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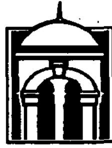

IS THE INTER-BANK MARKET OUT OF CONTROL?: *DUNN & DELTA v. COMMODITY FUTURES TRADING COMMISSION*

I. INTRODUCTION

On February 25th, the U.S. Supreme Court decided the case of *Dunn & Delta Consultants v. Commodity Futures Trading Commission*,[1] which addressed the scope of the Commodity Futures Trading Commission's (CFTC) regulatory authority. The main issue was whether the "Treasury Amendment" to the Commodity Exchange Act exempts off-exchange traded options on foreign currency from the jurisdiction of the CFTC. The case not only called into question the validity of billions of dollars in foreign currency contracts, but could have ultimately decided the fate of America's commodity exchanges.

A unanimous Supreme Court took a plain language approach to the issue and decided in favor of Dunn & Delta Consultants, holding that the CFTC did not have jurisdiction. The court proceeded to then use the legislative history of the Commodity Exchange Act to further justify its holding.

For decades, the world's largest banks and professional currency traders, presumably have traded foreign currency contracts outside the regulatory framework of the CFTC.[2] The traders were relying on section 2(ii) of the Commodities Exchange Act of 1936, otherwise referred to as the "Treasury Amendment," which stated to the effect that the

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1. 117 S. Ct. 913 (1997).

2. *See* Joanne Morrison, *Regulation: High Court Case May Clarify CFTC's Power over OTC Foreign Exchange Markets*, THE BOND BUYER, May 29, 1996, *available in* 1996 WL 5638959 at *2.

CFTC did not have jurisdiction over "transactions in foreign currency" not traded on a board of trade.[3]

Since the Supreme Court was allowed to decide this issue,[4] it was correct, as this note contends, in holding that options contracts on foreign currency are "transactions in foreign currency" for purposes of the Treasury Amendment. However, the Court should have also held that this issue alone is not dispositive of the case, and further concluded that the marketing activities of the defendants entitled the CFTC to jurisdiction over them, a result consistent with the legislative intent of the CEA.

The case of *Dunn v. Commodity Futures Trading Commission* focused on the regulation of financial derivatives markets. Derivatives are contracts, and at times securities, whose value is derived from the future price of an underlying financial asset. Derivative products are not wealth creating—their function is to allocate risk. The common term used to describe derivatives is that they are a zero sum game, that is, where the gain of one party is the loss of another. This is unlike the stock market where on any given day there can be more winners than losers, or vice-versa.[5]

In the United States, derivatives are either traded on an exchange or in the over-the-counter market (OTC).[6] Exchange traded derivatives are comparatively small standardized contracts traded on the floor of an exchange. On an exchange traded derivative, the counter-party to the transaction is always the exchange.[7] In the OTC derivatives market, the contracts are very customized and typically very large. Additionally,

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3. 7 U.S.C § 2 (1994).

4. *See* Fred Vogelstein, *Two Futures Trading Bills Aim to Fix Problems*, WALL ST. J., Sept. 23, 1996, at C14. There are currently two bills being proposed to the legislature:

> The first bill, proposed by Senators Richard Lugar (R., Ind.) and Patrick Leahy (D., Vt.), the chairman and ranking minority member, respectively, of the Senate Agriculture Committee, would ease federal regulation of U.S. commodity exchanges in hopes of making it easier for them to compete with rapidly growing exchanges abroad . . . . A provision that would give regulators power over nonexchange-traded futures may be added next year, when the bulk of the debate on the bill is expected to take place. The second bill, proposed by Rep. Charles Schumer (D., N.Y.), would give the Commodity Futures Trading Commission authority to regulate non-U.S. commodity contracts if they provided for delivery of the commodity in the U.S.

Id. Additionally, the Treasury Department and the CFTC are attempting to work out an agreement in regards to the regulation of off-exchange futures and options contracts. Should any of these efforts be successful, then the case would be rendered moot.

5. *See generally* Bernard Karol & Mary Lehman, *Unprecedented Technological and Mathematical Sophistication Has Created a Vast Market for Derivatives*, REVIEW OF SECURITIES & COMMODITIES REGULATION, July 1, 1994, *available in* 1994 WL 2257245 at *1.

6. *See id.*

7. *See id.* at *3.

dealers match trades for their clients, and often trade for their own account. However, since there is no clearinghouse in the OTC market, there is significant credit risk from the counter-party should they lose money and not be able to "cover" their losses. There is no exchange floor in the OTC because the OTC has no physical existence; it is merely a network of computers connecting traders.

A. *What are Commodity Futures and Options Contracts?*

A futures contract is an agreement to buy or sell a specific amount of a commodity (e.g., metals, grains, pork etc.) at a particular price in a stipulated future month. A futures contract obligates the parties to perform unless one or both of the parties sells or trades the contract. A similar financial tool is the forward contract which has the same basic features as a futures contract. The principal practical difference is that forward contracts are generally much smaller in price and quantity. Forward contracts are usually very unique to the purchaser, so they are not easily traded. Futures contracts, however, are more easily traded and are thus more favored by the large institutions and professional traders.[8]

An options contract allows the buyer the right (but no obligation) to purchase (call option) or the right to sell (put option) a given quantity of the cash security at a specific "strike" price for a specified period of time.[9] The strike price of an option is the trade price for the asset if the option is exercised. The strike price distinguishes an option from a futures contract, and results in an initial cost premium over the current

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8. *See* JOHN DOWNES & JORDAN ELLIOT GOODMAN, FINANCE & INVESTMENT HANDBOOK 27 (3d ed. 1990). The futures markets are broadly divided into two categories of participants: (1) hedgers, who have a position in the underlying commodity and use futures to create countervailing positions, thus protecting against loss due to price changes; (2) speculators, who do not own the underlying asset for commercial or investment purposes, but instead aim to capitalize on the ups and downs of the contracts themselves. It is the speculators who provide the liquidity essential to the efficient operation of the futures markets.

> The great majority of futures contracts are closed out before their expiration- or delivery-date. This is done by buying or selling an offsetting contract. It is vital to note that with futures, in contrast to options, the alternative to an offset is a delivery, though this is done with title documentation, . . . not by the legendary dumping of pork bellies on the front steps of absentminded contract holders. When the future is a contract to buy value, delivery of the future is avoided by buying an offsetting future to sell.

