BY THE COMPTROLLER GENERAL

Report To The Congress

OF THE UNITED STATES

Regulation Of The Commodity Futures Markets—What Needs To Be Done

Although the Commodity Futures Trading Commission has made a significant beginning in extending Federal regulation to segments of the industry never before regulated, much remains to be done to fully implement the mandate and congressional intent of the 1974 act which created the Commission.

The Commission has been hampered by a variety of organizational and management problems and by weaknesses in planning which have prevented it from making optimal use of its resources. It has also had to contend with widespread fraud in commodity options trading.

To enhance Federal regulation of the futures markets and to promote effective industry self-regulation, the Commission needs to correct weaknesses in such program areas as contract market designations, rule enforcement review, abusive trading practices, registration, customer claims, and market surveillance.

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

This report assesses the performance of the Commodity Futures Trading Commission in regulating the Nation's commodity futures markets and details the actions which need to be taken to strengthen regulation of these markets.

We reviewed the Commission as a followup to our 1974 recommendation that the commodity futures industry be regulated by a strong, independent agency and in anticipation of the Congress having to decide whether the Commission should be reauthorized after fiscal year 1978.

We made our review pursuant to section 8 of the Commodity Exchange Act (7 U.S.C. 12-3).

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

Comptroller General
of the United States

COMPTROLLER GENERAL'S REPORT TO THE CONGRESS

REGULATION OF COMMODITY FUTURES MARKETS--WHAT NEEDS TO BE DONE

D I G E S T

Because of the vital role that futures markets play in the U.S. economy, the Commodity Futures Trading Commission should be reauthorized for 4 years beyond fiscal year 1978 to regulate futures trading in an atmosphere as free as possible from potential conflict of interest. (See ch. 2.)

The Commission, an independent agency, was created by the Commodity Futures Trading Commission Act of 1974 on recommendation of GAO. The agency has broad regulatory powers which its predecessor, the Commodity Exchange Authority in the Department of Agriculture, did not. The act contains a "sunset provision" authorizing the Commission only through fiscal year 1978.

Futures trading is the buying and selling of standardized contracts for the future delivery of specified grades and amounts of commodities. Ten commodity exchanges provide organized central markets where trading can take place through open outcry and competitive bidding. The trading volume for calendar year 1977 was 42.9 million contracts valued at over a trillion dollars. (See ch. 1.)

In this first report on the activities of the new Commission, GAO finds many weaknesses in program activities and management functions. However, if GAO recommendations are carried out, they should provide the basis for improved regulation of the futures markets.

As to futures contracts on financial instruments, the Congress should (1) grant the Securities and Exchange Commission regulatory jurisdiction over some types, such as stocks and bonds, and limited authority over others, such as Treasury bills and bonds and (2) establish an interagency advisory council to serve as a forum for representing the views of affected agencies. (See ch. 2, pp. 15 and 16.)

COMMISSION PLANNING NEEDS GREATER EMPHASIS

The Commission has been slow in recognizing that a formalized planning process is a basic management function and decision tool. Because of this, its regulatory posture has been overly *ad hoc* and reactive, as opposed to anticipatory and preventative. GAO recommends actions to help correct these deficiencies in chapter 13, pages 227 and 228.

WEAKNESSES IN ORGANIZATION AND MANAGEMENT HAVE HAMPERED OPERATIONS

The Commission's performance has been affected adversely by a number of organizational and management problems, including

--lack of strong management experience in top executive positions,

--management weaknesses in the Executive Director's office due to organizational instability and jurisdictional disputes,

--high rate of staff turnover,

--failure to develop professional cadres and managers from within the organization, and

--lack of a broad representation of views on Commission advisory committees.

GAO's recommendations focusing on these matters and on the need for the Congress to amend the act to delete a requirement that the Executive Director be confirmed by the Senate will be found in chapter 14. (See p. 242.)

MARKET DESIGNATION PROCESS NEEDS IMPROVEMENT

An important and far-reaching responsibility of the Commission is the designation of exchanges as contract markets in particular commodities. GAO found, however, that the Commission's initial market designation reviews, done in 1975 under statutory time constraints, were not comprehensive enough to assure that

only contract markets meeting statutory and Commission requirements were designated. GAO's recommendations to assure that unresolved issues are followed up on and that future market designation reviews are improved are found in chapter 3. (See p. 33.)

NEED TO IMPROVE RULE ENFORCEMENT

Exchange enforcement of its own rules is the key to the self-regulatory process which the Congress envisioned when it established the Commission. The Commission reviews exchange rule enforcement procedures and performance as part of its regulatory oversight. Its reports evaluating rule enforcement at the New York and Chicago exchanges show that effective self-regulation in the commodity markets is not yet a reality.

