions concerning the allowance of commodity option trading in the United States.[108] In light of the Commisson's view that option trading serves beneficial purposes and is being used legitimately, it may be inferred that even if an unfavorable response is given its motion to reconsider, the Commission will not ban commodity option trading. There are appropriate alternatives to segregation of funds within the United States which might be utilized to provide equivalent customer protection. A London Commodity Exchange has suggested that if adequately identified, United States customer funds could be segregated in London in the form of a trust.[109] This would not only afford customers the protections provided by segregation, but would also avoid the burden of double segregation currently imposed on option dealers by the Commission's present segregation scheme.[110] Also, to avoid the commingling of United States customer funds and option dealers house funds which currently occurs in the London general accounts, each future commission merchant could establish an option customer account separate from its own house trading account, which would not be subjected to any right of setoff which the London exchange may have against the option dealer.[111] Other possible alternatives

105. [1974] COMM. FUT. L. REP. (CCH) ¶ 20,245.

106. *Id.*

107. *Id.*

108. *Id.*

109. [1974] COMM. FUT. L. REP. (CCH) No. 35 Other Developments at 4-5.

110. Double segregation results because option dealers must first segregate the premium here in this country and then send other funds (since they are prohibited from sending the premium itself) to secure the option obligation from the firm in which he is "jobbing" the option. Thus, he pays twice by segregating twice. *See* 41 Fed. Reg. 44,560, 44,564 (1976). The Commission was aware of this double segregation problem. *Id.* at 44,564. The charge of double segregation played a role in procuring the present preliminary injunction against the segregation regulation. Plaintiffs claimed the regulation required them to segregate 90% of the funds, whereas normally they would forward 75% to their London principals. [1974] COMM. FUT. L. REP. (CCH) ¶ 20,245.

111. [1974] COMM. FUT. L. REP. (CCH) No. 35 Other Developments at 4-5.

to the segregation requirement may include financial guarantees such as letters of credit or bonding.[112]

In an attempt to control the trading practices of option dealers, the Commission promulgated the disclosure regulation. Meaningful disclosures are especially important in an area where sharp trade practices have resulted in substantial loss of customer funds. The Commission's disclosure regulation, however, does not provide the customer with sufficient information to fully evaluate the risks and advantages surrounding the option transaction. The summary statement sufficiently discloses price information,[113] but fails to give an informative statement of the risks which should be considered by the customer before entering into the option transaction. For example, although the statement warns the customer that he should be fully aware of his rights and obligations before entering into the option transaction,[114] the customer is not informed what those rights and obligations are. The type of person preyed upon by sharp practitioners of the commodity option trade is generally the unsophisticated investor whose knowledge of the commodity market is limited or virtually nonexistent.[115] His attraction to the market stems from the highly publicized profit potential.[116] It is extremely important that the customer be given thorough, accurate information about the operations of the market so he can make an intelligent decision. Furthermore, disclosures should be made concerning the futures commission merchant and his associates, especially in regard to their financial condition. More importantly, the fact that the futures commission merchant cannot guarantee the option should be disclosed to the customer. The identity of those who purport to guarantee the option and their relationship and obligations to the customer, or *lack of such,* should also be revealed.[117] Information of this nature is necessary to

112. 41 Fed. Reg. 51,808, 51,812 (1976).

113. *See id.* at 51,808, 51,815 (to be codified in 17 C.F.R. § 32.5).

114. *Id.* at 51,815.

115. *See* CFTC v. J.S. Love & Assocs. Options, Ltd., No. 76-928, slip op. at 6 (S.D.N.Y. Aug. 12, 1976) (failure to inform that options trading requires sophisticated investor); King Commodity Co. v. State, 508 S.W.2d 439, 444 (Tex. Civ. App.—Dallas 1974, no writ) (advertising literature boasting that option customers need not watch market quotations but spend time elsewhere leaving details to option dealer). *See also* Clayton Brokerage Co. v. Mouer, 520 S.W.2d 802, 809 (Tex. Civ. App.—Austin) (solicitation of customers unfamiliar with commodity options), *dismissed as moot per curiam,* 531 S.W.2d 805 (Tex. 1975); Stipulation, *supra* note 15, at 21 (target customers, small investors disillusioned with stock market).