Id. at 610-611.

9. *See* HAIM LEVY & MARSHALL SARNAT, CAPITAL INVESTMENT & FINANCIAL DECISIONS, (5th ed. 1994). "A call option is a right (but not an obligation) to *buy* a given number of shares of the underlying stock at a given price (striking price) on or before a specific date (the expiration date)." *Id.* at 610 (emphasis added). "A put option is a right (but not an obligation) to *sell* a given number of shares of the underlying commodity at a specified price on or before a specific date." *Id.* at 611 (emphasis added).

value of the option. Options also have a limited loss feature (assuming a covered position), unlike futures contracts.[10]

A cursory look at the history of the futures and options markets reveals their primary use and function, as well as the reasons for their sudden growth in popularity. American futures markets were formally started in Chicago in the mid 1800's as a means of hedging agricultural products such as wheat.[11] Before the Chicago markets existed, farmers would dump wheat in the city streets due to plummeting prices caused by excess supply after the harvest. The futures contracts provided the farmers with price certainty and passed the risk of low prices on to speculators and traders. Regulation of the futures market began with the Grain Futures Act of 1922 and the Commodity Exchange Act of 1936.[12]

Options on stocks were created and traded by OTC dealers prior to 1973, then in that year the Chicago Board Option Exchange (CBOE) began trading call options on individual stocks. The advantage the CBOE offered was that the contracts purchased could be resold at any time, unlike the OTC options which were not easily traded once they were purchased due to valuation problems.[13]

Futures markets are important because they can alleviate fluctuations in interest rates, currency values, stock prices and other variables that cause major problems for financial executives. Futures markets also provide institutions and firms with the necessary tools to manage their

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10. *See* ROBERT T. DAIGLER, FINANCIAL FUTURES & OPTIONS MARKETS: CONCEPTS AND STRATEGIES 3 (1994).

11. *See id.* at 4. "Viable futures markets were developed in Chicago because of its location as the principle transportation center for wheat, corn, and other agricultural products from the Midwest. . . . Location also became important for cotton futures, which began trading in New York in 1872." *Id.*

12. *See id.*

13. *See id.* at 5. The dealers of options could not value the contracts accurately until 1973, the year Black and Scholes published their model for determining the fair value for options. In the years prior to 1973, the dealers would just price the option contracts so high so as to tilt the prospects of profiting in favor of the dealers. The Black and Scholes formula is still widely used by both academics and practitioners. The Black and Scholes formula gives the price of a current call (Co) by :

$$C_0 = S_0N(d_1)\text{-}Exe^{-rt}N(d_2)$$

Where:

S_0 = current stock price

Ex = exercise price

e = base of natural logarithms = 2.7128

r = continuously compounded annual riskless rate of interest

t = remaining time to expiration of the call expressed as a fraction of a year

$N(d_1)$, $N(d_2)$ = the values of the cumulative normal distribution at points d_1 and d_2 respectively. *Id.*

risk of cash positions by cheaply changing their risk profiles.[14] Options markets can provide many of the same advantages as futures markets. Additionally, option contracts can provide a protection from price loss while allowing upward gains, but the options user must pay for this protection.[15]

The growth of futures and options has boomed in the past twenty years. Trading volume is estimated to be ten times what it was in 1976. Businesses today see the use of futures and options as an element of daily business. General Motors Corporation, Harvard University, and Goldman Sachs routinely hedge their exposure to other markets through futures and options.[16]

B. History of Commodity Futures Regulation

The CFTC was created by Congress in 1974 while re-engineering the Commodity Exchange Act of 1936 (CEA).[17] The CFTC replaced the Commodity Exchange Authority and was also given a much broader mandate.[18] The CFTC is allowed to regulate: contract markets on which futures contracts are traded; the brokerage houses that place futures contract orders for customers; and floor brokers who are directly engaged in the execution of those futures contract orders. Additionally the CFTC regulates the introduction of brokers, persons associated with introducing brokers, commodity pool operators, commodity trading advisors, persons associated with commodity trading advisors, and registered futures associations. Leverage contracts were also brought under the CFTC jurisdiction.[19]

The regulatory power of the CFTC is set forth in § 2(a)(1) of the CEA.[20] In this section the term "commodity" is defined 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

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14. *See* LEVY & SARNAT, *supra* note 9, at 632. Consider a multinational firm of exporters who are involved in international trade. An American who sells products to Germany will get his income according to the term of the sales agreement 30 days from now. However, since his sales are in German marks, his income in dollars is a random variable reflecting the future unknown exchange rate. If the German mark declines *vis-a-vis* the dollar, his dollar income will decline. To protect himself against such events, the American investor can buy a call option to buy the U.S. dollar (or a put option to sell German marks). *Id.*

15. *See* DAIGLER, *supra* note 10, at 7. Options contracts require the buyer to pay the seller of the option a "premium," which represents the value of the contract, based on a Black and Scholes analysis.

16. *See* Vogelstein, *supra* note 4.

17. Commodity Futures Trading Commission Act of 1974, Pub. L. No. 93-463, 88 Stat. 1389 (1974) (as amended in scattered sections of 7 U.S.C.).

18. *See* 7 U.S.C. §§ 6d, 6k, 21.

19. *See* 7 U.S.C. §§ 6c, 23.

20. *See id.* § 2(a)(1).

in," as well as specified agricultural products.[21] Thus, the CFTC has the authority to regulate all futures trading in the United States markets, regardless of the underlying commodity.[22] The breadth of the CFTC's jurisdiction is better understood when the expanded definition of commodity is also read in conjunction with the exclusive jurisdiction clause, found in § 2(a)(1), which provides that:

> the CFTC shall have exclusive jurisdiction, except to the extent otherwise provided in subparagraph (B) of this paragraph, with respect to accounts, agreements (including any transaction which is of the character of, or is commonly known to the trade as, an "option" . . .), and transactions involving contracts of sale of a commodity for future delivery, traded or executed on a contract market designated pursuant to section 5 of this Act or any other board of trade, exchange, or market . . . [23]

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21. *Id.* Although originally the subject of some debate, it now appears clear that this definition makes any good or article a commodity, regardless of whether that good or article is the subject of futures trading, but makes services, rights, and interests commodities only if futures contracts are traded on them. *See* S. Rep. No. 850, 95th Cong, 2d Sess. 27 (1978), *reprinted in* 1974 U.S.C.C.A.N. at 92 Stat. 865.

