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# REPORT TO THE CONGRESS

## Improvements Needed In Regulation Of Commodity Futures Trading

Department of Agriculture  
Commodity Futures Trading Commission

**BY THE COMPTROLLER GENERAL  
OF THE UNITED STATES**

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COMPTROLLER GENERAL OF THE UNITED STATES

WASHINGTON, D.C. 20548

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21 To the President of the Senate and the  
Speaker of the House of Representatives

This report summarizes improvements needed in regulation of commodity futures trading. Administration of activities discussed in this report was the responsibility of the Commodity Exchange Authority, Department of Agriculture; however, effective April 21, 1975, the newly established Commodity Futures Trading Commission, a separate independent agency, became responsible for these activities.

We made our review pursuant to the Budget and Accounting Act, 1921 (31 U.S.C. 53), and the Accounting and Auditing Act of 1950 (31 U.S.C. 67).

We are sending copies of this report to the Director, Office of Management and Budget; the Chairman, Commodity Futures Trading Commission; and the Secretary of Agriculture.

A handwritten signature in black ink, reading "Thomas G. Staats".

Comptroller General  
of the United States

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ABBREVIATIONS

AMS	Agricultural Marketing Service
CE act	Commodity Exchange Act
CEA	Commodity Exchange Authority
CPA	certified public accountant
FCM	futures commission merchant
GAO	General Accounting Office
SEC	Securities and Exchange Commission

COMPTROLLER GENERAL'S  
REPORT TO THE CONGRESS

IMPROVEMENTS NEEDED IN  
REGULATION OF  
COMMODITY FUTURES TRADING  
Department of Agriculture  
Commodity Futures Trading  
Commission

D I G E S T

Because of the concern of the Congress and the key role commodity futures markets play in establishing commodity prices, GAO has made a series of recommendations for the newly established Commodity Futures Trading Commission which replaced Agriculture's Commodity Exchange Authority on April 21, 1975.

Trading in commodity futures is the buying and selling of contracts at fixed prices for delivery in some future month of a specified quantity of a commodity. (See p. 3.)

To improve the regulation of commodity exchanges and commodity futures trading, GAO is recommending that the Commission:

- Improve effectiveness of trade practice investigations by requiring accurate and useful trade records, instituting a modified marketwide surveillance program using computers, and acting quickly on violations and publicizing penalties imposed. (See p. 31.)
- Complete complaint investigations promptly to increase public confidence in the futures markets and to deter trading abuses. (See p. 38.)
- Work with the Administrator of the Agricultural Marketing Service and with other Federal agencies to insure that adequate cash-price information will be provided for all commodities traded in the futures markets. (See p. 45.)

--Redirect the Commission's audit function to a strong oversight role and transfer the primary responsibility for enforcing the required financial provisions and regulations to the exchanges. (See p. 51.)

--Implement a formal research program for commodity futures trading and consider such areas as foreign and trader influence on the futures markets when establishing priorities. (See p. 65.)

GAO's interim report to the Congress of May 3, 1974, stated the need to (1) create a separate independent agency to regulate futures trading, (2) expand the Government's authority to regulate this trading effectively, and (3) improve certain administrative procedures and practices.

On October 23, 1974, the Commodity Futures Trading Commission Act of 1974 established a separate independent commission with expanded regulatory authority to supervise the commodity markets. The act became effective on April 21, 1975. (See p. 1.)

GAO's interim report said trade practice investigations were ineffective and recommended that Agriculture's Commodity Exchange Authority put more emphasis on planned high-priority investigations to seek out abusive trade practices on the commodity exchange floor. (See p. 6.)

GAO's trade practice investigations at five commodity exchanges, as described in this report, showed that

--trading abuses were occurring,

--improvements in exchange records were needed, and

--a modified marketwide surveillance program using computers was needed.

For several years the Authority had been aware of errors in the trading records and of the need for additional information but had not taken corrective action. (See p. 6.)

The Commission's approach to trade practice investigations should be aimed at establishing itself as a deterrent to abusive practices. Action should be brought as quickly as possible against offenders when violations are found and penalties imposed should be publicized to deter other potential offenders. Additional occurrences could then be treated as repeat offenses and appropriate penalties imposed. (See p. 30.)

GAO believes that delays in completing customer complaint investigations could be reduced by requiring commodity exchanges and futures commission merchants to respond promptly to requests for information and by requiring more visits to futures commission merchants by investigators. (See p. 32.)

The Commission needs information on cash prices that are representative of commodity sales to identify unusual relationships between cash and futures prices and to detect price manipulations. (See p. 40.)

The Authority had used considerable manpower on audits to insure that customer funds were properly segregated and that futures commission merchants met minimum financial requirements. GAO believes the Commission should redirect its audit role to a strong oversight role and transfer the primary responsibility for enforcing the required financial provisions and regulations to the exchanges. By redirecting its audit role, the Commission could concentrate more on known or suspected non-compliance cases and could increase its work in other enforcement areas. (See p. 46.)

A formal ongoing research program is needed to provide the Commission with the information to improve the regulation of the futures market. GAO suggests that in establishing priorities certain areas, such as the influence of hedgers and speculators on the futures market, the extent of foreign trading in the futures markets and the effect of foreign purchases in the cash market be studied. (See p. 60.)

## CHAPTER 1

### INTRODUCTION

The Commodity Exchange Act (CE act), as amended (7 U.S.C. 1), authorized the Secretary of Agriculture to regulate trading in contracts for future delivery of certain specified agricultural commodities on boards of trades (commodity exchanges) designated as contract markets. (A list of commodity futures markets and commodities traded is shown in app. I.)

The Secretary of Agriculture established the Commodity Exchange Authority (CEA) to administer the CE act and gave CEA all his authority under the act, except for his authority to (1) approve commodity exchanges to trade in future contracts for regulated commodities, (2) promulgate regulations, and (3) conduct disciplinary proceedings for apparent violations of the CE act or regulations. The Secretary, or his designee, served as Chairman of the Commodity Exchange Commission, which was established by the CE act and which included the Secretary of Commerce and the Attorney General or their designees. The Commodity Exchange Commission established the limits on speculative trading in regulated commodities and ordered disciplinary action against commodity exchanges that trade futures contracts in regulated commodities.

Our interim report to the Congress on CEA and on commodity futures trading (B-146770, May 3, 1974) included our preliminary observations and recommendations on certain legislative and administrative matters based on a survey of CEA operations and legislative developments. The Congress considered legislation amending the CE act to strengthen the regulation of commodity futures trading. On October 23, 1974, the Congress enacted the Commodity Futures Trading Commission Act of 1974 (Public Law 93-463) which established an independent regulatory Commodity Futures Trading Commission with broad new authority to regulate futures trading and commodity exchange activities.

The new act covers most of our interim report legislative recommendations including

- establishing an independent commission, separate from the Department of Agriculture;
- regulating all goods, articles, services, rights, and interests traded for future delivery;
- requiring the Commission to determine whether to permit trading by floor brokers and futures commission

merchants (FCM) for their own account while also trading for their customers;

- authorizing the Commission to seek, through the Attorney General or directly from the courts, to enjoin contract markets or persons from violating the act;
- authorizing the establishment of additional points for the delivery of a commodity;
- imposing penalties up to \$100,000 for both administrative and criminal violations; and
- expanding registration and examination for fitness requirements to include all individuals handling customers' accounts.

The act would also provide for a new definition of hedging; provide Commission approval of exchange bylaws, rules, regulations, and resolutions; authorize the Commission to require such trading reports and trading information, including transaction timing, when needed; and establish a research and information program to determine, among other things, the feasibility of trading by computer. In addition, the act provides that pending proceedings not be abated but be disposed of pursuant to the applicable provisions of the CE act in effect before the effective date of the new act. This act became effective on April 21, 1975.

The Department of Agriculture, by letter dated July 15, 1974, indicated that it generally agreed with and would implement our administrative recommendations relating to (1) monitoring exchanges' programs for enforcing trading rules and financial requirements, (2) reviewing adequacy of and need for speculative trading and position limits on regulated commodities, and (3) consolidating guidance documents on price manipulation investigations. The Department did not agree, however, with our recommendations on trade practice investigations and on giving commodity exchanges primary responsibility for certain audits. These two areas are discussed further in chapters 2 and 5.

We reviewed CEA's procedures for supervising and enforcing its responsibilities at CEA headquarters in Washington, D.C., and its regional offices in New York City, Chicago, and Kansas City. We obtained information from the following commodity exchanges; the Chicago Board of Trade; the Chicago Mercantile Exchange; the New York Mercantile Exchange; the New York Cotton Exchange and Associates; and the Board of Trade of Kansas City, Missouri, Inc. We hired

three consultants with expertise in the operations of the futures market. (See app. III.)

### DEFINITION AND PURPOSES OF FUTURES TRADING

Futures trading is the buying and selling of contracts for delivery in some future month of specified quantities of a commodity at fixed prices. The physical commodity itself is not bought and sold on the futures markets; however, these markets are important in the marketing of physical commodities. The futures market's primary purpose is to help establish commodity prices and to permit trade members to hedge or protect themselves against major losses if adverse price movements occur for the physical commodities in the cash market.

#### Hedging

The futures market provides a means whereby producers, merchandisers, and processors can transfer some of the risks of adverse price movements of the physical commodity to speculators. This process is known as hedging. The hedger, unlike the speculator, has a financial interest in a commodity; that is, the hedger owns or has a firm commitment to buy or sell a quantity of the physical commodity or has a future need for the commodity. There are two types of hedges used in the futures market, the buying (long) hedge and selling (short) hedge.

The buying hedge consists of buying futures contracts for quantities of the commodity approximately equal to the quantity of the physical commodity needed to fulfill processing requirements or other commitments. This hedge may be used by flour millers and cattle feeders or by grain merchants having firm cash sales commitments for future delivery which exceed inventories. The buying hedge protects the hedger from any future price advances of the commodity on the cash market and allows him to project his materials costs and to price his product with the lowest possible profit margins.

The selling hedge consists of selling futures contracts for quantities of the commodity approximately equal to the quantity of the physical commodity owned and/or firmly committed to be purchased. This hedge may be used by farmers or by grain merchants having inventories which are not committed in the cash market. The selling hedge, therefore, provides the hedger with a guaranteed price for his inventory and protects the value of his inventory from any future price decline of the commodity on the cash market. A second advantage of the selling hedge is that lending institutions normally

will loan a higher percentage of the estimated inventory value if it is protected by a selling hedge.

### Speculating

The futures market speculators do not own or deal in the physical commodities in which they trade. These traders hope to realize a profit by assuming the risks of price fluctuations. The speculator buys futures contracts when he thinks prices are too low and sells futures contracts when he thinks prices are too high. The speculators are considered by the futures trading industry to be an integral part of the futures market because the additional volume of trading generated by the speculators reduces the price disturbances which can result from placement of hedges for any large quantities of a commodity and improves the possibilities of effecting a transaction for a hedge order limited to a specific price.

### COMMODITY EXCHANGES

The primary responsibility of a commodity exchange is to insure a competitive market free of attempts at a price manipulation. The exchanges generally are responsible for developing and enforcing trading rules; establishing contract terms, including the months of delivery; supervising traders and trading; establishing margin requirements; establishing price fluctuation limits (the permissible price change during the day); and inspecting all commodities tendered for delivery. The exchange may also establish limits on speculative trading.

Under the CE act, the Secretary had to designate an exchange as a contract market for a regulated commodity before the exchange could engage in futures trading in that commodity. To be designated a contract market, the exchange had to maintain certain records and file reports, as prescribed by the Secretary; prevent dissemination of false, misleading, or inaccurate commodity information; prevent price manipulations and the cornering of any commodities; comply with the Secretary's final orders and decisions concerning violations of the CE act; and enforce exchange trading rules and contract terms.

The CE act specified that any individual, association, partnership, corporation, or trust (1) soliciting or accepting orders to buy and sell regulated commodity futures and (2) accepting any money, securities, or property or extending credit to margin trades on contracts must register each year with CEA as an FCM. FCMs are sometimes referred to as brokerage firms or commission

houses. An FCM charges a commission for filling customers' orders.

Futures contracts are bought and sold on the trading floor of the exchange by a floor broker, who may buy or sell futures contracts for others, for his own account, or for an account which he controls. He may trade on a fee-per-unit basis for more than one FCM or for other exchange members or he may be compensated as an employee or as an official of an FCM. Floor brokers registered each year with CEA. A floor trader could buy or sell contracts only for his own account and was not required to be registered with CEA.

## CHAPTER 2

### CEA TRADE PRACTICE INVESTIGATIONS INEFFECTIVE

In our interim report, we stated that CEA's trade practice investigations continued to be inadequate to disclose or discourage abusive trading practices on the exchange floors. We had found that CEA's trade practice investigations were primarily based on complaints or referrals, and we recommended that CEA put more emphasis on conducting trade practice investigations on a high-priority planned basis to seek out abusive practices in commodity trading under its jurisdiction.

In its July 15, 1974, comments on our interim report, the Department disagreed with our suggested method of conducting trade practice investigations. The Department stated that marketwide investigations to seek out abuses were too costly in relation to the benefits obtained but that CEA planned to increase its selective-type investigations as personnel became available. In addition, CEA was establishing new branches in two of its regional offices to be responsible for reviewing and analyzing exchange rules, monitoring exchange rule enforcement, and conducting trade practice investigations.

Our investigation of trade practices at five commodity exchanges showed that trading abuses were occurring and that a need exists for a modified marketwide surveillance program to safeguard futures markets' customers. We believe the most effective approach is to use computers in reviewing exchange trade register information to identify suspect trades, by putting emphasis on areas not adequately covered by exchanges' surveillance programs. Such investigations cannot be done effectively by computer, however, until errors in the exchange records are corrected and certain other information, such as timing of trades, is required. We believe that the benefits derived from such a modified approach would be worth the costs.

CEA was aware of the inadequacies in the trading records for several years but took little or no action to require the exchanges to have accurate records to facilitate the surveillance function. Until the records are corrected and aggressive action is taken against trading abuses, the effectiveness of trade practice investigations will continue to be limited.

CEA's APPROACH TO TRADE  
PRACTICE INVESTIGATIONS

For several years CEA conducted marketwide trade practice investigations that generally involved analysis of all trades of futures contracts made for a particular commodity at an exchange during a specified period. At first, these investigations were done manually and later with computers. The computerized investigations were quite extensive in scope and involved the analysis of about 26 computer runs, some of which were more productive in identifying violations than others. Since 1971 CEA trade practice investigations have been based primarily on referrals from other CEA offices or complaints from the public.

There are two principal concerns in overseeing futures trading on commodity exchanges: (1) protecting the price-setting mechanism of the markets and (2) protecting the trading public against abusive practices. CEA believed that trade practice investigations were the best means for detecting abusive practices which would constitute unfair treatment of market users for whose accounts trades are made or would tend to restrict free and competitive trading.

Commodity futures trades are executed by brokers in designated pits on a commodity exchange floor. These trades may be executed for the broker's own account or for the accounts of others. Orders from the public are usually given to a broker by an FCM, whose role is similar to that of the stockbroker in the security markets. Each FCM is a member of the exchange clearinghouse (organization responsible for matching buy and sell trades) or has an arrangement with a clearinghouse member to clear his trades. Each broker reports his trades to a clearing member who, in turn, reports them to the exchange clearinghouse where they are matched and recorded in the exchange records.