GAO found that while the Commission's rule enforcement review program has produced some positive results, more remains to be done. GAO's recommendations to improve the program and assure affirmative self-regulation of the commodity futures industry are found in chapter 4. (See pp. 56 and 57.)

MANY UNRESOLVED ISSUES RELATING TO TRADING PRACTICES

Dual trading--floor brokers and futures commission merchants trading for their own accounts as well as for customers--can result in abusive trading practices, such as a floor broker or futures merchant directly competing with a customer's interest. Questions of whether to continue to permit dual trading and whether it is needed for market liquidity are among the pressing issues facing the new Commission and have not been considered systematically or comprehensively. (See ch. 5.)

The Commission should develop and analyze evidence based on experiences in the market to determine whether dual trading is necessary for trading liquidity and whether it promotes abusive practices.

Although the Commission issued regulations on trading standards for floor brokers and futures merchants to guard against dual trading abuses, it has done little to see that the standards are being followed.

Similarly, the Commission has published regulations for time sequencing of all trades to the nearest minute, but has not used its authority to obtain exchange compliance. No enforcement action was taken against six exchanges which violated the regulations. GAO concluded that the Commission does not have sufficient expertise and information on time sequencing of trades.

GAO's recommendations to improve decisionmaking on dual trading issues and to assure that Commission regulations on trading standards and time sequencing are enforced will be found on pp. 79 and 80.

Reconstructing trading by means of a trade practice investigation is the primary method for detecting and deterring abusive trading. However, the Commission has not aggressively or systematically investigated for noncompetitive trades by individuals nor established a plan for a periodic review of trading at each exchange. GAO's recommendations to the Commission include developing a computerized investigative capability and a comprehensive plan to perform investigations at each exchange.

REGISTRATION AND AUDIT PROGRAMS CAN BE MORE EFFECTIVE

The Commission's registration program is not as effective as it could be in preventing unfit and unqualified individuals and firms from being registered and reregistered. The primary screening of applicants consists of name checks against Securities and Exchange Commission records of persons or firms that have committed securities-related violations and against FBI arrest and conviction files. These checks are useful in weeding out some unfit applicants. However, the Commission should fingerprint applicants and check the prints against FBI records. Other GAO recommendations on these matters will be found in chapter 6, pages 92 and 93.

The Commission has been slow in implementing a 1975 GAO recommendation that it redirect its audit function to a strong oversight role and transfer the primary responsibility for enforcing required financial provisions of the regulations to the exchanges and require that futures merchants engage independent public accountants to audit their financial statements. GAO's latest review showed that the Commission does not audit futures merchants often enough to assure that customers' funds are adequately safeguarded. GAO's recommendations on these and other audit matters will be found in chapter 7, page 105.

MARKET SURVEILLANCE NEEDS IMPROVEMENT

Market surveillance consists of monitoring the performance of futures markets to detect and prevent disruptions as well as adverse conditions, such as price manipulations. Because of statutory requirements, both the Commission and the exchanges perform market surveillance. These efforts, now largely performed independently, can be made more effective with improved coordination, mutual understanding, clear delineation of responsibility, and a sharing of market data. The Commission, together with industry, should work toward improving the overall surveillance effort.

The Commission needs reliable cash price data to perform surveillance. However, deficiencies in the cash price data, known to the Commission, have not been corrected. The Commission should search for alternatives to improve cash price data and continuously monitor commodities to keep current with changing market conditions. For these and other recommendations see chapter 8, page 130.

COMMODITY OPTIONS REGULATION HAS NOT BEEN EFFECTIVE

In contrast to a commodity futures contract, a commodity option represents a right but not an obligation to buy or sell a commodity (or a futures contract) at an agreed price within a specified time. During the past few years, option trading on foreign commodities has attracted

substantial customer interest as well as the participation of allegedly fraudulent operators who saw the potential for quick profits through high-pressure, boilerroom type operations. At the same time the Commission's efforts to regulate option trading and prevent fraudulent and illegal activity have been generally ineffective. (See ch. 12.)

The Commission, deciding not to suspend option sales, tried to regulate their sales by issuing regulations covering, among other things, fraud, registration of persons offering options to the public, segregation of funds, keeping of books and records for Commission inspection, and minimum capital requirements.