22. Prior to the 1974 Act, the CEA provided that:

> The word "commodity" shall mean 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.

23. 7 U.S.C. § 2(a)(1), *as amended* by Futures Trading Act of 1982, § 101, Pub. L. No. 97-444, 96 Stat 2294 (1983)(codified as amended in scattered sections of 7 U.S.C.). The breadth of the language in the exclusive jurisdiction provision may be attributable, at least in part, to the congressional desire to insure that there were no gaps in the regulation of commodity futures, commodity options, or other commodities-related instruments. The pertinent portions of § 2(a)(1) of the CEA read in their entirety as follows:

> Provided, that the Commission shall have exclusive jurisdiction, except to the extent otherwise provided in subparagraph B of this paragraph, with respect to accounts, agreements (including any transaction which is of the character of, or is commonly known to the trade as, an "option," "privilege," indemnity," "bid," "offer," "put," "call," "advance guaranty," or "decline guaranty"), and transactions involving contracts of sale of a commodity for future delivery, traded or executed on a contract market designated pursuant to section 5 of this Act or any other board of trade, exchange, or market, and transactions subject to regulation by the Commission pursuant to section 19 of this Act; and provided further, That, except as hereinabove provided, nothing contained in this section shall (i) supersede or limit the jurisdiction at any time conferred on the Securities and Exchange Commission or other regulatory authorities under the laws of the United States or of any State, or (ii) restrict the Securities and Exchange Commission and such other authorities from carrying out their duties and responsibilities in accordance with such laws. Nothing in this section shall supersede or limit the jurisdiction conferred on courts of the United States or any State. Nothing in this Act shall be deemed to govern or

This section gives a "single expert agency" the responsibility for developing a "regulatory framework for the futures and options industry."[24]

Given the broad language in § 2(a)(1) of the CEA, several clauses were added to clarify the CFTC's jurisdiction. One such clause was added by the Senate Agriculture Committee in response to urging from the Department of Treasury,[25] which states that:

> Nothing in this Act shall be deemed to govern or in any way be applicable to transactions in foreign currency, security warrants, security rights, resales of installment loan contracts, repurchase options, government securities, or mortgages and mortgage purchase commitments, unless such transactions involve the sale thereof for future delivery conducted on a board of trade.[26]

This clause is usually referred to as the "Treasury Amendment." The Treasury department was concerned that the CFTC would try to regulate foreign exchange trading between banks, and the amendment was designed to exclude the inter-bank market,[27] which the Treasury Department felt did not need regulation because inter-bank market participants "are sophisticated and informed institutions."[28] The Treasury Department was of the opinion that the CFTC did not have the expertise to regulate this "complex banking function" and "would confuse an already highly regulated business sector."[29] The Treasury Department urged the Senate Committee to make clear that the CFTC would have no authority to regulate transactions in foreign currencies or the other enumerated instruments, unless those transactions occurred on organized

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> in any way be applicable to transactions in foreign currency, security warrants, security rights, resales of installment loan contracts, repurchase options, government securities, or mortgages and mortgage purchase commitments, unless such transactions involve the sale thereof for future delivery conducted on a board of trade. The term "future delivery" as used herein, shall not include any sale of any cash commodity for deferred shipment or delivery.

Id.

24. 120 Cong. Rec. 30, 459 (statement of Sen. Talmadge, indicating that the 1974 Act was designed to insure that affected entities-exchanges, traders, customers, etc.-would not be subject to conflicting agency rulings); S. Rep. No. 850, 95th Cong., 2d Sess. 21-22 (1978), *reprinted in* 1974 U.S.C.C.A.N. at 92 Stat. 865.

25. *See* S. Rep. No. 93-1131 (1974), *reprinted in* 1974 U.S.C.C.A.N. at 5843, 5887.

26. 7 U.S.C. § 2. Congress adopted virtually without change the language recommended by the Treasury Department. *See* S. Rep. No. 93-1131, *supra* note 25, at 5889. In an enforcement action under CEA § 14(d), 7 U.S.C. § 18(d), the CFTC did have jurisdiction to decide whether an account executive violated the CEA and CFTC rules by trading ahead, but it violated Article III of the United States Constitution for the CFTC to hear counterclaims not relating to the CEA or the regulations. *Id.*

27. *See* S. Rep. No. 93-1131, *supra* note 25.

28. *Id.* at 5888.

29. *Id.*

exchanges.[30] Despite the legislative history, there is still much litigation concerning the scope of CFTC's jurisdiction.

II. THE CASE LAW

The exact scope of the CFTC's jurisdiction has been the subject of much debate. In *Chicago Board of Trade v. Securities Exchange Commission*,[31] the Seventh Circuit Court of Appeals was asked to decide on who had regulatory jurisdiction over option contracts on Government National Mortgage Association (GNMA) Securities.[32] The court construed the legislative history to read that the CFTC had exclusive jurisdiction over option contracts. However, the Treasury Amendment was not at issue. The Second Circuit Court of Appeals considered the CFTC's jurisdictional reach with regards to the Treasury Amendment in *Commodity Futures Trading Commission v. American Board of Trade*.[33] The court held that option contracts on foreign currency were not "transactions in foreign currency," for purposes of the Treasury Amendment's exclusion to jurisdiction. Thus, the court held that the CFTC had jurisdiction over options contracts on foreign currency.[34] The *Dunn* case arose in the Second Circuit and the appeals court followed its own previous interpretation from *American Board of Trade*, and stated that the CFTC had jurisdiction over Dunn and Delta Consultants, even though *American Board of Trade* was distinguishable on the fact that the events occurred on an exchange.[35] In the *Dunn* case, the events took place off-exchange, but the Court of Appeals saw no reason to distinguish between on-exchange and off-exchange.[36]

A sharply different view was reached by the 4th Circuit in *Salomon Forex v. Tauber*.[37] Dr. Laszlo Tauber was a private trader, who would negotiate individual futures and options contracts with banks and large companies. Dr. Tauber had personally traded over 2700 foreign currency contracts worth billions of dollars. Salomon Forex was the counterparty on one particular trade with Dr. Tauber, and when the market

30. *See id.*

31. 677 F.2d 1137 (7th Cir. 1982), *vacated*, 459 U.S. 1026 (1982).