CEA regulations required each exchange to maintain a record showing for each futures trade the date, commodity, future, quantity, price, buying and selling broker, buying and selling clearing member, and a symbol indicating the type of customer. The customer indicator shows whether the person executing the trade

--was trading for his own account or an account which he controlled;

--was trading for his clearing member's house account;

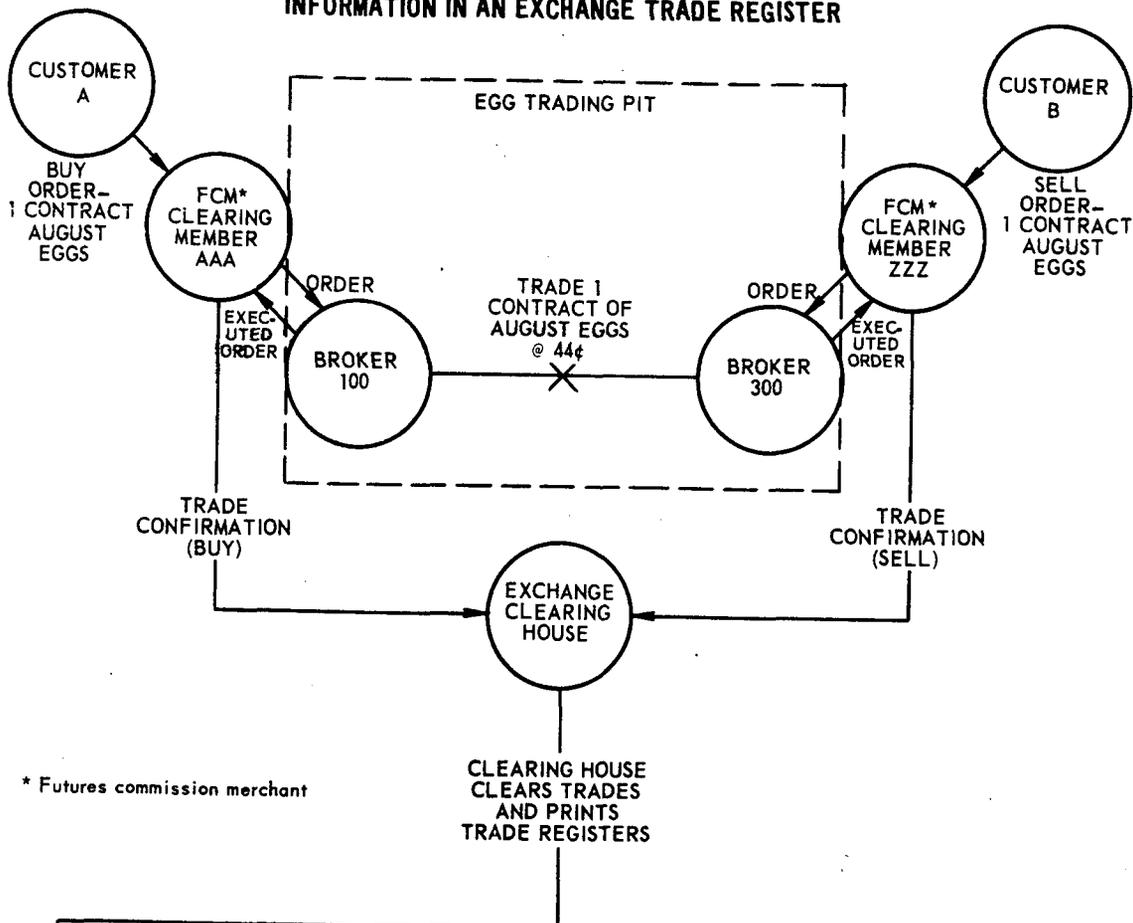
- was trading for another member present on the exchange floor, or an account controlled by such member; or
- was trading for any other type of customer (generally the public).

The required record, an exchange trade register, consists of individual registers for each clearing member showing all of the trades cleared on a given day. On the following page is an illustration of a commodity trade for two customers and the principal information shown in an exchange trade register.

Marketwide trade practice investigations generally begin with a review of trades as recorded in the exchange trade registers to seek out indications of abusive practices. Abusive practices, such as the following, may result in the customer not receiving the best possible price because the trade was not executed competitively in the trading pit.

- Broker's or FCM's taking the opposite side of their customers' order for their own account or an account in which they have an interest.
- Broker's or FCM's offsetting their customers' orders (directly or indirectly filling one customer's buy order against another customer's sell order without bona fide execution of such orders according to exchange rules).

**ILLUSTRATION OF A FUTURES TRADE  
FOR TWO CUSTOMERS AND THE PRINCIPAL  
INFORMATION IN AN EXCHANGE TRADE REGISTER**



\* Futures commission merchant

**AAA TRADE REGISTER**

<u>BUY</u>	<u>SELL</u>	<u>COMMODITY</u>	<u>FUTURE</u>	<u>PRICE</u>	<u>CUSTOMER TYPE</u>	<u>EXECUTING BROKER</u>	<u>OPPOSITE BROKER</u>	<u>OPPOSITE CLEARING MEMBER</u>
1		EGGS	AUGUST	44¢	4	100	300	ZZZ

**ZZZ TRADE REGISTER**

<u>BUY</u>	<u>SELL</u>	<u>COMMODITY</u>	<u>FUTURE</u>	<u>PRICE</u>	<u>CUSTOMER TYPE</u>	<u>EXECUTING BROKER</u>	<u>OPPOSITE BROKER</u>	<u>OPPOSITE CLEARING MEMBER</u>
	1	EGGS	AUGUST	44¢	4	300	100	AAA

--Prearranged trading--trading between brokers in accordance with an expressed or implied agreement or understanding which results in their trading with each other.

--Wash trading--entering into or purporting to enter into transactions for the purpose of giving the appearance that purchases and sales are being or have been made without actually taking a position in the market.

--Accommodation trading--wash trading entered into by one broker to assist another broker to indirectly take the opposite side of his customers' orders, make wash trades, etc.

Other abusive practices may consist of such items as:

--Trading which exceeds speculative trading limits established by CEA or the exchanges to curb the trading of individuals whose trades might unduly affect the market price.

--Broker buying or selling for his own account while having a customer's order to buy or sell at the same price or at the prevailing market price.

In making a trade practice investigation, investigators are concerned with the relationship of the opposite sides of each trade, the timing of the transaction, and the nature of the trade--whether it was a regular pit trade or one of the designated transactions which was identified by special symbols or coding. For example, all trades in which one broker is both buyer and seller in the same transaction are highly suspect, since there is a strong inference that the trade was not made competitively in the pit. In such trades, the broker may be taking the opposite side of his customer's order, offsetting his customers' orders, or possibly making a wash trade for some purpose of his own.

CEA conducted five computerized investigations between May 1967 and June 1970. One investigation showed evidence of violations by 23 exchange members and included such practices as offsetting customers' orders, taking the opposite side of customers' orders, making prearranged trades, and making accommodation trades. The other four investigations were less successful in disclosing violations, but three were conducted primarily to test or evaluate the computerized system and changes incorporated therein.

In August 1970 the CEA Administrator expressed the opinion that the cost of these investigations was too high in relation to the number and types of violations being found. In

January 1971 the Director, CEA Compliance Division, made a study of the program and concluded that the computerized system had not solved CEA's problem with trade practice investigations. The study pointed out that:

- CEA had never allocated sufficient resources to permit proper implementation of the program. Only about an estimated \$40,000 of the \$250,000 budgeted annually for the conduct of trade practice investigations had been spent for that purpose.
- Four of the five computerized trade practice investigations were seriously hampered by the exchanges' inadequate recordkeeping or other factors.
- CEA's computer programs needed further refinement and greater sophistication.
- CEA lacked skilled employees with experience in conducting such investigations.

The study further concluded that trade practice investigations had a dual purpose, and for that reason the Director recommended that CEA adopt a dual approach to its conduct. This was to consist of:

- Marketwide investigations to maintain surveillance over the exchanges' policing of their own trading rules and to detect any new noncompetitive trading practices that would warrant new regulation.
- Selective investigations of individual trading situations which for some reason appeared to be suspect for the purpose of detecting abusive trading practices by individual brokers.

The dual approach was not adopted. In August 1971 the computerized marketwide program was replaced by a selective program which, in practice, was generally limited to narrowly defined investigations involving a single trade or group of trades on which a complaint was received or which was referred by another CEA office.

In its July 15, 1974, response to our interim report, the Department stated that marketwide trade practice investigations to seek out abusive trading would be desirable if costs were not a factor. The Department estimated that examining 1 percent of the transactions, which it considered a minimum for this type of investigation, would cost at least \$600,000, compared with the approximately \$40,000 which CEA currently spends annually on its selective investigations.

The Department commented that as conditions permitted and as personnel became available, CEA planned to increase its selective-type investigations.

We believe that a need exists to make modified marketwide trade practice investigations to evaluate the effectiveness of exchange self-enforcement programs and to safeguard the futures markets customers. The most effective way to monitor the large number of trades that occur is by using a computer in reviewing exchange trade registers to identify suspect trades. We do not, however, advocate a return to the large-scale computer analyses CEA made before 1971.

A modified marketwide investigative approach might function as follows:

- Investigators would review each exchange trading surveillance program and identify the area or areas most deficient.
- A special computer program could be used to identify any suspect trades in the areas identified.
- Suspect trades could be investigated on a sample basis and, if warranted by the findings, the remainder of the trades could be referred to the exchanges for investigation.

The Commodity Futures Trading Commission should continue the program of investigating suspect situations which are identified by complaints from the public or referrals from its regional offices. We believe that the benefits derived from a modified approach which would limit the number of suspect trades for followup, such as indicated above, would be worth the costs.

#### IMPROVEMENTS NEEDED IN EXCHANGE RECORDS

CEA's task of translating suspect cases into provable violations was often very difficult and time consuming. Some violations, such as a broker taking the opposite side of his customer's order or trading over the speculative limits, could be proved from the trade records, assuming they were correct. Many other violations, however, such as prearranged trading or accommodation trading, had to be proven by inference from the known facts after extensive analyses of trading records and interviews with all of the parties involved.

Our investigations into trade practices showed the exchange trade registers were erroneous and misleading and lacked certain information needed for effective investigations, such as transaction timing. As a result, some

possible abusive trading practices would not be identified and CEA would spend an inordinate amount of time obtaining and analyzing clearing members' records and interviewing brokers about trades that would not be suspect if the trade registers were accurate.

Erroneous data makes trading records unreliable

We made trade practice investigations, in varying depths, at five commodity exchanges. These exchanges collectively accounted for about 84 percent of all commodity futures trading during fiscal year 1973, as follows.

<u>Exchange</u>	<u>Percent of commodity contracts traded during FY 1973</u>
Chicago Board of Trade	53.4
Chicago Mercantile Exchange	23.9
New York Mercantile Exchange	2.5
New York Cotton Exchange and Associates	2.4
Board of Trade of Kansas City, Missouri, Inc.	<u>1.7</u>
Total	<u>83.9</u>

The exchanges' trade registers contained numerous errors in identifying executing brokers, customer types, transfer trades, and trades cleared on dates other than the execution date. Such errors cause the trade registers to show apparent abusive trading practices which must be followed up with clearing members and/or brokers before the investigator can determine whether the suspect trades actually occurred in the manner the records indicated. Conversely, actual trading abuses may be obscured if the true details of the trades are not disclosed in the trade registers. As a result of the erroneous data, the trade registers, which are generally the starting point for investigations, cannot be relied on to show the true nature of trading activity. Our findings concerning erroneous data are summarized below by commodity exchange.

Chicago Board of Trade

At the Chicago Board of Trade, we found that the records of 15 of 38 clearing members reviewed had been miscoded or had misidentified data and thereby caused erroneous information to be entered in the trade registers. Some clearing members were miscoding entries, as follows:

--Two clearing members were routinely using incorrect codes to identify transfer trades (bookkeeping transfers) rather than the uniform code that was prescribed by the exchange under CEA regulations. As a result, their transfer trades appeared in the trade registers as regular pit trades.

--Three clearing members were routinely coding all trades the same, regardless of the actual customer type.

--One clearing member had erroneously identified a specific broker as having executed all trades that were cleared the day after execution, regardless of the actual executing broker.

--One clearing member miscoded the customer type on trades because the firm had run out of prepunched cards with the appropriate customer type.

In our trade practice investigation, we selected 61 trades for which the trade registers showed the same broker both buying and selling in the same transaction. We obtained the basic trading records--the floor orders and/or broker trading cards--from the 31 clearing members involved in those trades. Review and followup of those records disclosed that, for 27 of the 61 trades, the clearing member had miscoded or misidentified some data, and the suspected brokers had not actually executed both sides of the trade as shown by the trade registers. For the remaining 34 trades, clearing members' records indicated that the same broker was, in fact, on both sides of the transactions.

We referred 13 of the 34 trades to CEA for its followup assistance on a priority basis. When CEA reviewed additional records and interviewed the brokers in question, it found that 12 of the 13 suspect trades had not actually occurred in the form indicated by the records and that the erroneous information originated with the brokers rather than with the clearing members. The two brokers in question had an employee who prepared their trading cards from the information recorded on their executed floor orders. The employee who was preparing trading cards for five different brokers had prepared trading cards showing the wrong broker as having executed the trades.

In investigating the 13 trades, the CEA investigator determined that:

--The two brokers had violated CEA regulations by failing to properly identify themselves as the executing floor brokers on orders they filled.

--The two brokers were responsible for causing false records to be prepared by a clerk because of the above failure.

--Contrary to CEA regulations, one broker's trades did not identify the opposite floor broker.

On November 1, 1974, CEA issued warning letters to each of the brokers involved for failing to comply with the CE act and regulations. Both brokers were advised that further failures to comply could lead to formal action.

Thus, the records for 39 of the 61 suspect trades were found to be erroneous. The remaining 22 trades were referred by CEA to the exchange for investigation on November 27, 1974.

#### Chicago Mercantile Exchange

Our review of the trade register at the Chicago Mercantile Exchange on January 23, 24, and 28, 1974, indicated that 41 floor brokers had executed both the buying and selling sides of 114 trades. On November 27, 1974, CEA referred the trades to the Chicago Mercantile Exchange for investigation.

On February 21, 1975, the exchange reported to CEA that no trading violations were found. The exchange's investigation showed that 89 of the trades had indicated a possible violation because of coding errors. The 25 other trades had been executed according to exchange rules except that on some occasions records required to be submitted by the brokers were not in the exchange files. CEA officials told us they planned to review the results of the exchange's investigation and would investigate the exchanges' recordkeeping procedure.

We also noted previous CEA reviews which indicated that errors in the trading records existed.

--In a 1969 investigation, CEA found more than 20 percent of a sample of opposite broker information in the exchange's trade register was erroneous. CEA did not bring this matter to the exchange's attention, apparently through oversight.