Because the 1974 act granted the Commission exclusive jurisdiction over options--effectively preempting the States[9] and the Securities and Exchange Commission's regulatory activities in this area--the Commission should have carefully assessed whether it had the necessary resources to properly regulate options. In GAO's view, the preemption of other Government agencies, coupled with the limited staff and experience of the Commission and its considerably broadened regulatory responsibilities, pointed to a need to proceed slowly and with care in the options area--an area that is controversial and scandal ridden.

The Commission's decision to permit option trading resulted in the creation of a regulatory vacuum which was exploited by some unscrupulous individuals to the detriment of many unsuspecting option investors. Understaffed, overextended, and lacking in the ability to enforce compliance effectively with its option regulations, the Commission was never able to make these rules the meaningful customer protections they might have been.

The Commission's efforts on options have drained its resources seriously and interfered with its ability to deal with its primary responsibility--commodity futures regulation.

Despite delays in implementing its option regulations, costly and time-consuming legal challenges to the regulations, and steadily

accumulating evidence of flagrant and widespread violation of its rules, the Commission only recently suspended the sale of options after June 1, 1978. GAO recommends that the Congress support the Commission's actions by amending the act to suspend option trading.

The Commission still intends to go ahead with a pilot program of option trading on domestic exchanges. GAO believes that such a program is inadvisable at this time. In view of its broad mandate and responsibilities in the area of futures regulation, as well as the many areas identified in GAO's review as requiring urgent attention, GAO recommends that the Commission, for the time being, devote all of its resources to improving the regulation of futures trading.

To enhance customer protection, GAO recommends that the Congress amend the act to grant the States authority to act on options and commodity fraud. (See pp. 209 to 211 for GAO's detailed recommendations to the Commission and to the Congress on option trading.)

REPARATIONS PROGRAM INADEQUATE TO MEET DEMAND

Since 1976 the Commission has operated a reparations program for adjudicating monetary claims against Commission registrants who violate the act or Commission regulations. The program would be most effective if it provided relatively fast adjudication to as many aggrieved parties as possible. However, a growing backlog problem and seemingly overly complex regulations have jeopardized the program's effectiveness.

GAO also concluded that the Commissioners need to significantly increase their involvement in reviewing cases initially decided by administrative law judges. As a further measure to speed up the program, the Congress should increase from $2,500 to $5,000 the amount of damages needed to justify extensive oral hearings before the judges. (See ch. 9, p. 144 for GAO's recommendations.)

ECONOMICAL PROCUREMENT POLICIES AND PROCEDURES SHOULD BE FOLLOWED

The Commission has not followed many established policies and procedures for efficient and economical procurement and management of property and services by Government agencies. In negotiating long-term leases for its offices, the Commission did not obtain appraisals of the fair market value of the leased property which are necessary to assure that legal rent limitations are not exceeded. Also, the Commission spent amounts on improvements to leased property in excess of legal limitations and entered into long-term leases which are prohibited by law.

Although its procurement approach enabled it to obtain office space, furniture, supplies, and services of a higher quality than that normally obtained by Government agencies, there was little assurance that these procurements were made to the best advantage of the Government, price and other factors considered. GAO's recommendations, including the need to amend the act to place leasing authority under the General Services Administration, appear in chapter 10, pages 159 and 160.

FINANCIAL DISCLOSURE SYSTEM NEEDS TO BE STRENGTHENED

GAO's review of the Commission's financial disclosure system for employees and regulations on the misuse of nonpublic information leads it to recommend that the Commission should require lower level auditors, investigators, economists, and attorneys to file financial disclosure statements annually and establish a certification system for employees not required to file statements. (See ch. 11., p. 170.)

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Because the appropriate legislative committees and the Congress need GAO's report as early as possible in the reauthorization review process, GAO did not obtain formal comments from the Commission; however, the results of its review were discussed with agency officials.

GAO's tentative review results were also presented in February 1978 statements before the Subcommittee on Agricultural Research and General Legislation, Senate Committee on Agriculture, Nutrition, and Forestry and the Subcommittee on Conservation and Credit, House Committee on Agriculture. The Commission had the opportunity to respond to GAO's findings before those subcommittees.

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ABBREVIATIONS

CBT Chicago Board of Trade

CFTC Commodity Futures Trading Commission

CME Chicago Mercantile Exchange

FBI Federal Bureau of Investigation

FCM futures commission merchant

GAO General Accounting Office

GSA General Services Administration

SEC Securities and Exchange Commission

CHAPTER 1

INTRODUCTION

A dramatic increase in the volume and value of trading on the Nation's commodities exchanges has taken place since the early 1970s. In fiscal year 1970, 13.6 million contracts valued at $148 billion were traded. About 42.9 million contracts valued at over one trillion dollars were traded in calendar year 1977.