32. *See* DOWNES & GOODMAN, *supra* note 8. GNMA is an acronym for the Government National Mortgage Association, also nicknamed Ginnie Mae. GNMA is an agency of the Department of Housing and Urban Development. GNMA guarantees, with the full faith and credit of the United States Government, full and timely payment of all monthly principle and interest payments on the mortgage-backed pass-through securities of registered holders. *Id.*

33. 803 F.2d 1242 (2d Cir. 1986).

34. *See id.* at 1248.

35. *See id.* at 1241.

36. *See generally* Dunn v. Commodity Futures Trading Commission 58 F.3d 50 (2nd Cir. 1995), *rev'd*, 117 S. Ct. 913 (1997).

37. 8 F.3d 966 (4th Cir. 1993), *cert. denied*, 114 S. Ct. 1540 (1994).

moved sharply, Dr. Tauber lost over $26 million.[38] Salomon Forex demanded payment, but Dr. Tauber refused and Salomon Forex brought suit.[39] The issue at trial was whether the CEA applied to individually negotiated sales of foreign currency futures and options that were off organized exchanges.[40] Dr. Tauber argued that since the transactions did not follow CEA guidelines, they were illegal and he should not be responsible. Dr. Tauber cited the *American Board of Trade* ruling where the CFTC was found to have jurisdiction over foreign currency futures and options contracts.[41] The District Court ruled that the transactions were exempt from the jurisdiction of the CEA by the Treasury Amendment.[42] The Appeals Court affirmed and stated that the legislative history indicated that "all off-exchange transactions in foreign currency, including futures and options, are exempted from regulation by the CEA.[43] This particular holding is directly counter to the Second Circuit because it holds that options are "transactions in foreign currency" for purposes of the Treasury Amendment. Dr. Tauber also argued that even if futures and options were "transactions in foreign currency," that the amendment was only to be applied to the banks and institutions, rather than individuals.[44] To this the court responded by stating "[i]t is the nature of the trade . . . , not the corporate form of the trader, that determines whether a trade is within the CEA."[45] The court went on to distinguish *American Board of Trade* and *Chicago Board of Trade*, by stating that those cases dealt only with exchange trading on behalf of the general public, not individual, large scale deals between professionals.[46]

III. *DUNN & DELTA CONSULTANTS V. CFTC*

In this case, the CFTC sued four defendants: (i) William C. Dunn; (ii) Delta Consultants, a New Jersey corporation formed and solely owned by Dunn; (iii) Delta Options, Ltd., a Bahamian company to which Dunn is both managing director and advisor; and (iv) Nopkine

38. *See* 8 F.3d 966, 969. Additionally, Dr. Tauber owned a foreign currency trading company, held a seat on the nation's largest foreign currency exchange, and was estimated to be worth over half a billion dollars. *See id.*

39. *See id.*

40. *See id.* at 970.

41. *See id.* at 973.

42. *See id.* at 969.

43. *See* 8 F.3d 966, 976.

44. *Id.*

45. *Id.* at 977.

46. *Id.* at 978.

Co., Ltd., a British Virgin Islands company., to which Dunn was an advisor.[47]

The case begins in 1992, when some of the defendants were soliciting investments from individuals, partnerships, and companies. The potential investors were told that Delta Options was going to use their money to execute investment strategies involving the purchase and sale of call and put options on various foreign currencies. The defendants were using trading techniques with various names such as "strangles" and "boxes".[48] These techniques were executed with the intent of gaining abnormal returns for the investors. The trades were executed in the name of the defendants and no options were sold directly to the investors.[49]

The defendants executed their strategies in the OTC market.[50] When trading is done OTC, it means that it was not done on an organized exchange (i.e., New York Stock Exchange, Chicago Board of Trade, Pacific Exchange, etc.). In this instance the defendants were using the inter-bank market (also known as the OTC in this instance) to execute their trades. The inter-bank market is a system of bank and professional traders who negotiate deals among themselves when forming the futures and options contracts. There is no standard agreement forms, as all terms are negotiated.[51]

According to affidavits submitted to the CFTC, Dunn and his companies were deceiving investors about the risks of currency trading in general, as well as the risks involved with the strategies being implemented by the defendants. The defendants were also deceiving investors as to the value and success of their accounts. Delta Options would send their investors printouts of their accounts showing impressive returns and ask the investor if they would like to re-invest, and usually they would.[52]

During the latter part of 1993, investors were starting to get vague communications from Defendants concerning investor accounts. Delta Options began pushing back client maturity dates on their positions and thus prevent the clients from receiving their alleged account balance. In

47. *See Dunn*, 58 F.3d 50, 51 (2nd Cir. 1995), *rev'd* 117 S.Ct. 913 (1997).

48. *See* DAIGLER, *supra* note 10. A box spread is a combination of two calls with different strike prices and two puts with strike prices equivalent to the calls. All options have the same expiration date. This combination is called a box spread because the options traded form the four corners of a box when the call and put option prices are placed next to each other. A strangle strategy consists of an equal number of put options and call options on the same underlying commodity at the same strike price and maturity date. *Id.*

49. *See* 117 S. Ct. at 915.

50. *See id.*

51. *See* Karol & Lehman, *supra* note 5, at *5.

52. *See Dunn*, 58 F. 3d at 52.