--In a January 1974 investigation of floor broker registration, CEA reviewed the clearing members' records for 43 trades executed by 7 brokers. CEA found that 10 of the 43 trades had been miscoded. In nine trades the executing broker was misidentified, and in one trade the customer type was erroneous. CEA did not bring these errors to the exchange's attention because the error problem was a side issue in its investigation.

--As part of an investigation in December 1973, CEA referred 33 trades to the exchange for followup. The exchange's response in July 1974 indicated that 7 of the 33 trades had been miscoded and had not been executed as the records indicated. Of the remaining 26 trades, 3 were in violation of exchange rules, and 23 were in accordance with exchange rules.

#### New York Mercantile Exchange

At the New York Mercantile Exchange we selected 62 trades executed by 11 brokers which warranted followup due to some suspicious aspect. We interviewed the executing brokers and representatives of several clearing members involved in the trades and found that the customer type had been miscoded for 52 of the 62 suspect trades and that the trades had not occurred as shown in the records. Further, two of the brokers said that they were routinely miscoding their personal trades because of a misunderstanding of CEA's coding requirements.

Coding errors were made by both brokers and clearing members and included situations such as the following:

--The trades by three brokers for their own accounts were erroneously coded as trades for general customers. One of the brokers told us that he used the customer code for his personal trades because he considered himself a customer of the clearing member who cleared his trades.

--The trades by four brokers for their own accounts were erroneously coded as trades for broker-customers. The clearing member for one of the brokers said that he coded such trades as broker-customer on the basis that he was clearing the trades for another broker on the exchange floor. One of the brokers said that, because of his firm's recordkeeping system, he and two associated brokers used CEA's customer code numbers to identify their personal trades.

It appeared that there was widespread misunderstanding of CEA's coding requirements among the brokers and clearing members resulting in numerous trades being miscoded in the records.

#### New York Cotton Exchange and Associates

In our investigation at the New York Cotton Exchange and Associates, we identified 14 trades by 3 brokers which indicated that they had taken the opposite side of their customers' orders. We determined, however, that 6 of the 14 trades had been miscoded in the trade register and had not occurred as

shown in the records. For the remaining eight trades, the broker had the permission of his customers to take the opposite side, as permitted by the exchange rules.

We also identified eight other trades where the trade register indicated that the broker was trading for customers without being registered with CEA. CEA's followup of these trades disclosed that they were miscoded and were actually executed for the broker's own account. Brokers who traded only for their own account were not required to be registered with CEA.

Board of Trade of Kansas City, Missouri, Inc.

The Board of Trade of Kansas City, Missouri, Inc., had a relatively low volume of trading, and its clearinghouse matched and cleared trades using a manual process. In its clearing operation, the clearinghouse was alert for coding errors and made a periodic data verification step to minimize the errors in the trading records. We noted some coding errors in the records, but CEA's investigation found that the exchange had previously identified the errors and had taken action to correct the records.

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CEA was aware of errors in the trading records for several years but had not taken corrective action. For example, the Director of CEA's Compliance Division analyzed the erroneous data problem in January 1971 and concluded that errors frequently occurred because there was no economic motivation for any member to be sure he properly recorded all elements pertaining to a particular trade, as long as the future, the quantity, and the price data were correct and the trade cleared.

Later, in August 1971, a CEA study team recommended that CEA require the exchanges to make periodic accuracy checks to make the trade registers more useful for policing floor trading practices. The CEA Administrator adopted the recommendation but took no action to implement it.

In April 1974, after our investigations were underway, CEA sent letters to the Chicago Board of Trade and to the New York Mercantile Exchange advising them of the need for accurately coding the trading records. Both exchanges agreed to issue instructions to their clearing members in this regard.

Without accurate records, some possible abusive trading practices may not be identified and an inordinate amount of time spent investigating trades that would not be suspect if the trade registers were accurate. The Commodity Futures Trading Commission should require each exchange to implement a periodic review to insure the accuracy of the records. The Commission should monitor this program, using disciplinary actions if necessary, so that the trading records can be used effectively for surveillance purposes.

Additional data needed for effective investigations

In September 1974 a joint Department-commodity futures industry study team made several recommendations aimed at establishing a new computerized futures trading data system that would provide CEA with trading and position information daily. Two of the system's major features are the reporting of trade execution time and a computer system to process the data and make it available to CEA analysts. According to the study team's report, the new system can be implemented over a 36-month period after funding is authorized.

The report includes industry study team members' comments which state in essence that the costs of such a system are underestimated and the 3-year timetable overly ambitious and optimistic. The industry members also expressed their concern over the reporting by a business activity of every transaction occurring each day solely to achieve regulation.

Although the joint study team's recommendations would provide access to a comprehensive data base for trade practice investigations and other purposes, concrete results from the study may be years away. Meanwhile, our investigations have shown that trading abuses are occurring and that additional data is needed to enable the Commodity Futures Trading Commission to make effective investigations.

### Transaction timing information

CEA regulations required some form of transaction timing information on all trades executed for customers but did not require timing information on trades executed for the broker's own account or executed for a house account by an officer or employee of the firm. The latter omissions deter any investigation in which the execution time of the trade is critical. Further, even on the trades where timing information is required, such information is not readily accessible in a form to facilitate surveillance.

Since timing information is not required on a broker's personal trades, the abusive practice of a broker's trading for his own account while he has a customer's order in hand is virtually impossible to detect because the time sequence of the broker's trades cannot be determined from the records. This omission bears heavily on the question of whether or not dual trading--trading by brokers, both for customers and for their own accounts--should be prohibited or restricted, which was a matter of concern in congressional hearings in 1973 and 1974 and which was discussed in our interim report. Neither CEA nor the commodity futures trading industry knows the extent of dual trading abuses, and neither can know in the absence of timing information.

For example, we referred 83 trades by 11 brokers at one exchange to CEA for further investigation because it appeared that they were taking the most favorable trades into their own accounts to the detriment of their customers. Brokers are not required to show the execution time for their personal trades or for trades for their firms' accounts. CEA was able to find sufficient timing information for 33 trades to show the brokers had not traded ahead of their customers. For the remaining 50 trades CEA was unable to determine when the trades were executed and therefore could not determine if the brokers had the customers' orders when the personal trades were made.

Trades for a house account could be used for abusive practices in the same way as trades for a broker's own account, and the timing of such trades could be similarly critical in an investigation. The importance of timing information on trades for a house account was also demonstrated by one aspect of CEA's investigation concerning the 1972 Russian wheat sales. There was a suspicion that some large grain houses might have manipulated the closing prices of Kansas City wheat futures to increase the wheat export subsidies, which were recomputed daily on the basis of closing prices. Because the execution time of many of the trades was not recorded, CEA could not, except for one case, establish

whether such trades had affected the closing prices. The Department of Agriculture referred this case to the Department of Justice on May 23, 1973, for its consideration and possible legal action.

The timing of a broker's trades for his own account is also important for surveillance even if he only makes intraday (scalp) trades and does not execute orders for customers. In our report to the Congress "Need to Strengthen Regulatory Practices and Study Certain Trading Activities Relating to Commodity Futures Markets" (B-146770, July 16, 1965), we pointed out that CEA did not know the extent of scalp traders' participation in the markets or their influence on futures prices.

CEA pointed out that scalp traders would tend to accentuate price movements if they were buying on price advances and selling on price declines. CEA told us that it could not measure the influence of scalp traders on futures prices because of the lack of timing information on the brokers' scalp trades.

CEA regulations required some form of timing information on trades for customers, which includes general customers, house accounts where the broker is not a firm officer or employee, and other brokers on the floor. In trades for general customers and house accounts, the order records were required to show the time the order was received and the time a report of execution was made. In trades for other brokers on the floor, the executing broker's trade card must show the time of execution.

In either case, however, the timing information was only shown on the basic trading records and was not shown in the trade register, which was the prime source document for surveillance activities. Since the basic trading records are retained by the various clearing members, the timing information is not readily accessible in a form that can be used for surveillance purposes. The investigator has no source from which to isolate suspect situations involving the timing of trades and would only obtain the basic trading records from the various clearing members if he had some other reason to suspect that an abuse had occurred.

In short, timing information is now required for only a part of the trades, and even for those the information is not required to be readily accessible in a form to facilitate the surveillance function. Since at least 1965, CEA recognized that the absence of transaction timing information on brokers' personal trades impeded its surveillance

function in a number of respects; however, CEA never required such timing information.

All brokers not identified  
in computer records.

At the Chicago Board of Trade and the Chicago Mercantile Exchange, the computerized trade clearing process leaves the opposite brokers for about 14 percent of the trades unidentified in the computer records. This omission hampers the effectiveness of a trade practice investigation using computer techniques, because the computer records are incomplete, and the investigator must manually search out the needed information in the trading records.

Both the Chicago Board of Trade and the Chicago Mercantile Exchange clear trades and prepare trade registers by computer processing. The information on each trade submitted to each exchange clearinghouse identifies the executing broker but does not identify the opposite broker. The trade-clearing process is based on the matching of five factors: commodity, future, clearing member, opposite clearing member, and price. If the total quantities bought and sold at that five-factor control point are equal, all of the trades that are included are cleared. Any trades that remain uncleared at the end of the day are returned to clearing members for reconciliation and resubmission later as trades of a prior date.

Since the trades are cleared by matching opposite clearing members, without regard to the brokers who were on the opposite sides, the exchanges use a "forced match" process to identify the opposite brokers in the trade register as required by CEA regulations. The process used at both exchanges is, essentially, as follows:

- If, at a given control point, there is only one broker who bought or sold, he is identified in the trade register as the opposite broker to all of the opposite trades.
- If, at a given control point, there is more than one broker who bought or sold, the computer process does not identify the opposite broker in the trade register. Each clearing member is responsible for reviewing the trade register and for manually identifying the opposite broker for these trades.

On the basis of our tests of the Chicago Board of Trade trade registers for 3 days in January 1974 and CEA's experience in a 1969 trade practice investigation at the Chicago

Mercantile Exchange, about 14 percent of the trades are cleared without the opposite brokers' being identified in the computer processing.

In 1966 a CEA systems study team was established to develop a system for conducting trade practice investigations using computers. The study team concluded that the exchanges' trade-clearing process would have to be changed for computer-based trade practice investigations to be fully effective. The principal changes recommended were that clearing members identify the opposite brokers in their input to the clearinghouse and that the clearinghouse clear all trades by matching opposite brokers in addition to the five factors that are now matched. This proposed change was intended to eliminate the problems associated with about 14 percent of the trades for which the opposite brokers were not identified under the existing process.

Although it never required the recommended changes to be made in the exchanges' trade-clearing processes, CEA attempted to make trade practice investigations using computers. This computerized investigation program was considered unsuccessful and was abandoned in 1971.

#### Broker-customers not identified

A broker may engage in an abusive trading practice indirectly by having trades for his own account executed by another broker on the exchange floor. In such circumstances, the trade register would not identify the broker-customer for whose account the trade was made but would identify the executing broker as trading for another broker.

Because of the possibility of abuse, the investigator has reason to be suspicious of all trades executed for other brokers but has no means to isolate the specific trades that would warrant review. For such trades, the investigator must contact the clearing member to determine the broker for whose account the trade was executed before he can make a judgment as to whether or not the trade is suspect. This is a time-consuming task that would be eliminated if broker-customers were identified in the trade register.

A CEA study team recommended in August 1971 that such identification be required in the trade registers. The Administrator, CEA, agreed with the recommendation but did not implement it.

### Trade register format

Although CEA regulations required that pertinent information for both sides of each trade be recorded in the trade registers, there was no prescribed format for presenting the information. Consequently, even though identifying the type of customer on the opposite sides of each trade was necessary to isolate many abuses, only one of the five exchanges reviewed showed such information on one record in its trade register. For the other exchanges it was necessary to review the record for each side of a trade to determine the opposite customer types, which was rather a hit-or-miss proposition.

This record problem hinders the effectiveness of attempts to manually screen the trading, because each individual record shows the customer type for only one side of the trade, and the investigator must refer to another record in the trade register to obtain the information on the other side.

The Commodity Futures Trading Commission should act promptly to:

- Require that the time of execution of all trades be recorded and shown in the exchanges' trade registers.
- Require that exchanges identify the broker on both sides of each trade in the exchanges' trade-clearing processes.
- Require that exchanges identify broker-customers in the trade registers.
- Develop a standardized format for presenting information in the trade registers to facilitate market surveillance.

### OUR TRADE PRACTICE INVESTIGATIONS IDENTIFIED POSSIBLE VIOLATIONS

Although our investigations were seriously impeded by the errors and additional information needed in the trading records, we referred to CEA for further investigation 439 trades involving possible violations or abusive trade practices. We also referred two possible cases of speculative trade limit violations. As of December 1, 1974, CEA had investigated 264 of the suspect trades and had referred 175 trades to the exchanges for their investigation. Sometimes CEA expanded its investigation to cover trades in addition to those we referred.

CEA's investigation of the suspected trades referred by us showed that certain of the trades were legitimate; however, for other trades (1) trading and recordkeeping violations were occurring, (2) adequate information was not available to determine whether a violation had occurred, (3) coding errors had falsely indicated violations. CEA had taken, or was considering taking, administrative action on the trading and recordkeeping violations identified. In one of the cases of speculative trade limit violations, the exchange suspended the broker for 380 days on the basis of CEA's investigation of our referral.

We investigated trade practices at the five exchanges to (1) determine whether abusive practices were occurring, (2) identify ways CEA could improve its investigations, and (3) evaluate CEA's method of making its investigations. We have already pointed out that there was a need to improve the exchange records and to make specialized investigations, using computers, putting emphasis on weaknesses in exchanges' surveillance programs.

Violations and abusive practices are occurring and a need exists for making a modified marketwide surveillance effort to enforce the act and to safeguard customers in the futures markets. The Commodity Futures Trading Commission should establish itself as a deterrent to abusive practices by actively seeking out abuses and by taking prompt action against violaters and publicizing the penalties imposed.

#### Abusive practices identified

Most of the suspicious trades were related to brokers' handling of customers' orders. Following are examples of the types of abusive practices that we referred to CEA.

We identified 106 trades where brokers appeared to be taking the opposite side of customers' orders for their own accounts. This practice could result in a broker's benefiting financially at the expense of his customer. It also prevents the customers' opinion of commodity price from having its intended effect on the futures price. At one exchange we identified a variation on the practice of a broker's taking the opposite side of a customer's account. Certain brokers would receive a customer's order, partially fill the order, and pass the unfilled order to another broker in order to take the opposite side.

For example, broker A received an order to sell 100,000 bushels of wheat. Broker A sold 60,000 bushels at \$4.75 a bushel and then passed the remainder of the order to broker B.

Broker B completed the order by selling the 40,000 bushels to broker A at \$4.75 a bushel. The customer might have received a higher price if the trade had been executed competitively in the trading pit.

We referred 50 trades of this type by 3 brokers to CEA. When CEA investigated the trades the three brokers admitted passing the orders to other brokers. CEA believed the brokers may have violated the CE act, CEA regulations, and exchange rules. In a letter dated May 2, 1975, we were told that the investigating office had recommended to the Commodity Futures Trading Commission that the brokers involved be charged with violating the CE act.