The sharp increase in commodity trading is the result of a variety of diverse occurrences that have affected the markets and consumers. The price of agricultural commodities increased to record highs during the early 1970s because of unanticipated foreign purchases of U.S. commodities, successive devaluations of the U.S. dollar, depletion of Government-held agricultural surpluses, and adverse weather conditions. A reason for recent increases in trading is the wide variety of commodities that are now available. Trading is no longer limited to agricultural products. New futures contracts are continually being added, such as interest rate futures and foreign currency futures. Another reason for the recent increase, according to industry and Government sources, is that more producers are learning to use the futures markets as a way to market their products at better prices and as an effective antidote to price volatility.

Until 1974, the Secretary of Agriculture was authorized by the Commodity Exchange Act, as amended (7 U.S.C. 1 et seq.) to regulate futures trading only in certain specified agricultural commodities. The contracts, which included among others frozen pork bellies, corn, wheat, soybeans, live hogs, and oats, were traded on boards of trade (commodity exchanges) designated by the Secretary as contract markets. In 1973, 18 exchanges were approved to trade in futures contracts; however, only 10 were .ctive at that time. Trading was also conducted on exchanges in approximately 18 commodities not then subject to regulation under the act. These commodities included lumber, silver, U.S. coins, cocoa, propane gas, and others.

The Secretary had established the Commodity Exchange Authority to carry out the act, but kept his authority to (1) approve trading on designated exchanges, (2) conduct disciplinary proceedings, and (3) promulgate regulations. The act also made the Secretary, or his designee, chairman of the Commodity Exchange Commission which was established

to set limits on speculative trading and order disciplinary actions against exchanges regarding trading in regulated commodities.

CREATION AND RESPONSIBILITIES OF THE COMMODITY FUTURES TRADING COMMISSION

During 1973 and 1974 hearings were held in both the House and Senate to consider the effectiveness of the Department of Agriculture in supervising futures trading, the effect of futures trading on consumer food prices, and the need for additional statutory authority to ensure public confidence in the integrity of trading and exchange activities. We reported to the Congress (B-146770, May 3, 1974) our interim observations on the operation of the Commodity Exchange Authority and futures trading. We recommended that a strong, independent agency be established separate from the Department of Agriculture to regulate all commodity trading, including but not limited to the previously regulated agricultural commodities.

After a careful consideration of the views of interested parties, a strong, independent agency, the Commodity Futures Trading Commission (CFTC), was established by the Commodity Futures Trading Commission Act of 1974, Public Law 93-463 (88 Stat. 1389). The 1974 act substantially revised the Commodity Exchange Act 1/ to provide comprehensive regulation of all commodities, goods, and services traded in the futures markets. 2/ Effective April 21, 1975, CFTC became the sole administrator of the act, replacing the Secretary of Agriculture and the Commodity Exchange Authority and Commission. According to Senator Talmadge, chairman of the congressional conference committee that agreed on the CFTC Act, the Commission was to be "comparable in stature and responsibility to the Securities and Exchange Commission" (SEC) which regulates the securities industry.

CFTC was given substantially more authority than its predecessor agencies to enforce the broad mandate of the act. Added powers include responsibility to obtain court injunctions, to litigate in court with its own attorneys, extraordinary powers to deal with market emergencies, and to conduct an education and research program.

1/We refer to the amended Commodity Exchange Act as the act.

2/A schedule of the 10 active exchanges, volume of trading, and commodities traded is shown in appendix I.

In addition, the Commission is responsible for

--designating as contract markets any exchange demonstrating that futures trading in the contract for which designation is sought will, among other things, not be contrary to the public interest;

--reviewing for approval bylaws, rules, regulations, and resolutions of designated contract markets relating to trading requirements;

--processing through administrative hearings reparations claims by traders who allege monetary injury due to a violation of the act by one registered with CFTC;

--regulating transactions in standardized margin or leverage account contracts in gold and silver bulk coin or bullion; and

--registering and examining the fitness of persons handling traders' accounts, futures commission merchants, commodity pool operators (persons who manage entities much like a securities mutual fund), and commodity trading advisors.

To ensure that designated markets are operated efficiently, effectively, and without manipulation, CFTC is authorized to establish additional delivery points for traded commodities, to regularly inspect designated contract markets, and to set limits on the total number of open positions in a market individual traders or concerted trading groups may hold in a particular market ("speculative limits"). Further, the act authorizes CFTC to define a number of regulatory terms, including bona fide hedging, and to determine whether or not to allow certain trading practices, including dual trading--trading by brokers for their own account as well as for the public--and commodity options trading. CFTC is also directed to consider the antitrust consequences of its acts and to achieve its objectives by the least anticompetitive means. Penalties are provided for violation of the act.