November, the defendants sent out notices to investors stating that they would not be able to repay the investor's money, due to losses set at $95 million.[53]

Apparently, Defendants had engaged in a "Ponzi" scheme. By sending the printouts to the investors, the investors were inclined to keep their money in the investment because they thought they were making great returns. When an investor wanted to withdraw from the investment, they would be paid with funds from new investors or those who re-invested. At some point, losses from the trades were so great that the defendants could no longer pay the investors who wanted to withdrawal.[54] Additionally, $19.5 million was mysteriously transferred to an account in Switzerland.[55]

The CFTC commenced their action on April 5, 1994. The CFTC applied for and received a restraining order, freezing the Defendant's assets. On May 4, 1994, the CFTC requested an appointment of a temporary receiver. the Defendants argued that there was no subject matter jurisdiction because the CFTC had no power to regulate options on foreign currency, so the defendants were outside the CFTC's jurisdiction. The trial court held for the CFTC and appointed a receiver.[56]

The central issue in the case was whether the CFTC had the power to regulate options in foreign currency. This turned on whether trading in off-exchange options on foreign currencies is excluded from the CFTC's jurisdiction by the Treasury Amendment of 1974[57] which reads in pertinent part:

> Nothing in this chapter shall be deemed to govern or in any way be applicable to transactions in foreign currency . . . , unless such transactions involve the sale thereof for future delivery conducted on a board of trade.[58]

The Second Circuit Court of Appeals followed what they termed was "clear precedent," and held that the phrase "transactions in foreign currency" does not include options, even options traded off-exchange.[59] The court was relying on the *American Board of Trade* case, which provided the court's reasoning that an option was simply the right to engage in a transaction in the future. Until this right matured, there was no exempt "transaction."[60] The exercise of an option would constitute a "transaction in foreign currency," but the purchase or sale of the op-

53. *See id.*
54. *See id.*
55. *See id.*
56. *See id.* at 53.
57. *See* 7 U.S.C. § 2.
58. 7 U.S.C. § 2(ii).
59. *See Dunn*, 58 F.3d at 53.
60. *See id.*

tion itself would not be such a "transaction" under the Treasury Amendment. Thus, the trial court's decision that the CFTC had jurisdiction was affirmed.[61]

The court did note that their interpretation of the phrase "transactions in foreign currency" was in conflict with the 4th Circuit's interpretation in *Salomon Forex*.
The court responded by stating, "the conflict was for the Supreme Court to resolve."[62]

A. *What was at Stake in Dunn & Delta Consultants v. CFTC?*

Had the court overturned *Salomon Forex*, the enforceability of hundreds of billions of dollars in foreign currency contracts would have become suspect.[63] The inter-bank market essentially matches parties to a trade, who then negotiate the agreement to trade in terms of the quantity of the currency and the date it is to be delivered.[64] The CFTC regulated exchanges use a standard form contract with the terms of quantity and date already filled in.[65] The individually negotiated contracts would not be valid under CFTC regulations, and thus they would not have been enforceable.[66]

The organized exchanges such as the Chicago Board of Trade and the American Exchange were hoping that *Salomon Forex* would be overturned because they claim their economic welfare was in jeopardy.[67] In 1988, the organized exchanges held over seventy-eight percent of the exchange market world wide, but in 1996 held only forty percent of the market.[68] The exchanges claim the decrease is due to their being regulated. The exchanges argue that the unregulated markets are taking business away because they don't have a cost of compliance and they have the advantage of being able to bring new products to the market

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61. *See id.*

62. *Id.* at 54.

63. *See Securities Groups File High Court Brief Cautioning Against U.S. Regulation Of Foreign Currency Transactions*, WEST'S LEGAL NEWS, Aug. 21, 1996, *available in* 1996 WL 470233, at *1.

64. *See* Karol & Lehman, *supra* note 5, at *6.

65. *See id.* at 3.

66. This was one of the arguments by Dr.Tauber in *Salomon Forex*, who contended that since the individually negotiated contracts were not equivalent to the standard form contracts required of the exchanges, the contracts were illegal as such and unenforceable. *See generally* 8 F.3d at 966.

67. *See Future of Futures Trading Commission at Issue in U.S. Supreme Court Case*, Legislation, WEST'S LEGAL NEWS, Sept. 24, 1996, *available in* 1996 WL 536205 (blaming antiquated laws and explosive growth of the futures industry as the reasons for the exchanges downfall).

68. *See* Vogelstein, *supra* note 4, at 2.

sooner, since they have no regulatory oversight.[69] The exchanges felt they would gain many of the inter-bank market participants if the inter-bank market is regulated by the CFTC, since the exchanges are already equipped for regulatory compliance.[70]

IV. ANALYSIS

A. *Options are "Transactions in Foreign Currency"*

Options should be read to be "transactions in foreign currency." The two conflicting appeals court cases are the *American Board of Trade*[71] and the *Salomon Forex*[72] cases. In *Dunn & Delta Consultants*,[73] the Second Circuit was following its precedence in *American Board of Trade*.

The *American Board of Trade* decision was not as well reasoned as the *Salomon Forex* decision and the Supreme Court was correct in overturning the *Dunn* case. In *American Board of Trade*, the court was more concerned with the identity of the parties rather than the nature of the trades.[74] The court essentially ignored the plain language of the amendment and relied on semantics to justify their position.[75]

The fact that the court would require the option to be exercised to fall within the gambit of the amendment demonstrates a misunderstanding as to the use and purpose of options contracts. That is to transfer the risk of price movements to those willing to take the risk, and to transfer the risk cheaply. If parties to a trade are required to exercise the option contract in order to fall within the Treasury Amendment exclusion, then the court has effectively taken away a very useful risk management tool. At the outset of contract formation, the parties will not know if the contract will be executed because they do not know how the price of the underlying commodity will change. Thus, the parties will not know whether their contract is legal or illegal. This will effectively discontinue the use of formal options contracts by the inter-bank market. The market instead will have to rely on futures contracts

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69. *See id.*

70. *See id.*

71. 803 F.2d at 1242.

72. 8 F.3d at 966.

73. 58 F.3d at 50.