We also found 43 trades where it appeared that clearing members were taking the opposite side of the customers' orders. For example, at one exchange we referred to CEA 36 trades by 10 clearing members. CEA found no violations by three clearing members in six of the trades. CEA found that one member (two trades) had violated the CE act and CEA regulations and that the remaining six members may have violated an exchange rule.

CEA referred the trades of one of the six members to the exchange for investigation. The exchange is required to enforce its own rules concerning trading. The exchange initially issued an interpretation that the rule did not apply to the 21 trades for 235,000 bushels of wheat, but this interpretation was later rescinded.

Later, one of the exchanges' regulating committees concluded that the "spirit" of the rule was not violated. CEA officials stated that the exchange's investigation appeared inadequate and its conclusions inappropriate. Of the 21 trades, 19 were made between brokers that were officers of the same firm.

In a letter dated May 2, 1975, we were told that neither the investigating office nor the commodity exchange had found any clear-cut violation regarding the 21 trades. The exchange, however, sent a letter to the firm as a reminder to its officers that all trades must be executed in a competitive manner. The letter stated also that two warning letters and five noncompliance letters had been issued, primarily because of recordkeeping violations, as a result of investigating the 36 trades referred by us.

We referred 34 trades to CEA which had the appearance of wash-trading--buying and selling, or purporting to buy and sell, without actually taking a position in the market.

CEA's investigation of 17 of these trades found insufficient evidence or showed that the brokers were not making wash trades. Some coding errors were identified, and at CEA's request the exchange involved advised its members of the requirement for accurate records. CEA referred the remaining 17 trades to the exchanges for investigation on November 27, 1974.

A key factor in proving wash trades is demonstrating that trades were made at the same price in a relatively short time. The brokers trading cards are not required to show the time their trades were made since the trades were for the brokers' personal accounts. A CEA investigator for 11 of the trades said that it was difficult to show wash trading because the brokers were "scalpers" (brokers that trade on small price changes) and that it was difficult to show they were not making a small profit or loss or were liquidating their open trades before the close of the market.

We referred 18 trades to CEA where the broker appeared to be making more favorable trades for his own account than for his customers. For example, our review of trading in the May 1974 Maine potato futures showed that a customer's order to sell five contracts of May potatoes at the market price was time stamped as received on the exchange at 11:02 a.m. The order was time stamped at 11:25 a.m. when it was reported back to the brokerage firm as executed.

Because the New York Mercantile Exchange had some timing information on trades, our review of the broker's personal trades showed that he had sold two contracts at 11:03 a.m. for his own account at a price of \$12.30. The customer's order to sell five contracts was executed at 11:04 a.m. but at a price of \$12.26--4 cents less than the broker's trade. This 4 cents difference would amount to a possible \$100 loss to the customer. At 11:05 a.m. this broker sold five additional contracts for his own account again at a price of \$12.30.

CEA's investigation did not find any violation on the 18 trades, although one broker's records were incomplete and some coding errors existed. CEA reported that the broker in the above example had said that he did not have the customers' orders when he sold the two contracts for his account. The broker explained that a few minutes could elapse from the time an order was placed until he received it in the trading pit. On the basis of its review of the exchange's timing procedures and related trading records, CEA concluded that the broker's explanation was reasonable.

## Speculative limit violations

CEA established speculative trading limits for certain commodities to curb the trading of persons whose trades might unduly affect prices. Speculative limits cover both the number of contracts that may be bought and sold daily (trading limits) and the number of contracts that may be owned or controlled by one person (position limits). CEA believed that limits on speculative trading and positions are one means of giving economic forces the fullest possible opportunity for maintaining free and competitive markets.

Our investigation at one exchange showed that a broker had exceeded CEA's daily speculative trading limit for corn futures on 2 of the 5 days reviewed. The daily trading limit was 3 million bushels bought or sold by one trader in all futures combined. The trade registers showed, however, that the broker had both bought and sold the following amounts.

<u>Date</u>	<u>Bushels</u>	
	<u>Bought</u>	<u>Sold</u>
	(millions)	
Jan. 7, 1974	3.4	3.2
Jan. 9, 1974	4.4	4.1

Although all the trades were coded as trades for the broker's own account or for an account which he controlled, some of the trades were made for the accounts of two other brokers. The trades for one of the other brokers exceeded 1.1 million bushels both bought and sold on 1 day. Further, in seven of those trades the other broker was on the opposite side of the trades--three times trading for a house account, once for a customer's account, and three times for his own account. The latter transactions appeared to be wash sales, since the same account was on both sides of the trades, which totaled 225,000 bushels of corn.

It thus appeared that the first broker had exceeded the daily speculative trading limit and/or had made accommodation trades for the second broker who, through accommodation, was taking the opposite side of his customers' orders and making wash trades.

CEA's investigation concluded that the broker did not exceed the speculative trading limits because the trades were for another broker and had been improperly coded. CEA's investigation also failed to provide firm evidence to support accommodation or prearranged trading. CEA did show, however,

that the broker had violated CEA's recordkeeping regulations and, we were told on May 21, 1975, that administrative action was under review.

The trade register also showed that on January 7, 1974, another broker had made equal and opposite trades of 285,000 bushels of May and September wheat with two other brokers. Since the broker's trades were equal and opposite, they had no financial or other effect and so had the appearance of prearranged accommodation trades. We referred this case to CEA for followup, and, we were told on May 21, 1975, that a report on the investigation was being prepared.

At one other exchange the trade registers also showed that a broker had exceeded the speculative trading limit for shell egg futures on 2 successive days. The daily trading limit for all futures combined was 150 contracts bought or sold by one trader. The trade registers showed, however, that this broker had both bought and sold the following amounts.

<u>Date</u>	<u>Contracts</u>	
	<u>Bought</u>	<u>Sold</u>
Jan. 23, 1974	277	291
Jan. 24, 1974	219	211

When we referred this apparent violation to CEA for followup, we learned that CEA had been aware of numerous similar violations by the same broker for almost 4 years but had not taken prompt enforcement action. Instead, CEA had constantly added to its information to build a bigger case. The broker had previously violated the daily trading limit for shell eggs on two occasions and had failed to submit required reports in 1969. CEA sent warning letters for those offenses in September, October, and November 1969. CEA's subsequent actions were as follows:

- In February 1970 CEA began another investigation of the broker's trading in shell egg futures.
- In July 1970 CEA completed its work and recommended that a complaint be issued against the broker. CEA's investigation showed that the broker had exceeded the speculative trading limit on 3 days in February and March 1970. The March violations were also noted by the exchange, which fined the broker for violating exchange rules.
- In July 1970 the Director, CEA Compliance Division, requested further development of the trading activities by this broker and his partners.

--In October 1972, some 27 months later, the expanded work on this case was nearly completed when CEA learned that the exchange had fined the broker for improper trading in shell egg futures. CEA again expanded its investigation.

--In July 1973 the work was completed and the case was forwarded to headquarters for issuance of a complaint.

--On May 31, 1974, CEA issued a complaint alleging that the broker, aided and abetted by an FCM of which he was a partner, had exceeded the daily speculative trading limit for shell eggs on 2 occasions in 1969, on 22 occasions in 1970, and on 31 occasions in 1972. The complaint further alleged that over the period the broker had failed to file required reports on 13 days and had filed false or inaccurate reports on 17 days.

The complaint, although strengthened by the additional work that was done, was delayed and was not made a matter of record until nearly 4 years after CEA had evidence of the violation. In the meantime, the broker continued to exceed the trading limit as indicated by the exchange trade registers for the days we reviewed in January 1974. In November 1974 the exchange, acting on the results of CEA's investigation of our referral, suspended the broker from trading for 380 days, beginning December 1, 1974, for 95 speculative limit violations in 1973 and 1974.

On January 8, 1975, the Department issued a consent order, recommended by CEA for violations occurring in 1969, 1970, and 1972, to (1) revoke, effective January 18, 1975, his registration as a floor broker and to prohibit him from trading for 1 year, and (2) cease and desist from violating the CE act as charged.

We believe action should be started as quickly as possible against violators and any penalties imposed should be publicized to deter other potential offenders.

## CONCLUSIONS

CEA's trade practice investigations resulted almost exclusively from complaints or referrals without an adequate effort to aggressively seek out abusive trading practices. The Commodity Futures Trading Commission should continue investigating such complaints or referrals; however, we believe that such investigations are insufficient to deter abusive trading practices or to identify violations. A modified marketwide investigation approach, using computers to review

exchange trade register information, should be implemented to meet this need. These reviews could place emphasis on areas not adequately covered by the exchange's surveillance programs.

From our experience, trade practice investigations cannot now be made effectively because of the errors and omissions in the exchange trading records. Some possible abuses cannot be effectively identified because needed information is not required, and too much effort is wasted in the pursuit of suspect trades because of erroneous information in the records. Also there is no assurance that abusive trades are being properly recorded and are visible in the records.

Because of the voluminous nature of the trading data and the fact that the investigator is looking for trades with certain characteristics which are identifiable from the codings used, the review process of isolating suspect trades can be most effectively made by using computers. We do not advocate a return, however, to the type of marketwide computerized trade practice investigations which CEA had previously performed. Those investigations attempted to review too many aspects of the trading at the same time--some 26 different computer output runs.

We suggest a modified marketwide approach in which the Commodity Futures Trading Commission would use a computerized trade practice investigation capability as part of its surveillance of exchange rule enforcement, putting the emphasis in areas which the exchange may not be adequately covering in its surveillance of trading. If accurate and informative source records are required and computer programs are developed to review the source data and isolate valid suspect cases, we believe that the computer, under those circumstances, would be expected to have a high degree of validity and that suspect cases identified would warrant the cost of followup either by the Commission or by the exchanges on a referral basis. We believe that the benefits derived from such a modified approach would be worth the costs.

The Commission's approach to trade practice investigations should be aimed at establishing a reputation as a visible deterrent to abusive practices. When violations are found, they should be brought to the exchange's attention to demonstrate the deficiency in rule enforcement. Action should be brought as quickly as possible against offenders and penalties imposed should be publicized to deter other potential offenders. There is little deterrent effect when a broker's misconduct is known for several years but action is not taken while accumulating evidence on additional

occurrences of misconduct. In our opinion, the trading community would be better served if action were initiated as soon as there was sufficient evidence that a violation had occurred. Additional occurrences of the same violation could then be treated as repeat offenses and appropriate penalties could be assessed.

RECOMMENDATIONS TO THE CHAIRMAN,  
COMMODITY FUTURES TRADING COMMISSION

The Chairman should improve the effectiveness of trade practice investigations by (1) increasing the accuracy and usefulness of the exchange trading records, (2) instituting a modified marketwide surveillance program with staff capable of using computers, and (3) acting quickly on violations and publicizing penalties imposed. To improve the trading records so that computers can be used effectively, the Chairman should:

- Require each exchange to implement a program of periodic review to insure the accuracy of the trading records.
- Monitor the exchanges' review program, using penalties when necessary, so that the trading records can be used effectively for surveillance.
- Require that the time of execution of all trades be recorded and shown in exchanges' trade registers.
- Require that the exchanges identify the broker on both sides of each trade in the exchanges' trade clearing processes.
- Require that exchanges identify broker-customers in the trade registers.
- Develop a standardized format for presenting information in the trade registers to facilitate market surveillance.

AGENCY COMMENTS

In its letter of March 10, 1975, the Department said that, since the Secretary of Agriculture's authority under the CE act ended on April 21, 1975, the Department did not believe it should comment further or act upon the recommendations unless immediate action, which was not deemed necessary, was required to protect the public.

The Department pointed out that its comments on certain areas--which included trade practice investigations--were furnished in response to our interim report dated May 3, 1974. Those comments have been recognized in this chapter.

### CHAPTER 3

#### IMPROVEMENTS NEEDED IN INVESTIGATING

##### COMPLAINTS FROM THE PUBLIC

CEA's policy was that all complaints received from the public would be investigated and that the complainants would be told of the progress on, and the results of, the investigations. Such complaints were a source of information to CEA in identifying violations of the CE act regarding futures trading. Because investigations of complaints were not being completed and reported promptly, improvements are needed so that such investigations will better serve the public, increase public confidence in the futures market, and deter futures trading abuses.

The Commodity Futures Trading Commission needs to (1) revise the regulations and complaint investigation procedures to facilitate prompt and thorough complaint investigations and (2) establish and enforce standards for completing investigations made by commodity exchanges.

##### REGULATIONS AND COMPLAINT INVESTIGATION PROCEDURES SHOULD BE REVISED

Many of the investigations of complaints CEA received in fiscal year 1973 were not completed promptly. Although CEA attributed most delays to the lack of adequate manpower and, therefore, increased its staff, our review showed that lengthy delays were experienced in obtaining from FCMS information CEA needed to conduct its investigations. In addition, on some complaints, CEA terminated the investigations because complainants failed to respond to requests for additional information. The complainants, however, were not put on notice that their cases would be closed if the information was not supplied.

We believe the delays in obtaining information from FCMS could be reduced by (1) revising the regulations to require FCMS to respond fully and promptly, within a specified time, to requests for needed information and (2) revising the administrative procedures to require greater use of visits by investigators to FCMS. We also believe that, before an investigation is terminated because a complainant has not responded to a request for additional information, the complainant should be informed that the investigation will be terminated if the information is not received by a specified date.

Information not being obtained  
from FCMS promptly

CEA, after obtaining all information needed from each complainant, made a preinvestigation analysis of the complaint to determine what information would be needed to establish whether the allegations were true. When information was needed from FCMS, CEA usually notified them of the allegation and specified the information needed. CEA guidelines provided that FCMS would usually be allowed 30 days to submit the information. CEA could also visit the FCMS to obtain the needed information.

CEA received 245 complaints in fiscal year 1973 and 338 in fiscal year 1974--an increase of 38 percent. The following table shows as of April 30, 1974, the status and age of investigations on complaints received by CEA in fiscal year 1973.

<u>Calendar days</u>	<u>Investigation continuing</u>	<u>Investigation concluded</u>	<u>Total complaints</u>	<u>Percent of total complaints</u>
1 to 90	-	121	121	50
91 to 180	-	50	50	20
181 to 270	-	25	25	10
271 to 360	7	15	22	9
Over 360	<u>20</u>	<u>7</u>	<u>27</u>	<u>11</u>
	<u>27</u>	<u>218</u>	<u>245</u>	<u>100</u>

We recognize that, in some cases, extenuating circumstances might cause long delays in completing investigations. As shown in the above table, however, 74 complaints, or 30 percent, were under investigation from 181 days to over 360 days, including 27 (18 were over 1 year old) complaints which were still under investigation as of April 30, 1974. We believe that such delays are unreasonable.

Most of the complaints received concerned the handling of customers' accounts by FCMS. The allegations included trading for the customers' account without specific authorization; unsatisfactory execution of orders; negligence; cheating; and "churning" of the customer's accounts, that is, trading the account in such a manner as to maximize brokerage commissions.