While the Commission is the prime regulator of the industry, the act contemplates considerable industry self-regulation. To further self-regulation, title III of the 1974 act authorizes any national futures association to register with the Commission as an industrywide, self-regulatory body subject to minimum statutory standards.

DEFINITION AND PURPOSES OF FUTURES TRADING

Futures trading is the buying and selling of standardized contracts for the future delivery of a specified grade and amount of a commodity. Commodity exchanges provide organized central markets where trading can take place through open and competitive bidding. The physical commodity itself is actually traded on the "cash" or "spot" market, and it is the economic purpose of the futures market to help the "cash" markets work better. This is performed by helping to establish cash prices and permitting traders to protect themselves from adverse price movements of the physical commodity.

In theory, futures and spot markets move roughly in tandem if a freely competitive market exists. During the period immediately before the futures contract expires, prices in the two markets tend to converge. Thus, positions in each market tend to cancel each other out; gains in the cash market would be offset by losses in the futures market.

Hedging

A primary purpose of futures markets is to allow producers, merchandisers, and processors to shift some of the risks of adverse price movements of the physical commodity. This is called hedging. The hedger has an interest in the physical commodity in that he either owns quantities of it, has a future need for it, or has a firm commitment to buy or sell a quantity of the physical commodity. 1/ There are two types of hedges used in the futures markets: the buying (long) hedge and the 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 that exceed inventories. The buying hedge protects hedgers from any future price advances of the commodity on the cash market and allows them to project their materials costs and to price their product at lower profit margins.

1/ Financial institutions use futures contracts on financial instruments for similar purposes.

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 adequately hedged in the futures market.

Speculating

Speculators are traders who, unlike hedgers, have no interest in the physical commodity itself. They trade in the market solely to profit from assuming the risks of price fluctuations--perhaps the same risks the hedgers desire to avoid. By standing ready to purchase or sell futures contracts based on price alone, speculators are viewed as increasing the liquidity and competitiveness of markets which adds trading volume and thus minimizes price fluctuation. This also adds to the possibility that hedge orders limited to a stated price are filled.

Commodity exchanges

Commodity exchanges are centralized marketplaces where standardized futures contracts can be bought and sold in a competitive, free market setting. The important role of the exchanges is recognized by the act in its provisions requiring any person maintaining an office in the United States for futures trading to conduct business through or as a member of an exchange designated as a contract market under the act. Acting in their own self-interest to preserve the integrity of their markets and under requirements of the act, exchanges are responsibile for

--enforcing their own rules and regulations designed to ensure that trading is done in an open and honest manner without fraud, deceit, or attempted manipulation;

--maintaining a disciplinary system for exchange members;

--maintaining complaint procedures for aggrieved customers;

--preventing false and misleading information from being disseminated; and

--maintaining trading records and reporting certain of those records to CFTC.

Exchanges may also set limits on speculative trading, establish margin limits, and set limits on the maximum daily price change allowable in a contract.

According to the act, five categories of people or firms must register with CFTC.

1. Futures commission merchants (FCMs)--Individuals, associations, corporations, and trusts soliciting or accepting orders for the purchase or sale of any commodity for future delivery.

2. Associated person--Any person associated with any FCM as a partner, officer, or employee in any capacity which involves (a) soliciting or accepting customers' orders or (b) supervising any person so engaged.

3. Floor broker--A person who may buy or sell futures contracts on the trading floor of the exchange for others, for his own account, or for an account which he controls.

4. Commodity trading advisor--A person who advises others directly or in writing on the value of commodities or on trading commodities for future delivery or who issues analyses or reports on commodities.

5. Commodity pool operator--A person who is engaged in a business, such as an investment trust or syndicate, and who receives from others funds to trade in commodities for future delivery on a contract market.

CFTC

CFTC started operations in April 1975 as an independent regulatory agency. The Commission consists of a chairman and four other members appointed by the President with the advice and consent of the Senate. The President is directed to seek to establish and maintain a balanced commission, including but not limited to persons knowledgeable in futures trading, its regulation, and the articles and goods covered by the act. The Chairman is chief administrative

officer with statutory authority to appoint and supervise personnel and distribute business among such personnel and administrative units within the Commission. In carrying out these functions, the Chairman is subject to the general policy direction and specific actions of the Commission. An executive director, chosen by the Commission and subject to Senate confirmation, is to handle such functions as assigned by the Commission. The executive director is responsible for the day-to-day operation of the Commission, and CFTC divisions and offices report to him.