116. *See* CFTC v. J.S. Love & Assocs. Options, LTD., No. 76-928, slip op. at 6 (S.D.N.Y. Aug. 12, 1976) (advertisement falsely stressing extraordinary profit); King Commodity Co. v. State, 508 S.W.2d 439, 442 (Tex. Civ. App.—Dallas 1974, no writ) (advertisement falsely emphasizing potentially unlimited profit). *See also* Clayton Brokerage Co. v. Mouer, 520 S.W.2d 802, 806-07 (Tex. Civ. App.—Austin), *dismissed as moot per curiam,* 531 S.W.2d 805 (Tex. 1975); Stipulation, *supra* note 15, at 13-15 (extensive advertising program).

117. Guarantees by London exchanges and clearinghouses do not extend to United States customers but only to exchange members. Promotional literature and advertising

enable the small investor to truly evaluate his investment, especially in light of the fact that commodity options as currently traded in the United States lack the customer protections afforded most investors in the futures market.

Although the registration and record keeping regulations can help the Commission monitor and control trading activities, strong supervision of trading practices is lacking. First of all, option grantors are not required to register and as a result there is no control over the persons granting the options and assuming financial responsibility for them. Most option contracts are originally issued by persons or firms in London who are not members of the London exchange.[118] These nonmembers issue their option by contacting an exchange member and selling their option to him.[119] Even if such persons were required to register, regulatory problems of enforcement would arise if they refused to do so.[120] Further problems of control exist since the option grantor can issue options beyond the number of underlying contracts available to support them. This can occur because London option grantors are not required to own the futures contract or physical inventory necessary to meet their obligation.[121] If not properly regulated, this situation can result in market chaos and great financial losses to American customers.[122] Since London options are originally sold on foreign exchanges, however, the Commission will have to depend on the self-regulatory safeguards of the London market.

Since the Commission cannot control London activities, it must concentrate its efforts on the trading activity that occurs in this country. Although option dealers are required to register, to maintain certain capital requirements, and to keep an orderly account of each transaction, the

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material issued by many option dealers state that the option is guaranteed by the London exchange but fail to mention that the guarantee does not run to the customer. *See* CFTC v. J.S. Love & Assocs. Options, Ltd., No. 76-928, slip op. at 5 (S.D.N.Y. Aug. 12, 1976) (*New York Times* advertisement deceptively conveying impression that London firm guarantee extends to customer). The option merchant is currently required to keep a permanent record of who guarantees or assumes financial responsibility for the option, but he is not required to disclose the information to the customer. *See* 41 Fed. Reg. 51,808, 51,816 (1976) (to be codified in 17 C.F.R. § 32.7(b)).

118. Long, *Commodity Options—Revisited,* 25 DRAKE L. REV. 75, 124 (1975); *see* RECOMMENDED POLICIES, *supra* note 26, at 135.

119. RECOMMENDED POLICIES, *supra* note 26, at 135.

120. Generally, London options are granted by British citizens. The Commission lacks the authority to enforce United States rules and regulations against them. Furthermore, any action to enjoin the sale of their options here in the United States would necessarily involve international considerations. The largest clearinghouse exchange in London has indicated that injunctive action would be undesirable and against the best interests of the United States and England. *See* RECOMMENDED POLICIES, *supra* note 26, at 124.

121. Long, *Commodity Options—Revisited,* 25 DRAKE L. REV. 75, 120 (1975).

122. A prime example was the wheat market collapse of 1933. *See* authorities cited note 29 *supra.*

Commission lacks any real control over the type and form of option trading which can occur. Also, there are presently no limits on the amount of trading in which any particular option dealer may engage. Trading limits may be necessary to prevent excessive speculation which can result in the manipulation of price movements or sudden and unreasonable price fluctuations. The Commission is aware of the overall lack of control, and makes it unlawful for any person to represent that fulfillment of the regulation constitutes Commission approval of the commodity option transaction.[123]

Stage One of the Commission's regulatory scheme, therefore, lacks many of the customer protections it was intended to supply. Stage Two, which will limit option trading to domestic organized exchanges and recognized foreign commodity exchange systems, offers the greatest potential for providing these missing protections.