As of April 30, 1974, CEA had identified 18 violations of the CE act or regulations involving 17 of the fiscal year 1973 complaints. CEA has taken disciplinary action on some of these

violations, ranging from issuing warning letters to instituting formal disciplinary procedures. For example, in August 1974 CEA issued a complaint against two persons involved in 2 of the 17 complaints. One person was charged with acting as an FCM without being registered; mishandling customers' funds; and cheating, defrauding, and deceiving his customers. The second person was charged with acting as an FCM without being registered and with mishandling customers' funds.

We examined the investigation case files of 96 of the 245 complaints received and found that CEA needed information from FCMs on 74 of the complaints. The information usually requested was a signed, written statement from the commodity futures representatives who handled the complainants' accounts and copies of various records relative to those accounts, including monthly statements; transaction confirmations; purchases and sales statements; margin calls; and customer orders.

In 26 of the 74 cases, FCMs took more than 30 days to provide all of the requested information. FCMs took up to 60 days on 10 of the cases; 61 days to 90 days on 6 of the cases; and 112 days to 315 days on the 10 remaining cases. In addition, we noted three cases in which, after delays ranging from 119 to 169 days, the FCM notified CEA that some of the requested records could not be found. For 6 of the 29 cases, FCMs were ultimately cited for various violations of the CE act or regulations, including the failure to retain required records or to make records readily accessible for inspection.

CEA had not given the FCMs deadlines for responding when the information was initially requested on the 29 cases, but CEA had followed up on its request in 26 cases. The number of followup contacts ranged from 1 on each of 10 cases to 4 on each of 2 cases.

Although CEA could request FCMs to submit information, including photographic reproductions of documents and records, the CEA regulations did not provide it with any authority to enforce compliance with these requests. Under the CEA regulations, the FCMs were required only to retain prescribed records and to make these records available for inspection.

We found that the CEA central region made extensive use of visits to FCMs to obtain the needed information, whereas the eastern and western regions relied primarily on mail requests for the information. In fiscal year 1973 the central region was able to complete investigations on 65 percent (80 cases) within 90 days as opposed to 32 percent (19 cases) by

the eastern region and 35 percent (22 cases) by the western region. CEA officials told us that the delays in the eastern and western regions were caused, in part, by higher priority price manipulation investigations in fiscal year 1973.

CEA guidelines provided that each complaint would be investigated by the CEA region having cognizance over the geographical area where the alleged violations occurred. In many complaints against FCMS, the alleged violation involved an FCM's branch office. We found, however, that FCMS generally retained the required information at a central location.

Our analysis of the 245 complaints received by CEA in fiscal year 1973 disclosed that, for about 33 percent of the complaints, the FCMS' records were located in the headquarters city of a CEA region but that the complaint investigation was the responsibility of another CEA region. The following table shows the complaints received in fiscal year 1973 involving FCMS which maintained centralized records in a CEA headquarters city and the CEA region responsible for investigating those complaints.

<u>Investigating CEA region</u>	<u>FCMS centralized records located in</u>		
	<u>New York City</u>	<u>Chicago</u>	<u>Kansas City</u>
Eastern (New York)	36	16	-
Central (Chicago)	20	69	-
Western (Kansas City)	23	21	-

The remaining complaints involved FCMS which maintained centralized records in other locations or were complaints which did not directly involve FCMS.

To assist the responsible regions in obtaining information from FCMS, the Commodities Futures Trading Commission should revise the procedures to provide that such information be obtained by the regional office which can most practicably visit the FCMS' central records locations. Because such visits are not always practicable because of travel costs or other factors, and to further minimize the delays encountered in obtaining needed information from FCMS, the Commission should revise the regulations to (1) require FCMS to respond fully and promptly to requests for information and (2) provide deadlines for FCMS to respond and aggressively enforce these deadlines.

Inadequate followup on some complaints  
received from the public

CEA, upon receipt of each complaint, analyzed and evaluated the allegations. In some instances, CEA found it necessary to obtain more information from the complainant before the investigation could proceed. For 23 of the 245 complaints received in fiscal year 1973, CEA terminated the investigations without giving the complainants notice that their cases would be closed if the requested information was not provided within a specified period.

CEA guidelines did not provide any instructions as to when investigations should be closed due to complainants' failing to provide additional needed information. Officials at the three CEA regions said that followup contacts usually were not made and that the investigations were eventually terminated, subject to reinstatement if the information was subsequently received. These officials stated also that the complainants usually were not informed that the investigation had been terminated.

We believe that when additional information is needed from a complainant, he should be notified that, unless the information is provided within a specified period, his case will be closed. Such notification should induce complainants to respond quickly, or, in any event, allow the case to be closed promptly.

In commenting on this matter on October 24, 1974, CEA officials agreed with our suggestion. CEA revised its procedures, effective October 29, 1974, to provide that complainants be notified that their cases will be closed if the requested information is not supplied within 30 days.

COMMODITY EXCHANGES SHOULD BE REQUIRED  
TO COMPLETE COMPLAINT INVESTIGATIONS PROMPTLY

The CE act required each regulated commodity exchange to enforce its rules concerning contract terms and trading. CEA, as a part of its responsibility to insure compliance with these provisions of the CE act, referred to exchanges for investigation those complaints received which involved possible violations of exchange rules. The CEA guidelines stated that the exchanges usually would be allowed 6 weeks to complete the investigation. We found that, after making these referrals, however, CEA did not take aggressive followup action to insure that the exchanges completed these investigations promptly and that many of the investigations took much longer than 6 weeks.

CEA's investigation of the 245 complaints received in fiscal year 1973 identified 27 complaints which also required investigation by exchanges for possible rule violations. Some of these complaints were combined for referral purposes or were referred to more than one exchange. CEA made a total of 29 referrals, and, as of August 1, 1974, investigations on 5 of these referrals had not been completed even though they had been at the exchanges from 24 to 55 weeks. Five of the 24 completed investigations required less than 6 weeks; however, 11 required from 8 to 23 weeks and 8 required from 30 to 62 weeks.

The exchanges found violations in 13 of the 24 completed investigations, including violations by 11 FCMs and 6 commodity futures representatives. The disciplinary action taken by the exchanges ranged from warning letters to fines and suspensions. The most severe penalty involved an FCM and commodity futures representative found guilty of violating exchange rules regarding a customer's account margins. The FCM was fined \$10,000 and placed on probation for 1 year, and the commodity futures representative was issued a reprimand and ordered to cease and desist from violating those rules.

We found that CEA had not established any date for a response on the fiscal year 1973 complaints referred to the exchanges and did not have any formal followup procedures. In November 1973 CEA began sending to some exchanges monthly lists showing the referrals for which CEA had not received the results of the exchanges' investigations. These lists, which show the date each referral was made, did not, however, require any response from the exchanges.

Although exchanges may have experienced delays in investigating some of the complaints referred by CEA, we believe that aggressive followup by CEA may have resulted in more timely completion of many of these investigations.

CEA promulgated a regulation, effective December 1, 1973, requiring each regulated commodity exchange to have a continuing program of rule enforcement, including:

- Investigation of complaints received from customers concerning the handling of accounts or orders.
- A procedure which results in the taking of prompt, effective disciplinary action for any violation which is found to have been committed.

CEA was developing criteria to evaluate the adequacy of exchange self-enforcement programs and was apprising the exchanges of the standards which must be met to have an acceptable program.

We believe that these standards should require exchanges to complete their investigations within a specified time and that the exchanges should be required to submit a status report periodically with a projected completion date when unforeseen delays occur.

#### CONCLUSIONS

CEA's complaint investigation program--which included investigations conducted by the commodity exchanges at CEA's request--provided a means of assisting individual members of the public and of facilitating the enforcement of the CE act and regulations. We believe that every complaint investigation should be completed promptly not only to quickly identify violations and violators of the act, regulations, and exchange rules but also to instill more public confidence in futures trading and to encourage the general public to file complaints when warranted.

Although CEA increased its staff to handle complaints late in fiscal year 1974, we believe that increased staffing alone may not solve the problem. CEA was experiencing delays in obtaining from FCMS information needed for its investigations. In our opinion the Commodity Futures Trading Commission could help reduce these delays by making appropriate revisions to the regulations and operating procedures.

The Commission should impose time limits for completing investigations of complaints referred to commodity exchanges and should require the exchanges to furnish periodic reports on the status of investigations on these complaints.

#### RECOMMENDATIONS TO THE CHAIRMAN, COMMODITY FUTURES TRADING COMMISSION

The Chairman should complete investigations of complaints promptly to increase public confidence in the futures market and to deter trading abuses. The Chairman should:

- Revise the regulations to insure that FCMS promptly submit information needed in investigations of customer complaints.
- Revise the complaint investigation procedures to provide that the regional office which can most practically visit an FCM central records location obtain needed information to assist the responsible regional office.

--Require exchanges to investigate customer complaints within a specified time and to submit status reports with projected completion dates if delays occur.

AGENCY COMMENTS

In its letter of March 10, 1975, the Department said that, since the Secretary of Agriculture's authority under the CE act ended on April 21, 1975, the Department did not believe it should comment further or act upon the recommendations unless immediate action, which was not deemed necessary, was required to protect the public.

## CHAPTER 4

### IMPROVED CASH-PRICING INFORMATION NEEDED

#### FOR SURVEILLANCE OF FUTURES MARKET

To effectively monitor commodity futures prices, the Commodity Futures Trading Commission needs daily cash price quotations that represent the bulk of various commodity sales in the contract market areas in order to identify unusual relationships between cash and futures prices and to detect price manipulations. The Department's Agricultural Marketing Service (AMS) daily cash price quotations for grains in Chicago, however, are not always representative of such prices but, instead, represent the price that cash merchandisers are paying or would pay for the particular grain at the close of the market each day. CEA used the AMS grain price quotes, but CEA officials believed that their monitoring would have been more effective if the quotes had been more representative of the bulk of actual sales in the area, particularly in Chicago.

AMS price quotations for potatoes were adequate for CEA purposes. Cotton price quotations should be adequate if changes in AMS's cotton-pricing procedures are implemented effectively.

We believe that AMS and the Commodity Futures Trading Commission should coordinate their efforts to determine the best means of developing the pricing information needed by the Commission.

#### AMS GRAIN PRICE QUOTATIONS WERE OF LIMITED VALUE TO CEA

The Chicago AMS office releases cash-pricing information for grains traded in Chicago. For wheat and soybeans, the quotations are based on sales and opinions or values obtained by the AMS price reporter from cash merchandisers at the Chicago Board of Trade. These quotations plus those for corn, oats, and barley are provided daily to CEA central region analysts.

CEA's market surveillance guideline stated that commodity cash prices were the most important indexes for measuring the performance of futures prices and that without such indexes CEA was unable to determine when futures prices were manipulated or exhibited unusual relationships. The CEA Administrator has stated that more representative cash prices are needed to effectively monitor futures markets and to prove price manipulation.

Each CEA regional office was required to maintain a daily cash price record on commodities under its supervision. CEA analysts identified unusual trends in futures prices by observing cash and futures price relationships. CEA relied primarily on AMS to provide daily commodity cash prices for its surveillance.

AMS is responsible for collecting, analyzing, and disseminating timely information on cash market prices for grains, poultry and eggs, fruits and vegetables, livestock, tobacco, dairy products, and cotton. This information is used to develop cash quotations that are released to CEA, major news services, and other users, such as producers, merchandisers, and shippers.

AMS officials stated that the Chicago grain price quotations represented primarily what cash merchandisers at the Chicago Board of Trade said they were paying or would pay for grain in railcars at the close of the market. Such quotes are based on sales and opinions or values obtained from these cash merchandisers.

CEA told us, however, that it could conduct its daily market surveillance more effectively if the price quotations were more representative of the bulk of actual cash transactions in the area.

AMS usually depends on the voluntary cooperation of cash merchandisers for cash-pricing data. In the Chicago grain market, this cooperation was obtained from cash merchandisers on the exchange floor who buy and sell grain. At one time, cash grain was actively traded on the exchange floor; however, the market has diminished and now represents a small percentage of the Chicago cash market. For example, out of 250 trading days in 1973, there were only 27 days when the Chicago Board of Trade had actual transactions for soybeans.

Further, certain grains are shipped to Chicago primarily by truck. Shown below is the percentage of wheat and soybeans shipped to Chicago during calendar years 1972 and 1973 by different transportation methods.

<u>Transportation</u>	<u>Wheat</u>		<u>Soybeans</u>	
	<u>1972</u>	<u>1973</u>	<u>1972</u>	<u>1973</u>
Lake vessel	2.2%	2.6%	-	-
Barge	7.1	10.5	5.5%	5.5%
Rail	22.2	24.2	32.5	27.4
Truck	68.5	62.7	62.0	67.1

We found that the Chicago AMS price reporter for grains was providing CEA with only railcar prices in his daily quotes. After discussing this matter with AMS officials in October 1974, however, we were informed that the reporter should start providing daily truck price quotations to CEA.

We reviewed Chicago cash prices for May 1971 Yellow Hard and Soft Red winter wheat and July 1973 Yellow soybeans, as compiled by CEA for price manipulation cases, and compared them with the AMS quotes for the same period.

For July 1973 soybeans, the AMS quotations differed from weighted average prices of actual transactions obtained by CEA by a dollar or more on 7 of 21 trading days in July 1973. For example, on July 3 the AMS cash quotation was \$7.00 a bushel and the weighted average of actual transactions for 85,352 bushels was \$8.90, a difference of \$1.90 a bushel. Furthermore, the quotations during calendar years 1972 and 1973 usually were different from actual cash prices on the days when cash transactions were reported by the Chicago Board of Trade.

In May 1971 wheat prices were relatively stable in both the cash and futures market since most daily price changes were for 2 cents or less. Yet, even with price stability, AMS quotations differed from weighted average prices by 3 cents or more on most days when actual transaction prices were available from CEA for comparison. Likewise, the 1972 and 1973 quotations for wheat usually were different from actual cash prices on the days when the Chicago Board of Trade reported cash transactions.

AMS officials, in commenting on the price differences in the July 1973 soybeans, said that some of the differences might have resulted from AMS's and CEA's contacting different sources during this period, which was a time of wide price fluctuations. They also thought that there may have been a lag in CEA prices compared to AMS prices because the AMS reporter obtained verbal quotes from his sources, whereas CEA obtained actual sales documents which may have been dated 1 or 2 days after the actual sale.

We acknowledge that there were wide price fluctuations during the period involved, but such fluctuations could not account for the large differences in CEA and AMS prices. Also a comparison of AMS and CEA prices, assuming a 1-day lag in CEA prices, showed that, although the differences were reduced, they were still significant (8 of the days showed differences ranging from 56 cents to \$1.08). AMS officials believed that more information on what actually caused these differences was needed because such large

differences may indicate the need for a new approach to price information gathering for one or both agencies.

AMS price quotes are of limited value if they do not represent a precise assessment of the going market value of grain in trade. CEA believed that it could be more effective if there was available a daily cash price that approximates the weighted average price computed by CEA for price manipulation cases. As an example, CEA officials cited their surveillance and investigation of the July 1973 soybean futures. They explained that an unusual disparity between AMS cash quotations and futures prices in July 1973 was one of the factors that encouraged the central region to initiate a price manipulation investigation.