The Commission is made up of several divisions and offices. The Division of Trading and Markets reviews applications for contract market designation, conducts trade practice investigations, reviews and analyzes contract market rules and rule changes, polices exchange rule enforcement programs, registers and audits persons required to register under the act, and drafts regulations to implement the act. The Division of Enforcement carries out the Commission's enforcement program aimed at uncovering violators of the act and deterring other possible violations. The program involves investigations, litigation, customer complaints and services, and reparation proceedings. The Office of Surveillance and Analysis conducts daily market surveillance, does economic analysis of contract terms, makes liquidation inquiries, and does special studies.

Other offices include:

--Office of the Chief Economist which is responsible for research on such things as the definition of commodity terms, dual trading, and options.

--Office of Hearings and Appeals which is responsible for implementing adjudicatory hearings required by the act, including reparation controversies.

--Office of Policy Review which is responsible for coordinating and reviewing long-term planning goals and policies.

--Office of General Counsel which represents the Commission in Federal courts in appeals from decisions rendered by U.S. district courts in injunctive, subpena enforcement, or other actions brought by the Commission; in appeals of Commission orders; in cases involving suits against the Commission; in both Federal and State courts as amicus curiae; and in private litigations involving issues arising under the act.

For fiscal year 1977, CFTC's expenditures were $13,085,000. CFTC's budget for fiscal year 1978 is $13,196,000. The agency has regional offices in New York, Chicago, San Francisco, Kansas City, and Minneapolis. CFTC's organizational chart is presented in appendix II.

SCOPE OF REVIEW

This report represents our first effort to review the effectiveness and efficiency of CFTC's operations. Soon after we began, the Chairman, Senate Committee on Agriculture, Nutrition, and Forestry requested us to assist the committee in its legislative oversight role. The committee chairman's office requested that we include in our review certain areas--dual trading, options, and several others--which were of particular concern to the committee. Also, the Chairman of the Subcommittee on Domestic Marketing, Consumer Relations, and Nutrition of the House Committee on Agriculture requested that we include in our review a study of CFTC's procurement practices and its system to safeguard against possible conflicts of interest by employees.

We interviewed officials and reviewed files, records, and internal correspondence at CFTC headquarters in Washington, D.C., and at regional offices in Chicago and New York. Of CFTC's 450 employees, about 370 worked at these three locations.

We also visited the eight exchanges in New York and Chicago. We were denied access to records at the Chicago Mercantile Exchange (CME) and were not granted access to records at the Chicago Board of Trade (CBT) until near the end of our review. In New York, one exchange, the New York Cocoa Exchange, Inc., refused us access to its records and the other four exchanges provided us with either complete or limited access.

To help us in our review, we hired three expert consultants knowledgeable in the operations of the futures markets. (See app. III.) We also attended seminars, Commission meetings, and symposia and contacted numerous persons, including State law enforcement personnel, involved with CFTC's activities.

OTHER REPORTS CONCERNING COMMODITY FUTURES REGULATION

The following reports to the Congress, dealing with commodity futures regulation, may be of interest to readers of this report:

1. "Need to Strengthen Regulatory Practices and Study Certain Trading Activities Relating to Commodity Futures Markets--Commodity Exchange Authority, Department of Agriculture" (B-146770, July 16, 1965).

2. "Interim Report on the Commodity Exchange Authority and on Commodity Futures Trading--Department of Agriculture" (B-146770, May 3, 1974).

3. "Improvements Needed in Regulation of Commodity Futures Trading--Department of Agriculture, Commodity Futures Trading Commission" (RED-75-370, June 24, 1975).

Another report of interest is on the effectiveness of CFTC's information-gathering program (GGD-77-52, May 26, 1977).

CHAPTER 2

CFTC SHOULD BE REAUTHORIZED

The 1974 act which created the Commodity Futures Trading Commission only authorized it to operate through fiscal year 1978. Legislation must be enacted reauthorizing the Commission if it is to operate beyond that date. We believe the Congress should reauthorize the Commission for 4 years. We also believe that the Congress should make certain modifications to the Commission's jurisdiction over futures contracts on financial instruments and create an interagency advisory council to serve as a representative forum for agencies having jurisdiction over the commodities underlying such futures contracts.

In our 1974 report we recommended that the Congress establish an independent agency to regulate the commodity futures industry. Because the commodity futures markets play a vital role in the country's economic well-being, we stated that they should be regulated by a strong and prestigious agency. We continue to believe this.