74. 803 F.2d at 1249. The court was only looking at the language which mentions financial institutions and banks. The court made no mention of the nature of the trades being executed, as was repeated throughout the legislative history. The court also failed to recognize that in order for an individual to be outside the CFTC regulation, under the courts ruling, all she would have to do is incorporate a company for the purpose of futures trading, and therefore qualify under the exclusion of the Treasury Amendment as a "sophisticated and informed institution." *Id.*

75. *See id.* at 1248. "An option transaction . . . does not become a 'transaction in' that currency unless and until the option is exercised."

solely, since those contracts don't have an exercise requirement. However, and this is where the courts demonstrates its misunderstanding, a trader can reach the same effect of an option contract by simply combining various types of futures contracts and creating was is commonly referred to as a "synthetic option." Thus, the courts requirement of an exercised option is rendered moot, because the traders can still have the same effect as an option.[76]

On its face, the Treasury Amendment exempts from regulation, futures transactions in foreign currency, unless they are conducted on a board of trade.[77] The language does not mention limitations on the identity of the parties of such transactions. Rather, the Treasury Amendment creates an exemption based on where the transaction occurs, not the identity of the participants.[78]

The Second Circuit did not consider the fact that large institutional trades today are done not by buying and selling the bulk commodity, but rather by buying and selling futures and options on the commodity.[79] This process is much cheaper than trading in huge quantities, as well as much quicker to execute.[80] Additionally, major transfers will not always cause market disruptions, thereby reducing the risk of loss solely from trading in the commodity.[81]

The court in *American Board of Trade* used legislative history to support its interpretation.[82] The court found that the legislative history revealed that futures should be considered "transactions in foreign currency."[83] However, the court felt that the descriptions of the intended reach of the Treasury Amendment, as set forth in the legislative history were not designed to exclude from regulation foreign currency options transactions.[84]

The court in *American Board of Trade* should not have made the distinction between futures and options.[85] Financial futures, forwards,

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76. *See id.*

77. 7 U.S.C. § 2.

78. *See* David S. Michell, *The Treasury Amendment & Foreign Currency Forward Transactions*, 5 COMMODITIES L. LETTER 1, 5 (1985).

79. *See* Karol & Lehman, *supra* note 5, at *19.

80. *See id.* at 20 n.8. For example, futures provide a benefit as a cash substitute when dealing with the asset itself has high trading costs or when it is cumbersome to trade the cash asset. A "cumbersome cash asset" with high trading costs is a portfolio of all stocks traded in the Standard & Poor's 500 Index (S&P 500). A futures trade in this portfolio is easy to make, whereas a trade in all 500 stocks is more costly and can be difficult to execute. *Id.*

81. Since the inter-bank market transactions are private, the general public does not always know of the trade, and therefore prices do not fluctuate due to supply and demand forces.

82. 803 F.2d at 1248-9.

83. *See id.* at 1249.

84. *See id.*

85. *Id.* Based on the courts ruling, a futures contract would be within the Treasury Amend-

and options are all known as derivatives, because their value is a function of an underlying commodity.[86] Derivatives are financial tools, their use depending on the individual's need. Options, for example, are more commonly used when the quantity of the commodity that needs to be hedged is uncertain. Futures are more useful when dealing with an asset itself which has a high transaction or trading cost.[87] It is important to recognize that a proper combination of options contracts is equivalent to a futures or forward contract and vice-versa. The process of using a combination of instruments (futures, forwards, and options) that act like another instrument, is referred to as "financial engineering."[88]

The situation is analogous to the following hypothetical: Government wants to regulate all tools in a given tool box (i.e., hammer, nails, wrench, etc.), but they wish to exclude screwdrivers from regulation. The question then arises whether both flat-head and Phillips head screwdrivers are exempt from regulation. The answer would clearly be yes because there is no reason to distinguish between the two, they are both screwdrivers. The only difference between the two is that a person alternates their use depending on the needs in a particular circumstance. The analysis could even go one step further and point out that in the right circumstances, a flat-head screwdriver can be used where a Phillips head is normally used, this could be called "tool engineering." The point being, futures and options are like the screwdrivers, they are derivations of a tool and there is no need to distinguish between them for purposes of regulation.

The court in *American Board of Trade* also seemed to overlook the fact that options on foreign currency were not common during the enactment of the Treasury Amendment, futures contracts were the primary tool.[89] Thus, it would not have been natural to include the word "options" in any of the legislative history materials. On the other hand, futures and forwards have in one form or another, existed since 2000 B.C.[90] In 1973 the CBOE started to trade call options on individual

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ment's exclusion because a futures contract obligates the parties to deliver, unlike an option contract where one party has the right but not the obligation to perform. In effect, the court would presumably treat the futures contract as an exercised option that is within the scope of the Treasury Amendment. *See id.*

86. *See generally* Karol & Lehman, *supra* note 5, at *4.

87. *See* DAIGLER, *supra* note 10, at 20.

88. *See id.* at 599.

89. *See generally* Karol & Lehman, *supra* note 5, at *3. The CBOE started trading options in 1973, and foreign currency options were not introduced until a few years later when the popularity of options became evident. *See id.*

90. *See generally id.* More modern forward agreements appeared in England and France by the fourteenth century, and organized trading markets existed in Japan and Europe by the eigh-

stocks. In that same year, Black and Scholes provided a model to determine the appropriate price for a call option. Due to popularity, the exchange began adding put options, stock index options, and foreign currency options.[91] Thus, the foreign currency option was not commonly used until the years after 1973, so it is only natural that the legislative history would not reflect the options tool.

1. The *Salomon Forex* Decision

The Supreme Court was correct in following the decision of the 4th Circuit in *Salomon Forex*. The court in *Salomon Forex* began their analysis by looking at the language in the Act and giving plain meaning to the phrase "transactions in foreign currency." The court concluded that the phrase was "broad and unqualified," and the phrase "unless conducted on a board of trade" must refer to futures, since forwards are not typically board traded.[92] Since the "unless" clause refers to futures, the court concluded that "transactions in foreign currency" must mean "all transactions in which foreign currency is the subject matter, including futures and options."[93]

The *Salomon Forex* court also looked at the legislative history of the Treasury Amendment,[94] noting that Congress adopted the Treasury Department's suggestion verbatim via the letter to the Senate committee which read, "[t]he department feels strongly that foreign exchange futures trading, other than on organized exchanges should not be regulated by the new agency."[95] Thus, the court concluded that the Treasury Amendment taken in its entirety, confirms "transactions in foreign currency," should be read broadly.[96] This conclusion was supported additionally by the fact that the "transactions in" phrase is used elsewhere in the Act to mean all transactions involving the commodity.[97]

The court also considered the context by which the Treasury Amendment was created.[98] The court noted that the CEA has always regulated only futures and options and never spot or cash forwards.[99] Considering this fact, the 1974 Amendment would have been unneces-

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teenth century. Forward trading in tulip bulbs in the 1600s was part of the speculative activity in that commodity that resulted in a collapse of tulip prices. *See id.*

91. *See Am. Bd. of Trade*, 803 F.2d at 1242.