CEA's investigation discovered, however, that a weighted average of actual transactions during July 1973 showed that there was less difference between cash and futures prices than originally believed. In this instance, a comparison of the AMS quotations and futures prices gave a false indication of price artificiality in the futures market.

In Kansas City, the AMS price reporter quoted cash prices for corn and wheat generally on the same basis as the Chicago reporter. Unlike the Chicago quotations, however, the AMS cash quotes in Kansas City were usually within the range of actual cash prices developed by the Kansas City Board of Trade. We were unable to compare the AMS cash price quotations with a CEA weighted average price because CEA had not developed such prices in Kansas City.

AMS headquarters officials, in commenting on this matter in November 1974, said that AMS was seriously concerned about the apparent narrow information base used in Chicago for the daily wheat and soybean cash price quotations. They said that over the years the volume of grain moving daily in Chicago had greatly diminished and that it was doubtful whether the price information base was still viable. AMS has requested the Department's Economic Research Service to study this problem.

AMS is exploring the possibility of reporting cash transactions at subterminal markets which it believes should better represent the price information that the Commission needs. AMS pointed out, however, that implementing such reporting would require a moderate increase in its grain market news staff.

#### POTATO PRICE QUOTATIONS AND REVISED COTTON QUOTATIONS ARE ADEQUATE

The AMS price reporter for potatoes was located in Presque Isle, Maine. His daily cash price quotes were based

on actual potato sales price information obtained from dealers. He verified the price information from the dealers by contacting several volume buyers. CEA officials stated that the AMS system for obtaining potato cash prices had functioned effectively and that the daily cash quotes were adequate for monitoring futures prices.

Certain factors made it difficult for CEA to use the AMS cotton quotations. For example, during price manipulation investigations of cotton futures, CEA found that sometimes cottons quotations lagged actual market values. Unlike grain quotations, AMS cotton quotations are based on prices determined by quotations committees which are established pursuant to law.

After comparing the Memphis cash quotations with sales records of selected cotton merchants, CEA concluded that, between November 1971 and February 1972, there was about a 1-week lag in accepting higher prices in the cash market because cotton quotation committee meetings were not held daily and because some committee members were reluctant to make quotation changes.

In July 1974 AMS made two major changes in the cotton quotation committee's procedures for establishing and reporting daily cash quotations. First, quotation committees will meet at least twice rather than once each week. Secondly, committee members will be contacted each business day to determine the prices to be quoted.

We believe the changes in procedures, if properly implemented, will make the price quotations adequate for monitoring cotton futures prices.

## CONCLUSIONS

To effectively monitor the largest grain futures markets, the Commodity Futures Trading Commission needs cash price quotations that represent the bulk of actual cash transactions in the area, such as a weighted average price. AMS grain price quotations primarily represent what cash merchandisers are paying or would pay for grain at the close of the market. Although such prices may be useful to other AMS clients, they are of limited value to the Commodity Futures Trading Commission because they do not approximate a weighted average of cash prices paid. The Commission needs quotations representative of actual cash prices paid to effectively do its daily market surveillance activities.

Because of the Commission's important market surveillance function, and because AMS has the greatest expertise in

obtaining grain cash prices, we believe that these two agencies should work together to provide the Commission with the price data it needs to work effectively.

RECOMMENDATIONS TO THE CHAIRMAN,  
COMMODITY FUTURES TRADING COMMISSION

To improve the daily monitoring of futures prices and to more effectively detect and prove price manipulations, the Chairman should work with the AMS Administrator to determine the specific cash-pricing information needed from AMS for effective surveillance over grain and other futures prices. The Chairman should work with other Federal agencies to insure that they have adequate cash-pricing information for all other commodities traded in the futures market.

AGENCY COMMENTS

In its letter of March 10, 1975, the Department stated that it recognized the need that the Commission would have for the best possible cash price information on commodities traded on futures markets and that AMS was exploring methods to improve cash price information and had requested the Department's Economic Research Service to study the problem. The Department stated it would instruct the Administrator, AMS, and the Department's liaison officer with the Commission to work closely with the Commission and to provide, to the best of its ability, the type of cash-price information that would meet the Commission's needs.

## CHAPTER 5

### REDIRECT THE AUDIT FUNCTION TO AN OVERSIGHT ROLE

In our interim report we stated that CEA had used considerable manpower on audits of FCMS to insure that customer funds were properly segregated and that FCMS met minimum financial requirements. We recommended that the Secretary of Agriculture direct the Administrator, CEA, to consider giving the exchanges primary responsibility for these audits, thus redirecting CEA's function to a strong oversight role. We suggested that the exchanges could make greater use of independent public accountants and of their own staffs in fulfilling this responsibility.

The Department, in disagreeing with our recommendation, said that independent public accountants' reports could not be relied on and that the exchanges' audit staffs were not working at an acceptable level and there was no indication that the staff would work better with an expanded role. We stated in our interim report that, because of the importance of this audit function in protecting customers, we were continuing our inquiries into this matter and planned to comment on it further in our final report.

On the basis of our further inquiries, we continue to believe that the exchanges should be delegated the primary responsibility for audits of FCMS. We recognize that the transfer of this audit responsibility cannot occur within a short period because the exchanges do not have the capability to adequately carry out this function. The Commodity Futures Trading Commission, however, should start working toward this goal.

To assist the exchanges in assuming this audit responsibility, the Commission should require FCMS to engage independent public accountants to make the required audits and to furnish reports on the results of these audits to the cognizant exchange and to the Commission. The Commission should provide the exchanges and auditing firms with guidelines and procedures for making these audits.

The Commission could then fulfill its oversight responsibility by auditing FCMS as necessary to test the reliability of the independent public accountants' work and by making comprehensive reviews of the exchanges' financial compliance activities. By redirecting its audit role, the Commission could concentrate more on known or suspected noncompliance cases and could increase its work in other enforcement areas.

In carrying out its responsibilities for regulating securities broker-dealers, the Securities and Exchange Commission (SEC), which has responsibilities similar to those that CEA had, directs its auditing work to an oversight role, and places primary responsibility for this function with the securities exchanges.

### CEA'S AND EXCHANGES' AUDIT REQUIREMENTS

To insure the adequate protection of customers' funds, the CE act required FCMS to meet minimum financial requirements at all times and to separately account for customers' funds invested in regulated commodities and specified that these funds not be commingled with other funds. CEA attempted to audit all FCMS each year to insure compliance with the segregated fund provisions of the act. CEA completed a total of 222 audits during fiscal year 1974.

CEA's minimum financial requirement audits were limited to those FCMS that are not members of the Chicago Board of Trade or the Chicago Mercantile Exchange. These two exchanges, whose memberships account for about 75 percent of all FCMS, were approved by the Secretary of Agriculture to enforce their own financial requirements against member FCMS. CEA monitored the two exchanges' programs for enforcing their minimum financial requirements. In this regard, CEA had already accepted an oversight role.

As pointed out in our interim report, CEA's regional professional staff was spending about 25 percent of its time making audits of FCMS. CEA estimated that, under the new futures trading legislation, which extends Federal regulation to all commodities traded in the futures market, it would need 15 additional employees at an estimated salary cost of \$206,000 to conduct audits of newly registered FCMS. These 15 employees represented an increase of about 58 percent in CEA's auditing staff.

To assist them in their enforcement duties, the Chicago Board of Trade and the Chicago Mercantile Exchange require their members to submit periodic financial statements, including annual financial statements certified by an independent certified public accountant (CPA) or financial statements submitted to, and according to the requirements of, the New York, Midwest, or American Stock Exchanges. The financial statements submitted by FCMS include a comparison of segregation requirements with segregated funds on deposit. Copies of these statements were also required to be submitted to CEA for monitoring the exchanges financial requirements enforcement programs.

FCMs who were not members of either of these two exchanges were required to submit, semiannually, financial statements to CEA that also include a comparison of segregation requirements with segregated funds on deposit.

Because most FCMs already use independent public accountants in the financial requirements and segregated fund audit areas, it appears practicable to extend or modify the public accountants' work to conform to audit procedures and guidelines furnished by the Commission.

Our suggestion to use public accounting firms more extensively is similar to one made by the Department's Office of Audit in a September 1971 report on CEA operations. The report recommended that CEA, in auditing FCMs, rely as much as possible on reports from independent public accountants or reports required by SEC. The report expressed the opinion that protecting customer funds was a responsibility of the exchanges and that CEA should place emphasis on insuring that exchanges can enforce the CE act minimum financial requirements and funds segregation provisions.

#### AGENCY COMMENTS AND OUR EVALUATION

The Department disagreed with our proposal to use public accounting firms more extensively, particularly with regard to segregated funds audits. The Department said that other regulatory bodies also indicated that CPA statements cannot be relied on. The Department said that in "A Report on the Auditors of Wall Street," dated July 1971, the Assistant Attorney General of the State of New York concluded that far too much management influence pervades the auditing function in the securities business.

Regarding the exchanges' audit staffs, the Department said that the staffs of the two largest exchanges were working at less than an acceptable level and that there was no indication that such staffs would operate at a more acceptable level if given an expanded role.

Regarding our view that CEA should be placed in a strong oversight role, the Department said that any oversight procedure which did not involve independent audits of brokerage firms on more than a sampling basis would be ineffective. CEA believed that such audits were necessary to determine whether the exchanges were protecting customers' funds and to develop evidence to prosecute exchanges that were failing to do so.

We recognize, as is evident from our interim report, that the work of the exchanges' audit staffs has been

inadequate. We also recognize that the Department is not fully satisfied with the results of some CPA audits of brokerage firms. We believe, however, that it is unrealistic and unreasonable to assume that improvements cannot be made by taking an aggressive role with the exchanges and by providing the exchanges and independent accounting firms with guidelines and procedures for making the required audits.

The auditing work might not be noticeably reduced at first because of the need to (1) continue to make audits of FCMs to determine whether the public accountants' reports on such FCMs are reliable and to insure that the audits follow the procedures and guidelines and (2) make periodic reviews of exchanges' compliance activities and work with the exchanges to improve the capability of their audit staffs. We believe that the Commission could redirect the audit function over a period of time to a strong oversight role without loss of effectiveness in the protection of customers' funds. Such a role should be the Commission's goal.

As stated in our interim report, all approved exchanges should be capable of insuring that their member FCMs comply with the CE act and regulations. CEA has stated that an exchange's lack of resources is not adequate justification for failing to enforce trading rules. We believe the same reasoning should be applied to exchanges' enforcing of segregated fund and minimum financial requirements. It is not reasonable to expect the Government to continue bearing these costs which should be considered as a necessary cost of the exchanges' doing business.

Using independent public accountants for auditing brokerage firms has been an established practice of SEC since its legislation was passed 40 years ago. SEC's philosophy is in direct contrast to that of CEA. SEC's regulatory approach has always emphasized the maximum use of the public accounting profession. SEC does not make routine audits of brokerage firms under its jurisdiction but, instead, requires that these firms be audited annually by independent public accountants. On a sample basis, SEC reviews the audited firms to check the accountants' work.

In commenting on the alternative to SEC's current reliance upon the performance of public and corporate accountants, an SEC commissioner, in June 1974, said:

"The alternative, a corps of federal auditors, which was wisely rejected by the Congress in 1933, remains as objectionable now as it was then. In fact, I think it has become unthinkable."

An SEC official said that SEC was bringing more disciplinary actions against public accounting firms, as indicated in CEA's comments, but that SEC was seeking to raise the work standards of the public accounting profession rather than increase the use of Federal auditors. We believe that the Commission should adopt such an approach.

The Chairman, Committee on Stockbrokerage Auditing, American Institute of Certified Public Accountants, in commenting on our proposal and on the position of CEA, stated that independent CPAs were uniquely qualified by education, professional training, and experience to perform examinations of financial condition of FCMs and of their compliance with prescribed financial standards, including the calculation of segregation of customer funds as specified by the CE act.

The Chairman stated also that CPAs are making reviews of compliance with CEA requirements in connection with their annual audits of securities broker-dealers pursuant to SEC requirements. He believes that procedures for reviewing an FCM's financial condition, net capital requirements, and segregation of customer funds can be done more effectively in conjunction with a CPA's examination of the FCM's financial statements.

#### CONCLUSIONS

We believe that the Commission should place primary emphasis on insuring that the exchanges can enforce the minimum financial requirements and funds segregation provisions. Even though CEA's regulatory philosophy was self-regulation by exchanges, and, in fact, the two largest exchanges are already responsible for enforcing their minimum financial requirements, CEA, by auditing each FCM's segregation funds, had assumed full responsibility for determining FCM's compliance with the segregated fund provisions of the CE act and regulations.

We believe that it is both practical and desirable to have the exchanges assume primary responsibility for enforcing the segregated fund and minimum financial requirements. The Commission should assist the exchanges by working with them in developing the necessary staff capability and by requiring FCMs to furnish the exchanges and the Commission with reports, attested to by independent public accountants, on audits of segregated funds and financial requirements. Such audits should be made in accordance with guidelines and procedures furnished by the Commission.

This assumption of responsibility should occur gradually because the Commission should do whatever is necessary,

including audits of FCMs, to insure that the exchange has capable audit staffs and that the reports by independent public accountants are reliable and accurate.

The approach to these audits should be similar to that of SEC, whose practice is to make maximum use of professional accountants to satisfy its auditing requirements and to improve the standards of such audits, where necessary, rather than having the Government assume the entire burden. It is not reasonable to expect the Government to continue bearing audit costs which should be considered by an FCM as a necessary expense of doing business.

Both CEA and independent public accountants did segregated fund audit work at FCMs, although CEA's audits were more detailed. By having public accountants do this audit work according to Commission guidelines and procedures, much of this duplication would be eliminated.

#### RECOMMENDATIONS TO THE CHAIRMAN, COMMODITY FUTURES TRADING COMMISSION

The Chairman should redirect the Commission's audit function to a strong oversight role and transfer the primary responsibility for enforcing the required financial provisions and regulations to the exchanges. To assist the exchanges in assuming this responsibility and to insure the continued effectiveness in the protection of customers' funds, the Chairman should:

- Develop and issue guidelines and procedures for audits of FCMs by independent public accountants and exchanges.
- Require all FCMs to engage independent public accountants to annually conduct minimum financial requirements and segregated funds audits and to furnish copies of reports on the results of such audits to the Commission and the cognizant exchanges.
- Test the reliability and accuracy of the public accountants' audit reports through audits of FCMs when necessary.

#### AGENCY COMMENTS

In its letter of March 10, 1975, the Department stated that, since the Secretary of Agriculture's authority under the CE act ended on April 21, 1975, the Department did not believe it should comment further or act upon the recommendation unless immediate action, which was not deemed necessary, was required to protect the public.

The Department pointed out that its comments on certain areas--which included the transfer of primary audit responsibility--were furnished in response to our interim report dated May 3, 1974. Those comments have been recognized in this chapter.

## CHAPTER 6

### PARTICIPATION OF SPECULATORS IN THE FUTURES MARKET

Both the Congress and the public showed great concern over the unprecedented price increases in 1973 for commodities in the cash and futures markets. Much of this concern centered around the participation of speculators in the futures market and the extent to which they may have contributed to the rise in prices. Concern was also expressed that large traders may have acted together to raise prices in the soybean futures market.