In reassessing the need for a separate agency to regulate the futures trading, we were also cognizant of the fact that the futures markets, if manipulated, can have significant repercussions on cash prices in the underlying commodities. Therefore, a regulatory agency must be in a position to step in quickly and, if necessary, take appropriate emergency action. A separate, independent agency, as free as possible from outside influence, would be in the best position to take such action and at the same time, foster public confidence in the futures markets.

Although our review has disclosed many weaknesses in Commission management and program activities, we believe that recent self-initiated changes underway at the Commission and implementation of our recommendations will lead to improved regulation of the commodity futures markets.

THE DEPARTMENT OF AGRICULTURE SHOULD NOT REGULATE FUTURES TRADING

In our May 3, 1974, report to the Congress, we stated why we believed an independent commodity futures regulatory agency was necessary. Those reasons are as valid today as they were then.

Some industry sources have proposed returning the futures regulatory function back to the Department of Agriculture. However, a potential conflict of interest

would exist if this were done because the Agriculture Secretary is charged by law to influence and maintain the prices of many of the commodities traded in the futures markets. It is not the function or role of commodity markets or of futures regulation to influence prices. The proper regulatory function of an agency which regulates futures trading is to assure that the market is free of manipulation. An agency which regulates futures trading must have a neutral role on commodity prices and be free of built in conflicts of interest.

The 1974 act changed the Commodity Exchange Act to include "all other goods and services" in the definition of regulated commodities. This has come to include financial instruments, metals, and foreign currencies. Because the Department of Agriculture has little or no expertise in these areas and because of the mushrooming growth in futures trading in nonagricultural commodities, returning futures regulatory authority to Agriculture would not be a suitable option in our view.

SEC AND FUTURES REGULATION

In August 1977 we asked the Securities and Exchange Commission for its views on whether the Commodity Exchange Act should be amended to have SEC assume the responsibilities of the present CFTC. SEC replied in a February 1978 letter setting forth its views on similarities and differences between futures and securities regulation, effects on SEC operations, and problems arising from the regulatory grant of exclusive jurisdiction to CFTC.

The SEC letter stated that CFTC's responsibilities as the regulator of the commodity futures markets are, to a significant degree, similar to SEC's responsibilities over securities markets. However, SEC noted that futures and securities are by no means wholly comparable. Futures do not have a capital-raising function similar to the securities markets.

SEC also pointed out that integrating all futures regulation into SEC could jeopardize SEC's ability to carry out its responsibilities under the securities laws which contemplated separate, expert, and quick administration by a body not distracted by other demands.

We have had discussions with representatives of SEC, CFTC, the Treasury Department, and other Federal and State agencies concerning the specific question of placement of regulatory jurisdiction over financial futures markets. We became convinced that certain modifications to CFTC's

exclusive jurisdiction are desirable in order to enhance the regulatory process in general and to ensure that the legitimate interests and concerns of other Federal agencies are taken into account in the designation of futures contracts on financial instruments (i.e., stocks, bonds, and U.S. Treasury bills) and the regulation of trading in such contracts.

In April 5, 1978, letters to the Chairman, Subcommittee on Conservation and Credit, House Committee on Agriculture, and the Chairman, Subcommittee on Agricultural Research and General Legislation, Senate Committee on Agriculture, Nutrition, and Forestry, we stated that we are in favor of amending the act to accomplish the following.

--Transfer to SEC jurisdiction over futures contracts written on all securities subject to the registration requirements of the Securities Act of 1933, 1/ including indexes of such securities. (No such futures contracts are now in existence, although a proposal for a Dow Jones average futures contract is presently pending before CFTC.)

--With respect to futures contracts written on securities exempt from the registration provisions of the Securities Act of 1933, provide that SEC shall have the right to bring an enforcement action under sections 17(a), 20, and 22 of the Securities Act of 1933, subject to CFTC's prior right to act.

--Create an interagency council composed of representatives of CFTC, SEC, Treasury Department, and such other agencies as the President may designate which would serve as a forum for representing and exchanging the views of those agencies interested in and affected by the designation of and trading in futures contracts written on securities.

With respect to our first proposal, we agreed with the arguments made by SEC in its presentations to us and in testimony before the Congress. Specifically, we found merit in SEC's contention that options on registered securities (presently regulated by SEC) and futures contracts on such securities (presently subject to CFTC jurisdiction) are derivative and essentially equivalent and interchangeable

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1/ Primarily this includes publicly traded corporate stocks and bonds.

financial instruments. SEC argued persuasively that, given its responsibilities for regulation of the underlying cash market in these securities and its authority over options on these instruments, it must, if it is to do an effective job of regulating and protecting the integrity of these markets, also have jurisdiction over futures contracts on such securities. The split or "bifurcated" jurisdiction which presently exists potentially limits the effectiveness of SEC regulatory and surveillance efforts and opens the door to "forum shopping" by those seeking the least stringent or most permissive form of regulation.