STAGE TWO—GENERAL REGULATORY SCHEME

The Commission's decision to ultimately limit commodity option transactions to designated organized domestic exchanges and recognized foreign commodity exchanges is significant.[124] This decision reflects the Congressional intent that option trading be confined to organized exchanges.[125] Furthermore, organized exchanges can offer many of the essential safeguards necessary to protect both the customer and the underlying market.

Restricting option trading to designated boards of trade in this country will automatically subject such transactions to the broad regulatory authority the Commission possesses over the boards of trade under the Commodity Future Trading Commission Act. The Commission has the power to determine which boards of trade will serve as contract markets.[126] Before boards of trade can be designated as contract markets, they must demonstrate to the Commission that the transactions conducted on their exchanges are consistent with the public interest.[127] This same public interest test would apply to option transactions, once option trading is limited to designated boards of trade. As is presently the case with futures contracts,

123. 41 Fed. Reg. 51,808, 51,817 (1976) (to be codified in 17 C.F.R. § 32.8) (effective Dec. 9, 1976).

124. This decision will eventually prohibit the current trading of options on off-exchanges which do not provide the essential customer protections afforded by the exchanges. For example, off-exchanges do not have a clearinghouse mechanism to guarantee the option. Nor are they subjected to the segregation, disclosure, and registration requirements as are the exchanges. Allowing commodity option trading on off-exchanges would present a difficult regulatory problem as it would necessitate promulgation of further regulations designed specifically for off-exchanges to provide for the essential customer protections. *See generally* 41 Fed. Reg. 7774, 7774-76 (1976).

125. *See* S. REP. No. 93-1131, 93d Cong., 2d Sess. 26 (1974).

126. 7 U.S.C. § 7 (Supp. V 1975).

127. *Id.* § 7(g).

the forms of option trading and the rules, regulations, and bylaws of contract markets relating to them will be subject to review and approval by the Commission.[128] After notice and hearing, the Commission would be able to require such changes in the contract terms as are necessary and appropriate for the protection of the public interest.[129] This review and approval process gives the Commission the control and supervision necessary to guard against the abusive use of options by guaranteeing the legitimacy of the option transaction.

Other requirements imposed on boards of trade can further enhance the integrity of option trading. Besides automatically subjecting option dealers to the registration,[130] segregation,[131] and disclosure requirements[132] of the Act, the clearinghouse mechanisms associated with boards of trade can guarantee the performance of the option obligation upon exercise of the privilege.[133] Furthermore, the Commission's authority to set limits on the amount of speculative trading occurring on contract markets can control any excessive speculation and manipulation of the market resulting from the abuse of option transactions.[134]

It would appear, then, that the exchanges' own surveillance procedures, coupled with the Commission's broad authority, would ensure adequate customer protection in commodity option transactions. The Commission realizes that the nature of options and the opportunities for abuses which have existed in the past may necessitate more stringent requirements than those currently imposed on contract markets with straight futures contracts.[135] As a result, the Commission may strengthen the protections afforded persons trading on organized exchanges by imposing stricter standards on those dealing in commodity option transactions.[136]

The Commission's plan will also allow options originating on recognized foreign commodity exchange systems to be traded in this country. While the basis for the Commission's decision is unclear, it may have been persuaded by international considerations.[137] Many of the foreign exchanges are well established[138] and have some measure of price determination, competitive trading,[139] and market supervision.[140] The decision to allow the

128. *Id.* § 7a(12).
129. *Id.* § 12a(7).
130. *Id.* §§ 6d(1), 6f(1).
131. *Id.* § 6d(2).
132. *Id.* § 6n(4)(B).
133. *See id.* § 6g(2).
134. *Id.* § 6a(1).
135. *See* 41 Fed. Reg. 51,808, 51,809 (1976).
136. *See id.* at 44,560, 44,562, 44,564.
137. *See* Recommended Policies, *supra* note 26, at 124.
138. *Id.* at 121.
139. *See id.* at 125.
140. *See id.* at 123.

trading of options originating on foreign exchanges, however, will involve special problems. The foreign exchanges do not provide many of the customer protections available on domestic exchanges. Some exchanges do not guarantee the transactions,[141] provide for segregation of premiums,[142] or utilize competitive pricing.[143] The exchanges are also subjected to little governmental supervision and are largely self-regulating.[144] London options, then, lack customer protections not only as sold in this country but also as traded on the London exchanges themselves.