Various supply and demand factors, such as adverse weather conditions that affected crop production and unanticipated purchases by foreign nations, appeared to be primarily responsible for the record-high commodity prices in 1973. The overall participation by speculators in the futures markets of seven selected commodities in 1973--as measured by the number of open contracts held--was, in most instances, generally less than in 1972 but participation by hedgers was generally more. In addition, although our analysis of a 3-day period of increasingly high soybean futures prices did not indicate a concentrated effort by traders owning large numbers of soybeans contracts to raise such prices, it did indicate that a large number of small traders were buying more contracts than selling, which would tend to exert pressures on prices.

### SUPPLY AND DEMAND FOR COMMODITIES

The record high prices in 1973, in our opinion, were attributable primarily to various supply and demand factors. A list of the major factors follows.

- Adverse weather and Russia's commitment to increase its meat output were largely responsible for that nation's unexpected purchase of wheat, corn, and soybeans from the United States.
- A drought, the worst in 20 years, befell India and areas of Africa. The result was a sharp reduction in peanut production, the world's third most important source of protein meal. Poor weather conditions in India and in areas of Africa lowered rice and coarse-grain production resulting in a requirement for wheat to meet food needs.
- A shift in ocean currents caused Peruvian fishmeal production to be largely reduced, roughly equivalent to 125 million bushels of soybeans.

- Heavy fall rains across much of the United States' major soybean-producing areas delayed harvests, destroyed thousands of acres of soybeans, and sharply reduced yields on hundreds of thousands of other acres.
- Adverse weather conditions delayed corn harvests until well into February 1973. Wet weather in the 1973 spring delayed land preparation and seedings in the Central States and led to concern about the size of the 1973 crop.
- Severe weather conditions during the winter in some areas of the United States, together with storms and flooding in the spring, resulted in unusually high death losses in calves and other young cattle. Possibly as many as 250 thousand cattle were lost in April alone.
- Dollar devaluations by the United States contributed to some increase in foreign demand. Some of the demand-dampening effect that would otherwise have been expected from rising price levels was reduced by the devaluations.
- Sharply higher feed prices, record high capital costs, high interest rates, retail price ceilings on meat, and uncertainties in the feed and livestock markets resulted in hog producers' altering previous intentions to expand production.
- Substituting lower protein feed in cattle rations because of the high cost apparently resulted in the rate of weight gain for cattle to be lower during 1973.
- Heavy rains and hurricanes during August and September 1973 caused harvesting delays and resulted in reduced yields and lower quality for cotton.
- Foreign demand for cotton increased sharply during a period of mid-1973 in anticipation of export controls.
- Increased exports of pork, especially to Japan, tended to tighten supplies, though the increase was not large in relation to domestic production.

This combination of supply and demand factors which resulted in large decreases in the world supply of previously plentiful grains and livestock at the same time that the world demand for more and higher protein foodstuffs was

increasing resulted in an unprecedented demand and thus sharp and dramatic price increases. Certain changes in policy by major countries, such as Russia's decision to increase beef production to satisfy consumer demand and the U.S. decision to devalue the dollar, resulted in further strains on the world food supply and in higher prices.

An additional factor which, in our opinion, also contributed to the price rise is the close interrelationship of the various commodities. Most of the commodities may be substituted for each other or are dependent on others. For example, the reduction of Peruvian fishmeal production resulted in a demand for a comparable high protein substitute--soybeans. At the same time, some countries were bowing to citizens' demands for more meat products, and soybeans are a prime ingredient in livestock feed. As the price of soybeans increased, the demand for lower protein substitutes--such as wheat and corn--also increased and thus placed increased demands on the world supply of these commodities and caused price increases.

In our opinion, this combination of supply and demand factors which occurred within a relatively short period was the primary cause of the increased prices. Moreover, cash prices generally were higher than futures prices during the period of price increases in 1973. This is an abnormal relationship between cash and futures prices caused by extreme supply shortages. In previous years, when supplies generally were surplus to needs, futures prices were higher than cash prices. Such a situation is referred to in the trade as a normal market because it is expected that the price of contracts for future delivery will exceed cash prices by at least an amount to cover carrying charges, such as the cost of storage, transportation, and insurance.

#### ANALYSES OF PARTICIPATION IN SELECTED COMMODITY FUTURES

We selected seven commodities--soybeans, wheat, corn, cattle, pork bellies, hogs, and cotton--and compared, for 1972 and 1973, the extent of participation in the futures market by speculators, hedgers, and nonreporting traders. CEA required traders who owned futures contracts over a certain amount to report their holdings and to classify their positions as either speculative or hedging. Traders who hold contracts under the amount required for reporting generally are small speculators, according to surveys made earlier by CEA. The holdings of these nonreporting small traders is the difference between the total open contracts and the sum of reported holdings of speculators and hedgers.

Our analyses did not consider if hedgers were using the futures markets for speculative purposes; however, we believe that the question should be considered as a possible research area by the Commodity Futures Trading Commission. (See ch. 7.)

Commodity market analysts consider an analysis of open interest to be the single most meaningful measure of the extent of participation by traders in the futures markets. Open interest represents the number of futures contracts that have not been canceled by an offsetting purchase or sale of a futures contract or by actual delivery of the commodity. A form of open interest commonly used in making analyses of trader influence on the futures market is net open interest. Net open interest differs from open interest by excluding the simultaneous holding by a trader of a position in a futures contract while holding an equal but opposite position in another futures contract for the same commodity.

These simultaneous holdings are excluded in a net open interest analysis because speculators taking these offsetting positions are concerned only with the differences in the prices between futures contracts and not with the overall commodity prices.

Our review was directed toward the long or buying side of the futures market because, in a period of rising prices, traders on the long side are the ones who will profit by an offsetting sale at a higher price. The following table shows a comparison of the average 1973 and 1972 percentages of net long open interest held by traders in the selected seven commodities. It shows that generally speculators and nonreporting traders participated no more, and quite often less, in the 1973 futures market than in 1972. Conversely, hedgers often participated more in the futures market in 1973 than in 1972.

Comparison of Average 1973 and 1972 Percentages  
of Net Long Open Interest Held by Traders

Commodity:	Speculators			Hedgers			Nonreporting traders		
	1972	1973	Difference	1972	1973	Difference	1972	1973	Difference
Soybeans	9	5	(4)	51	70	19	40	25	(15)
Wheat	10	10	-	47	53	6	43	37	(6)
Corn	8	8	-	55	66	11	37	26	(11)
Cattle	23	26	3	12	8	(4)	65	66	1
Pork bellies	21	20	(1)	2	3	1	77	77	-
Hogs	28	26	(2)	5	3	(2)	67	71	4
Cotton	4	8	4	50	58	8	46	34	(12)

Possible reasons for the reduced involvement by speculators and nonreporting traders in 1973 may have been:

--Actions by exchanges to increase permissible daily price movements which for soybeans were raised by 300 percent and for commodities, such as corn and wheat, were suspended.

--Uncertainties regarding supply, demand, and Government actions.

These reasons apparently created a larger risk of loss than many speculators wished to incur. The increased permissible daily price movements also provided a greater opportunity for (1) traders, primarily hedgers, to offset their short positions during the periods of sharp price increases and (2) futures prices to rise to a more realistic level in relation to the higher cash prices. In addition, speculators may have been discouraged from participating in the futures markets by the exchanges' requiring higher margin deposits to protect brokerage firms against losses incurred by customers due to adverse price movements.

Hedgers' overall involvement in 1973 on the long side was greater than in 1972 because of several factors, such as the increase in export sales and the anticipated shortages in many of these commodities. These factors caused increased use of futures markets by hedgers to offset possible increases in the prices of the commodities. Generally, hedgers on the long side would have profited from such futures transactions; however, their profits could have been offset by the purchase of the higher priced commodities in the cash market.

We analyzed the activity of speculators, hedgers, and nonreporting traders during periods of sharp price increases for each of the seven commodities to determine whether any one group was influencing the price rise. We found that speculators were selling more futures contracts than they were buying for soybeans, corn, cattle, pork bellies and hogs. Selling usually eases upward pressure on prices. In cotton and wheat, where speculators were buying more than they were selling, our analysis indicated that they were trying to limit their losses because they were predominately on the short side of the market.

Nonreporting traders were buying more than they were selling during periods of sharp price increases in all of the commodities, except corn and cotton; however, our analyses again indicated that generally they were buying to reduce their short positions in the market and thus reduce losses.

Hedgers generally were selling in soybeans, wheat, cattle, and hogs and were buying in corn, pork bellies, and cotton during periods of sharp price increases. In corn and pork bellies, the hedgers' buying resulted in reducing their short positions but in cotton they were increasing their long positions which would add more buying pressure to the market.

#### ANALYSIS OF SOYBEAN TRADING

Due to the especially large rise in soybean prices during 1973 and the concern expressed by some people that large traders may have acted in concert to raise soybean prices, we reviewed soybean futures trading for a 3-day period--May 31, June 1 and 4, 1973--during which time prices greatly increased. For example, the price of the July 1973 soybean future rose from \$9.84 to \$12.11, an increase of \$2.27. (See app. II.) Our analysis of open interest positions and volume of trading, as well as of the trading activity of selected large traders, showed no indication that a group of traders acted in concert to raise soybean prices during that 3-day period.

We analyzed the trading activities of 55 speculators and 26 hedgers who had open interest positions in soybean futures of 500,000 and 1,000,000 bushels or more, respectively, because they would be affected the most by price changes.

During the 3 days reviewed, the 55 speculators held over 80 percent of the long and short open interest positions and accounted for over 70 percent of the buy and sell volume of all speculators. The 26 hedgers accounted for similar percentages of the open interest and volume of trading of all hedgers.

During the 3 days the 55 speculators held larger short positions than long positions and sold more contracts than they bought. Moreover, the 10 speculators holding the largest net long positions also reduced these positions by selling more than buying. Consequently, we believe that speculators were not applying significant buying pressure in the market to drive up prices.

During the 3 days the 26 hedgers held larger long positions than short positions but reduced their long positions by selling more contracts than they bought. In addition, 10 of the hedgers had net long positions during each of the 3 days but were net selling as a group. Moreover, the three hedgers with the largest net long positions were each net selling for the 3-day period. This would not be indicative of an effort to raise prices.

Nonreporting traders, the largest in number of the three groups of traders, were net short during each of the 3 trading days. Our analysis showed that the overall actions of these traders during the 3-day period was withdrawal from the market by buying contracts. This would exert an upward pressure on prices.

## CONCLUSIONS

Rising prices in the seven commodity futures markets reviewed for 1973 appeared to result from strong foreign and domestic demands and uncertainties about available supplies throughout the world. The number of open contracts held by speculators in the seven commodities generally was less than during the relatively normal price year of 1972. Agency officials with whom we discussed this chapter and our consultants agreed with the results of our analyses and our overall conclusion that speculators were less involved in the futures markets in 1973 compared to 1972.

Hedgers' overall involvement in 1973, however, generally was greater than in 1972 because of such factors as the increase in export sales which resulted in hedgers' making greater use of the futures markets to offset commodity price increases.

Our analysis of soybean trading during a 3-day period of high price increases showed that hedgers and speculators sold more contracts than they bought during the period which would not be indicative of an effort to raise prices. Also, our analysis did not indicate that traders owning large numbers of futures contracts acted in concert to raise soybean prices during the 3 days reviewed. Nonreporting traders, however, were buying more than selling during the 3 days which would tend to exert an upward pressure on prices.

As indicated earlier in the chapter, one area of concern is the extent to which hedgers may be using the futures market to enable them to speculate. Also, it is possible that the movement in futures prices were accentuated at times by the behavior of commodity traders who were uncertain about market changes and were influenced by prevailing buying and selling sentiments. Our analysis was directed to a few specific market activities, and we believe that it is important for the Commodity Futures Trading Commission and the public to understand more fully the influence of speculators, hedgers, and nonreporting traders on the futures market. The Commission should make studies of such activities so that it can properly carry out its regulatory functions. (See ch. 7.)

## CHAPTER 7

### FORMAL RESEARCH PROGRAM NEEDED TO IMPROVE

#### OPERATION AND SURVEILLANCE OF FUTURES MARKETS

The Commodity Futures Trading Commission Act of 1974 requires that the Commission establish and maintain, as part of its ongoing operations, research and information programs to (1) determine the feasibility of trading by computer and the expanded use of modern information system technology, electronic data processing, and modern communication systems by commodity exchanges, boards of trade, and by the Commission itself for purposes of improving, strengthening, facilitating or regulating futures trading operations, (2) assist in developing educational and other informational materials regarding futures trading for dissemination and use among producers, market users, and the general public, and (3) carry out the general purposes of the act.

The act also requires the Commission to report annually its plans and findings for implementing research and information programs to the Congress.

On the basis of our overall review work, we believe that a formal research program is necessary if the Commission is to improve the surveillance of the futures markets. The principal aims of such research should be to increase the Commission's knowledge and understanding of the growth and development of futures markets so that it can (1) instill greater public confidence in futures trading by educating the market users and the public on the operations of futures markets and (2) expand its base of knowledge to enable it to continually improve its regulation of the markets.

The following sections of this chapter describe the types of research and analytical studies that have been done by CEA and some areas that we believe require research or study.

#### CEA's RESEARCH EFFORTS

CEA was uniquely equipped to do much useful research work in futures trading because it had access to large amounts of trading data that are unavailable to other people. CEA's research efforts were limited primarily to surveys of selected futures markets, special studies, and several analyses and technical studies under contractual or cooperative agreements with universities. These surveys and studies were undertaken as part of CEA's economic analysis program but were made only when staff was available.

The economic analysis program's primary responsibility was developing economic information and evidence on possible price manipulation cases. Program priorities and goals were established annually for the next fiscal year, but market surveys and special studies by CEA were deferred or delayed when situations developed involving suspected or actual price manipulations. The market analysts who made the surveys and special studies were also responsible for investigating suspected price manipulations which had a higher priority. Consequently, CEA's research activities were limited to whenever market analysts were available.

In July 1973 CEA issued a special report on trading on the Chicago Board of Trade which discussed (1) the relative importance of different types of traders, (2) the volume of trading at different rates of commission, (3) the volume of trading by board members and nonmembers, and (4) the amount and source of commission income to brokerage firms. This study was the first of its kind in over 50 years and the information developed could be useful in regulatory activities.

Since 1971 CEA had not issued a market survey report on any specific commodity. Market survey reports show the detailed composition of a specific commodity market as to the geographic location of trades, size of positions, and the amount of speculative or hedging holdings by traders in the market on the survey date. The surveys provide certain background and marketing information of interest to futures traders, growers, processors, and the general public to aid in understanding the market.

Because it had no formal research program, CEA relied on its daily marketing surveillance program to keep informed on the operations and performance of the various contract markets and the respective commodities. We believe, however, that such information was not adequate and that a formal research program is needed. Moreover, with all futures trading subject to regulation under the new act, it is vital that the Commodity Futures Trading Commission develop the information and expertise necessary to regulate these markets effectively and to provide information to the public in such areas as foreign influence in the futures markets.