92. *See Salomon Forex*, 8 F.3d at 975.

93. *Id.*

94. *See id.*

95. *Id.* at 976.

96. *See id.*

97. *See Salomon Forex*, 8 F.3d at 976.

98. *See id.*

99. *See id.* at 975.

sary if it did not include futures and options.[100] The Treasury Amendment can only have meaning if it is interpreted to exclude something more than that which was already excluded before it was enacted.[101] Thus, the court in *Salomon Forex* read the Treasury Amendment to apply to futures and option, and not solely to forwards.[102]

The *Salomon Forex* decision was correct not only because it was a better-reasoned interpretation of the Treasury Amendment, but also because it makes for better policy. If the CFTC was allowed jurisdiction over the inter-bank market, substantial disruptions would follow.[103] The vast majority of inter-bank market contracts are not in compliance with the CFTC, so they could not be enforced. Thus, roughly $650 billion would be in limbo.[104]

Bank regulatory agencies already indirectly regulate the inter-bank market.[105] The agencies require constant updating by the banks on their activities in the inter-bank market.[106] The agencies also require that the banks not take any speculative positions, and the banks must maintain liquid instruments.[107] Those inter-bank participants who are not banks are either corporations or "sophisticated traders" who do not need to be regulated by an agency whose underlying purpose is to protect the general public and the naive investor.[108]

The CFTC does not likely have the resources to effectively regulate the inter-bank market.[109] The inter-bank market is global in nature, and operates twenty-four hours a day.[110] It is difficult to imagine that a government agency could single-handedly regulate a market that has no physical existence yet trades upwards of $50 billion a day.[111]

If the CFTC were granted jurisdiction, the increased cost of compliance as well as inefficiency in the market would literally drive the

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100. *See id.*

101. *See id.*

102. *See* 8 F.3d at 975.

103. *See id.* at 976.

104. *See* Karol & Lehman, *supra* note 5, at *2. In the OTC market, dealers offer customized options in response to the specific requirements of their customers. Thus, the contracts do not meet the standard format requirement of the CFTC. *See id.*

105. This was pointed out in the letter from the Department of the Treasury. The Treasury Department noted that existing regulatory responsibilities are now lodged in the Comptroller of the Currency and the Federal Reserve. *See* S. Rep. No. 93-1131 *supra* note 25.

106. *See generally* Report of the President's Working Group on Financial Markets, 2 COMMODITY FUTURES L. REP. (CCH) ¶26,247 (Oct. 19, 1994).

107. *See id.*

108. *See* S. Rep. No. 93-1131, *reprinted in* 1974 U.S.C.C.A.N. 5843, 5887.

109. *See id.*

110. Laura Cohn, *Forex Options Dealers Play Down Chances of More Regulation*, DOW JONES INT'L NEWS, June 4, 1996.

111. *See id.*

American banks out of the business of foreign currency.[112] The foreign banks and exchanges operate free of regulation, so they would be able to deliver cheaper trade executions at a greater efficiency than their American counter parts who have the added cost of compliance.[113]

Had the Supreme Court followed *American Board of Trade*, these concerns would have been devastating to the American financial community, which in turn would have effects throughout the economy. Therefore, the Court was correct in holding that for the purposes of the Treasury Amendment, futures and options are within the meaning of "transactions in foreign currency."

B. The CFTC Should Still Have Jurisdiction Over Dunn & Delta Consultants

The language of the Treasury Amendment is ambiguous when the situation involves the general public. The court in *Salomon Forex* specifically avoided comment on whether the CFTC had jurisdiction when the public was involved.[114] In fact, none of the previous cases have dealt with the situation presented in *Dunn*, where there was a "sophisticated trader," but that trader was using funds from the general public.

The legislative history of the CFTC and the Treasury Amendment would support an interpretation that the CFTC does have jurisdiction in situations such as those presented in *Dunn*. When the CFTC was created, the intent of Congress was to regulate all aspects of futures and options trading.[115] To accomplish this, Congress gave the CFTC an "exclusive jurisdiction" clause[116], and greatly expanded the definition of "commodity."[117] However, different regulatory agencies lobbied for, and received, exclusions to the "exclusive jurisdiction" clause. The end product is that the CFTC still regulates all aspects of futures and options trading, except for the carefully carved exceptions. The Treasury Amendment was one of the carefully carved exceptions, the intent of which was to preserve the bank regulation of off-exchange foreign currency transactions by banks and sophisticated traders. If the activities of Dunn are excluded by the Treasury Amendment, then they effectively are unsupervised, this is clearly not the intent of Congress. Congress wanted everyone under some sort of regulatory umbrella. Thus, the Treasury Amendment was meant to exclude banks and sophisticated

112. *See generally* Morrison, *supra* note 2.

113. *See generally* Bob Drummond, *Court to Rule on Currency Options*, THE COMMERCIAL APPEAL, May 29, 1996, *available in* 1996 WL 9907925.

114. 8 F.3d at 978.

115. *See* 7 U.S.C. §§ 6c, 23; *See also* text accompanying note 21.

116. 7 U.S.C. § 2(a)(ii).

117. 7 U.S.C. §§ 1(a)(3), 2.

traders, not necessarily the entire inter-bank market and all of its participants.

The Treasury Amendment was enacted in 1974, when computers were not as widely used as they are today. Congress could not possibly have seen the impact that computers would have on futures and options trading.[118] In 1974, the banks and traders in the inter-bank market were making trades primarily over the phone. This is significant because in order to place a trade, a market participant would have to call another trader, who would either take the trade, or call another trader who might. Thus, the market participants were at least aware of who they were trading with if they did not know them personally.[119] Traders who did not regularly trade in the inter-bank market would have found it difficult to trade because they were outsiders to the market, they represented a greater credit risk if their trade lost money.[120] Thus, it would have been extremely difficult for a small trader or naive investor to enter the inter-bank market. This is possibly why the CFTC ceded jurisdiction so easily, because the people they wanted to protect (small traders and investors) were not in any danger of being victimized by the inter-bank market.