The Commission can meet the various customer protection problems associated with foreign exchanges by setting standards which must be met before the foreign exchanges are recognized as option trading systems.[145] The Commission must exercise caution, however, when it establishes the standards. The very considerations which may have prompted the Commission to allow option trading on foreign exchanges may hamper efforts to provide effective customer protections. Foreign exchanges have long been respected markets and have developed their own trading rules. Commission standards may call for more supervisory control than these exchanges are willing to tolerate. One London exchange has indicated that any changes which would require it to conform to Commission standards would be adopted only if it would not materially change the established rules of the London market.[146] The main clearinghouse in London has indicated that it would not extend its guarantee beyond exchange members and would carefully consider any requirement imposed upon its members by the Commission.[147] Any standards for recognition as a foreign commodity exchange system, therefore, must be weighed against the sovereignty of the London markets. Just as international considerations have influenced the Commission's decision to allow foreign option trading, international decisions may force the Commission to settle for less customer protection than it would prefer.

CONCLUSION

The Commission's efforts represent an initial attempt at federal regulation of option trading in the United States. It undertakes to grapple with

141. Long, *Commodity Options—Revisited,* 25 DRAKE L. REV. 75, 116, 118 (1975).

142. *Id.* at 116, 118.

143. *See* RECOMMENDED POLICIES, *supra* note 26, at 125, 131; Long, *Commodity Options—Revisited,* 25 DRAKE L. REV. 75, 118 (1975) (detailed explanation of the operations of the exchanges).

144. RECOMMENDED POLICIES, *supra* note 26, at 123.

145. The fact that the Commission states it will *recognize* foreign commodity exchange systems which meet stringent requirements implies that the Commission will set such standards. *See* 41 Fed. Reg. 44,560 (1976).

146. [1974] COMM. FUT. L. REP. (CCH) No. 35 Other Developments at 5.

147. RECOMMENDED POLICIES, *supra* note 26, at 130.

problems which previously resulted in the ban of a legitimate trading activity. This initial attempt to regulate has not been as successful as the Commission desires. Stage One does not accomplish its purpose of providing essential customer protections. Because of the Commission's concern to protect the public, it set stringent segregation requirements although it realized that double segregation would result and that other appropriate alternatives existed.[148] Ironically, this attempt to provide the most direct means of protection in the shortest possible time led to the downfall of what the Commission considered to be its most important customer protection.[149] This incident should warn the Commission that it must carefully balance its zeal for customer protection against the consequences which may result from immediate imposition of stringent safeguards, especially when less burdensome alternatives exist.

Stage Two presents a potentially viable system of regulating commodity option trading. The Commission has the power to regulate trading on the domestic exchanges that are well adapted to provide customer protections. Although the foreign exchanges lack essential customer safeguards, the Commission can establish standards which will provide for the necessary protection. Protection problems, however, exist. Requirements more stringent than those currently provided on the domestic exchanges may be necessary to fully protect the option customer, some of which, however, may prove to be too burdensome for the exchanges. Furthermore, standards set by the Commission may exceed the tolerance level of the London markets. In meeting these problems, the Commission must be cautious to avoid a fate similar to that of Stage One's segregation requirement. The ultimate success of Stage Two will depend on the Commission's ability to carefully weigh these considerations and to strike the delicate balance between the protective needs of the customer and the needs and capabilities of the exchange.

148. *See* discussion note 110 *supra*. The Commission was aware of the harshness of the requirement and the existence of appropriate alternatives but wanted to protect the public in the shortest possible time. *Compare* 41 Fed. Reg. 7774, 7776 (1976), *with id.* at 51,808, 51,809, 51,812.

149. *See* text accompanying notes 104-08, 110 *supra*. The segregation requirement, or an appropriate alternative, provides the most protection to customers. Without segregation, the other protections lose much of their value. *Compare* 41 Fed. Reg. 44,560, 44,564 (1976), *with id.* at 51,808, 51,812.