#### SELECTED AREAS NEEDING RESEARCH

Many areas in the futures markets need to be researched and obviously some order of priority will need to be established by the Commission since not all markets, questions, or areas can be studied at once. The following areas are subjects which were of concern during our review or were

brought to our attention by experts in the futures markets and which we believe should be given consideration in establishing the Commission's research priorities.

### Foreign influence in the futures markets

Much concern was expressed by various members of the Congress and others about the effect that foreign powers could have--either directly or indirectly--on the futures markets and hence on food prices. The ability of foreign governments to deal separately and simultaneously with several large U.S. exporters, such as Russia did in its huge purchase of U.S. wheat in 1972, could enable them to distort or manipulate commodity markets. A direct effect on the futures markets may occur when large exporters hedge their foreign sales by buying futures contracts; however, there is no requirement that such hedges be identified as related to foreign sales.

Although the Department began requiring U.S. exporters to provide information on export sales weekly and then daily as a means of evaluating foreign demand, such after-the-fact information did not prevent Russia from again purchasing large amounts of grains from U.S. exporters on October 3 and 4, 1974. As a result of the daily reporting system, however, the Department learned of the sales, and the Administration intervened on October 7, 1974, and the grain companies deferred, and later reduced the amount of the sales.

On October 7, 1974, amid mounting concern over the adequacy of domestic supplies, the Department requested U.S. exporters to cooperate in a voluntary system to obtain approval from the Department before making export sales of grains exceeding certain specified quantities. Such requests for prior approval, however, were only voluntary on the part of exporters, and the reporting system's effectiveness was a matter of concern.

The Department's program for voluntary prior approval of export sales was ended on March 6, 1975, because the supply situation had eased. The Department will continue, however, to require export firms to report within 24 hours all export sales of grains, soybeans, and soybean meal of 100,000 metric tons or more as well as weekly reporting on all export sales.

Foreign nations, firms, or individuals may also take direct positions in the futures markets as either speculators or hedgers. In such cases, they are subject to the same reporting and speculative requirements as domestic firms or individuals. CEA maintains no separate periodic accounting of these reports, although it has the capability to do so

and has prepared such reports by country by trader on occasions. There has been some concern that exporters may be inflating their foreign sales to enable them to, in effect, speculate in the futures markets. The inflation of sales would increase the exporter's hedging base without having any commitment for a commodity, thereby allowing him to speculate in the futures market without any of the limitations imposed on speculators.

Because of the concern that has been expressed and the possible effect on our domestic markets--both cash and futures--we believe the extent of foreign trading in the futures market and the effect of foreign purchases in the cash market should be studied. In addition, the possible use by hedgers of foreign sales commitments to speculate in the futures markets should be studied.

#### Trader influence on futures market

One of the principal problems highlighted by our review of CEA and by discussions with persons knowledgeable in futures trading was the need to know more about speculators, hedgers, and other traders and their activities with a view to providing better information to the public and a better base of knowledge for regulating the futures markets. Such studies could include:

--An analysis of the results of trader activity which would include a profiling of the successful and unsuccessful trader. In addition, more information about trading within days is necessary for a realistic understanding of behavior patterns and market performance. This would provide some insight into the behavior of various types of traders and might assist in developing information on the various factors which cause traders to use the market and which affect the timing of their purchases and sales and the impact such timing has on prices.

--A study of the different methods used by commission houses to recruit, train, and supervise registered representatives--the individuals primarily involved in soliciting customers. The protection of the commodity traders' money is an important Commission responsibility, but we believe the Commission also has a responsibility to protect the trader from unqualified commission houses or representatives. The traders' behavior, especially the small traders, who comprise the largest groups of traders, may often be heavily influenced by their commission house or registered

representative, and there are indications that many traders are not responsibly handled. We believe a study is needed to identify the best way to train, supervise, and regulate the commission houses and their representatives.

#### Use of injunctive authority

The futures trading legislation enacted in 1974 gives the new Commission injunctive authority to use in various situations, including those where it appears that price manipulation has or is about to occur. One generally accepted definition of a price manipulation is "to cause, with intent, the price of a commodity to be something other than what it would have been under the ordinary forces of supply and demand."

The word "ordinary" in this definition is important because it is not possible to recognize an abnormal or manipulative situation without first knowing what an ordinary or normal situation is. Yet little research or study has been made to determine whether standards could or should be developed by which to judge events that are alleged to be other than ordinary. Such research is necessary if the Commission is to exercise its injunctive authority judiciously. Otherwise, the use of this authority to terminate trading or force liquidations of positions could impair the competitiveness of the futures markets by disrupting the normal forces of supply and demand.

#### Contract provisions and delivery terms

The success of a futures market can depend on the appropriateness of the contract provisions, particularly the delivery terms and the location of the delivery points. Delivery terms and locations are especially important to producers and commercial users of the market if they should want to make or take delivery on a futures contract. The terms and locations are also important in preventing erratic price behavior as a futures contract approaches its expiration date. For example, in our interim report we pointed out instances where an insufficient number of delivery locations made price manipulations possible. Too few delivery points make control of the deliverable supply easier and make it difficult for sellers to deliver on the contracts. Too many delivery points, however, could make delivery too easy and result in the futures markets' being used to sell and deliver the commodity rather than to transfer the risks of possible adverse price fluctuations to another party.

Although the exchanges have done a lot of work in writing and revising contract specifications, a description of the important factors that determine the effectiveness of delivery terms has not been developed. Because the new legislation provides additional authority and responsibility in supervising exchange delivery rules, we believe studies should be made of the delivery terms of the various futures contracts to assist in accurately identifying potential problem situations.

## CONCLUSION

A formal ongoing research program is needed to provide the Commodity Futures Trading Commission with the information and knowledge to improve surveillance of the commodity futures market. CEA's limited research effort must be expanded to provide the knowledge needed to improve regulation of the futures markets. This is particularly true with the many new futures markets that came under Government jurisdiction in April 1975.

When appropriate, the results of this research and study should be made available to the markets' users and the general public to provide them with a better understanding of the futures markets and hopefully to increase the public's confidence in futures trading.

We recognize that numerous areas require research and study and that considerable time will be needed to effectively cover all areas. In this chapter, however, we have highlighted several areas which, on the basis of our review work, warrant attention as soon as practicable.

## RECOMMENDATION TO THE CHAIRMAN, COMMODITY FUTURES TRADING COMMISSION

The Chairman should implement a formal research program for commodity futures trading and, in establishing priorities for the research program, consideration should be given to research on

- foreign influence in the futures markets,
- trader influence on the futures markets,
- the use of injunctive authority, and
- contract provisions and delivery terms.

AGENCY COMMENTS

In its letter of March 10, 1975, the Department stated that since the Secretary of Agriculture's authority under the CE act ended on April 21, 1975, the Department did not believe it should comment further or act upon the recommendations unless immediate action, which was not deemed necessary, was required to protect the public.

COMMODITY FUTURES MARKETS  
OCTOBER 1974

Exchange	Regulated commodities (note a)		Nonregulated commodities (note b)	
	Actively traded	Not actively traded	Actively traded	Not actively traded
New York Mercantile Exchange	Maine potatoes Imported frozen boneless beef Butter	Idaho potatoes	Palladium Platinum U.S. silver coins Fuel oils	Aluminum Apples Nickel Plywood
New York Cotton Exchange	Cotton	-	-	-
Citrus Associates of New York Cotton Exchange, Inc.	Frozen concentrated orange juice	-	-	-
LPG Associates of the New York Cotton Exchange, Inc.	-	-	Propane gas	-
Tomato Products Associates of the New York Cotton Exchange, Inc.	-	-	-	Tomato paste
Wool Associates of the New York Cotton Exchange, Inc.	Wool	-	-	-
Petroleum Associates of the New York Cotton Exchange, Inc.	-	-	Crude oil	-
Chicago Board of Trade	Corn Soybeans Soybean meal Soybean oil Wheat Oats Gulf wheat	Rye Barley Flaxseed Grain sorghums Cotton Cottonseed oil Lard Choice steers	Iced broilers Plywood Silver Stud lumber	-
Chicago Mercantile Exchange	Butter Frozen pork bellies Live beef cattle Feeder cattle Live hogs Fresh shell eggs Frozen eggs Idaho potatoes Grain sorghums	Frozen boneless beef	Lumber	Turkeys
Board of Trade of Kansas City, Missouri, Inc.	wheat Corn	Soybeans Grain sorghums	-	-
MidAmerica Commodity Exchange, Chicago	Corn Soybeans Wheat Live hogs Oats	Barley Flaxseed Grain sorghums	Silver U.S. silver coins	-
Minneapolis Grain Exchange	wheat Durum wheat	Corn Oats Rye Barley Flaxseed Grain sorghums Soybeans Frozen pork bellies	-	-
New York Cocoa Exchange, Inc.	-	-	Cocoa	-
New York Coffee and Sugar Exchange	-	-	Coffee (c) Sugar - Domestic (\$10) Sugar (\$11)	Coffee (U) Molasses Sugar (World)
International Monetary Market of the Chicago Mercantile Exchange, Inc.	-	-	British pound Canadian dollar Deutschemak Japanese yen Mexican peso Swiss franc U.S. silver coins Canadian silver coins	Italian lira Dutch guilder

<u>Exchange</u>	<u>Regulated commodities (note a)</u>		<u>Nonregulated commodities (note b)</u>	
	<u>Actively traded</u>	<u>Not Actively traded</u>	<u>Actively traded</u>	<u>Not actively traded</u>
Pacific Commodities Exchange, Inc., San Francisco	Coconut oil Western shell eggs Western live cattle	-	-	-
Commodity Exchange, Inc., New York	-	Hides	Copper Mercury Silver	Lead Propane Rubber Tin Zinc

a/ The Commodity Exchange Act (section 2) defines regulated commodities as barley; butter; corn; cotton; cottonseed; cottonseed meal; eggs; fats and oils (including lard, tallow, cottonseed oil, peanut oil, soybean oil, and all other fats and oils); flaxseed; frozen concentrated orange juice; grain sorghums; Irish potatoes; livestock, livestock products; mill feeds; oats; onions; peanuts; rice; rye; soybeans; soybean meal; wheat; wool; and wool tops. Futures trading in onions was prohibited by law in 1958. (72 Stat. 1013)

b/ The Commodity Futures Trading Commission Act of 1974 provides for the regulation of all 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. This provision became effective April 21, 1975.

OPENING AND CLOSING SOYBEAN FUTURES PRICESFOR MAY 31, JUNE 1 AND 4, 1973,AND TOTAL CHANGE IN PRICE FOR 3-DAY PERIOD

Soybean future	May 31		June 1		June 4		Total change
	Open	Close	Open	Close	Open	Close	
July	\$9.84	\$10.58	\$10.95	\$11.32 1/2	\$11.80	\$12.11	\$2.27
Aug.	9.49	9.94	10.34	10.34	10.74	10.74	1.25
Sept.	7.54 1/2	8.26 1/2	8.66 1/2	8.66 1/2	9.06 1/2	9.06 1/2	1.52
Nov.	5.87 1/2	6.29 1/2	6.64 3/4	6.38	6.45	6.78	.90 1/2
Jan.	5.72 3/4	6.21	6.42 1/2	6.19 1/2	6.42 1/2	6.59 1/2	.86 3/4
Mar.	5.75	6.09 1/2	6.30	6.12 1/2	6.17	6.52 1/2	.77 1/2
May	5.70 1/2	6.06 1/2	6.21 1/2	6.06	6.10	6.45 1/2	.75

CONSULTANTS USEDDURING REVIEW

Paul T. Farris, Ph.D., Head, Department of Agricultural Economics, Professor of Agricultural Economics, Purdue University

Roger W. Gray, Ph.D., Professor of Agricultural Economics, Food Research Institute, Stanford University

Thomas A. Hieronymus, Ph.D., Professor of Agricultural Economics, University of Illinois



DEPARTMENT OF AGRICULTURE  
OFFICE OF THE SECRETARY  
WASHINGTON, D. C. 20250

March 10, 1975

Mr. Henry Eschwege  
Director  
Resources and Economic  
Development Division  
U.S. General Accounting Office  
Washington, D. C. 20548

Dear Mr. Eschwege:

This is in reply to your letter of February 12, 1975, inviting our comments on the draft report of the General Accounting Office's audit of the Commodity Exchange Authority.

The Department's comments on certain of the major areas covered by the report were furnished in response to the conclusions and recommendations contained in your interim report dated May 3, 1974.

Since the Secretary of Agriculture's authority under the Commodity Exchange Act ends on April 20, 1975, I do not believe the Department should comment further or act upon the recommendations contained in the draft report that relate to the Commodity Exchange Authority unless immediate action is required to protect the public. I do not find any of the recommendations which are in this critical category.

Your report will be made available to the Chairman and members of the Commodity Futures Trading Commission for their consideration and such action as they may deem appropriate.

The Department recognizes the need that the Commodity Futures Trading Commission will have for the best possible cash price information on commodities traded on futures markets.

The Agricultural Marketing Service is currently exploring methods for improving cash price information and has also requested the Department's Economic Research Service to study the problem.

I shall instruct the Administrator of the Agricultural Marketing Service and the Department's liaison officer with the Commission provided for under Section 101(8) of the Commodity Futures Trading Commission Act to work closely with the Commission and to provide, to the best of our ability, the type of cash price information that will meet the Commission's needs.

Sincerely,

A handwritten signature in black ink, appearing to read "Richard L. Feltner".

RICHARD L. FELTNER  
Assistant Secretary

PRINCIPAL OFFICIALS OF THE DEPARTMENT OF AGRICULTURE  
AND MEMBERS OF THE COMMODITY EXCHANGE  
COMMISSION AND COMMODITY FUTURES TRADING COMMISSION  
RESPONSIBLE FOR ACTIVITIES DISCUSSED IN THIS REPORT

	Term of office	
	From	To
<u>DEPARTMENT OF AGRICULTURE</u>		
SECRETARY OF AGRICULTURE:		
Earl L. Butz	Dec. 1971	Present
Clifford M. Hardin	Jan. 1969	Nov. 1971
Orville L. Freeman	Jan. 1961	Jan. 1969
ASSISTANT SECRETARY, MARKETING AND CONSUMER SERVICES:		
Richard L. Feltner	Apr. 1974	Present
Clayton K. Yuetter	Jan. 1973	Mar. 1974
Richard E. Lyng	Mar. 1969	Jan. 1973
<u>COMMODITY EXCHANGE AUTHORITY</u>		
ADMINISTRATOR:		
Alex C. Caldwell	Jan. 1960	Apr. 1975
<u>COMMODITY EXCHANGE COMMISSION</u>		
SECRETARY OF AGRICULTURE, CHAIRMAN:		
Earl L. Butz	Dec. 1971	Apr. 1975
Clifford M. Hardin	Jan. 1969	Nov. 1971
Orville L. Freeman	Jan. 1961	Jan. 1969
SECRETARY OF COMMERCE:		
Frederick B. Dent	Feb. 1973	Apr. 1975
Peter C. Peterson	Feb. 1972	Feb. 1973
Maurice H. Stans	Jan. 1969	Feb. 1972