Today, computers have eased the trading process greatly. Traders in the inter-bank market today often may have no idea as to the identity of the other party. Computers have effectively allowed anyone with a bank account and a modem to enter the inter-bank market, and such was not the case when the Treasury Amendment was enacted. Congress could not have possibly conceived a day when a person sitting in their home could trade on the inter-bank market. Had Congress known of the impact computers would have, they would not have tried to exclude banks and sophisticated traders from CFTC jurisdiction simply by classifying their activities as "off-exchange." Congress wanted the CFTC to help protect the small traders and individuals, who would trade on the organized exchanges. If Congress had foreseen a day when the public could access the off-exchange market, then they would have drafted the Treasury Amendment entirely differently.

The driving force behind the creation of the CFTC was to curtail the fraud and trading abuses that victimized the public and small traders.[121] The Treasury Department, in drafting the Treasury Amendment, drew a distinction between the "informal network of banks and dealers" intended to be excluded and "the participants on organized exchanges." While it could be said that Dunn was a sophisticated trader, it

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118. *See generally* Karol & Lehman, *supra* note 5, at *2.

119. *See id.*

120. *See id.*

121. *See* Commodity Exchange Act of 1936, ch. 545, §§ 5(4c), 49 Stat. 1491.

still remains that he was trading on behalf of people who would fall under the classification of "participants on organized exchanges," in other words, the general public. Therefore, it was not the trading activities of Dunn that brought him under the jurisdiction of the CFTC, but rather his marketing to the public, that makes him susceptible to CFTC jurisdiction. The CFTC has always understood this, and expressly stated their position in a congressional notice in 1985.[122] In the notice, the CFTC expressly stated that persons marketing off-exchange transactions to the public would not fall under the Treasury Amendment's exclusion to CFTC jurisdiction.[123] Dunn himself was a sophisticated trader and experienced inter-bank market participant and it is unlikely that he honestly felt he was outside all regulations. The players in the market know that just because they are "in" the market, this does not mean they are "outside" regulation.

V. CONCLUSION

Futures and options are nearly equivalent financial tools and there is no reason to distinguish between them. Thus the Supreme Court was correct in ruling that for purposes of the Treasury Amendment, options are to be considered "transactions in foreign currency . . . ." However, the Court could have went one step further and held that Dunn was still under the jurisdiction of the CFTC due to his actions in marketing to the general public.

The Treasury Amendment itself is antiquated at best. Congress has failed the financial community by not updating the amendment to reflect the current state of the industry, and the court must now decide how to handle the situation based on what Congress originally intended over twenty years ago. To provide guidance for lower courts, the Supreme Court should have advocated a three-part test. The first prong would ask whether the transaction was based on foreign currency. The second prong would look at the nature of the trade; is the transaction off-exchange, does it take place in the OTC market? Thirdly, the court should ask if the true party in interest is a bank, institution, or sophisticated trader? If the answer to any of the prongs is no, then the CFTC would have jurisdiction over the party. This would still allow the banks and sophisticated traders to trade free of regulatory oversight, while at the same time allow the CFTC to curtail fraud and abuse.

122. *See* 50 Fed. Reg. 42,983 (1985).

123. *See id.*

What Would Have Been the Impact of Such a Decision?

A decision by the Supreme Court allowing the CFTC jurisdiction over Dunn in this particular instance, would arguably have been in the best interest of most concerned (with the exception of Dunn). Mutual funds, pension funds, and various other investment pools would not be allowed out of CFTC oversight. This is exactly as Congress intended, the use of futures and options by the general public should be regulated by the CFTC.[124] Businesses would use the inter-bank market without CFTC oversight if the use is for business purposes (such as an overseas accounts receivable) under the business exception.[125] However, businesses with shareholders, established for the sole purpose of derivatives trading, could not trade without CFTC oversight, unless their corporation is regulated by another agency whose jurisdiction is recognized by the CFTC (e.g. banks). This keeps small traders and the general public on the organized exchanges and thus under the regulatory umbrella of the CFTC, while at the same time allowing the banks, institutions, and sophisticated traders to continue their operations free of oversight.

The organized exchanges would have likely protested such a decision. However, it is important to note that while the exchanges have lost market share, it is not necessarily due to their being regulated. The futures and options market has literally exploded with growth in the past few years. It should be noted that forty percent of a $50 billion daily market is still more than seventy-eight percent of a $20 billion market, so the market share argument is somewhat mischaracterized. Additionally, financial products are easily duplicated and cannot be patented, so the situation is such that there exists a booming market with comparatively low barriers to entry for foreign exchanges. It is only natural that there be a significant increase in competition by foreign exchanges. The American exchanges should take note of the fact that, often the reason traders use American exchanges is because they are so regulated. In a sense, the American exchanges have an advantage over foreign exchanges because American exchanges are more credible, which is a direct result of their being so closely regulated.

Congress is currently attempting to pass a bill entitled "The Commodity Exchange Act Amendments of 1997," that implicitly would follow similar guidelines. Congress dealt with the third prong of the analysis by defining a person who markets to the general public as a board of trade, and therefore under the regulation of the CFTC.[126]

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124. *See generally* Commodity Exchange Act of 1936, ch. 545, §§ 5(4c), 49 Stat. 1491.

125. *See* Vogelstein, *supra* note 16, at C14.

126. The Commodity Exchange Act Amendment of 1997, S. 256, 105th Cong. (1997). The amendment is currently pending in the Committee on Agriculture, Nutrition and Forestry.

While the Supreme Court was burdened with the responsibility of deciding the case before it, the ultimate burden of ensuring a smooth operation of the country's financial affairs is on Congress and the administrative agencies of Government. If the agencies cannot reach an agreement, then it is Congress that must take the initiative of reforming not only the Treasury Amendment, but also the CFTC regulatory framework. It is up to Congress to bring the CFTC into the '90's and beyond, not our judicial system.

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