The thrust of our proposed change is prospective. It is intended to forestall the kinds of regulatory and market surveillance difficulties which SEC has portrayed in its presentations to us and to the Congress. Because it does not involve existing futures contracts or established futures trading activity, we believe that our suggested division and transfer of regulatory jurisdiction can be accomplished easily and expeditiously, with negligible adverse impact on the industry or on market participants.

In the case of futures contracts written on unregistered or "exempt" securities (which include securities issued or guaranteed by the U.S. Government or Federal agencies) arguments supporting a reallocation of regulatory jurisdiction from CFTC to other agencies can also be made. However, in this area the problems associated with such a transfer are more numerous and difficult, while the advantages are less clear-cut and compelling. In contrast to securities which are subject to the exclusive Federal regulatory jurisdiction of SEC, exempt securities are subject to the jurisdiction of a number of Federal agencies (Treasury, Government National Mortgage Association, SEC, etc.) none of which exercises, or to our knowledge has sought to exercise, exclusive regulatory jurisdiction. Furthermore, while no futures contracts have yet been written on registered securities, a number of futures contracts have been written on exempt securities (e.g., Treasury bonds, Treasury bills, short-term commercial paper, and Government National Mortgage Association mortgage certificates) and are currently being actively traded on futures exchanges. Several new exempt security futures contract applications are pending before CFTC.

Thus, while the transfer of regulatory jurisdiction over registered securities futures from CFTC to SEC is organizationally simple, promotive of regulatory efficiency, and unlikely to have significant impact on market participants, the same cannot be said of a similar reallocation of jurisdiction over exempt securities futures. Most of the

agencies which have a direct interest in the exempt securities underlying such futures contracts are unprepared and unequipped to exercise regulatory control over futures trading in those securities. Nor do we think that such a fragmentation and dispersal of regulatory authority is likely to be effective or beneficial. Such a reallocation would have a substantial immediate impact on exchanges, commission houses, and other market participants and would likely lead in the long run to a number of duplicative and inconsistent regulatory requirements.

With a view to enhancing the protection of market participants from fraudulent and deceptive practices and in order to fill real and potential regulatory gaps, we also favor amending the act to provide SEC with the right to bring enforcement actions of an antifraud nature in connection with the marketing of futures contracts written on securities exempt from the registration provisions of the Securities Act of 1933. SEC action would be subject to CFTC's prior right to act. 1/

Finally, we are proposing that there be created an interagency Council on Regulation of Securities Futures composed of representatives of SEC, the Treasury Department, CFTC, and such other agencies as the President may deem appropriate, whose function it would be to ensure proper representation and consideration of the interests of these agencies in the regulatory actions undertaken by (1) CFTC with respect to futures on exempt securities and (2) SEC with respect to futures on registered securities.

The council would concern itself with proposals for the designation of registered and exempt securities futures as well as such policy-related market surveillance and regulatory questions as may arise from time to time in connection with the trading of existing securities futures. The council arrangement envisions the maintenance of continuous liaison and information exchange between and among its members for the purpose of promoting efficiency, coordination, and consistency in the formulation of overall Government policy. Formal meetings of the council members would take place according to a schedule and frequency agreed on by the council members and on an *ad hoc* basis in response to specific questions or issues which one or more members may

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1/ In chapter 12 we discuss the need for the States to be granted authority to investigate and prosecute fraud in commodity options or commodity futures.

wish to bring before the council. Decisions of the council would be advisory to CFTC and SEC.

CONCLUSIONS

The commodity futures markets play an increasingly important role in the Nation's economy. Because of this, futures trading should be regulated by a strong and independent agency which can instill full confidence in the operation and integrity of the futures markets. We believe that CFTC has made an earnest effort to achieve this objective. Although our review has disclosed weaknesses in Commission management and program activities, we believe the implementation of recommendations for improvement contained in this report, as well as CFTC-initiated efforts to upgrade the regulatory process, will lead to better regulation of the commodity futures industry.

We oppose proposals which would abolish CFTC and transfer its functions back to the Department of Agriculture. A potential conflict of interest would exist if Agriculture were to assume CFTC's responsibilities because the Secretary is charged by law to influence and maintain the prices of many commodities traded in the futures markets.

We are also not in favor of SEC assuming all of CFTC's responsibilities. We believe that the differences between CFTC and SEC in orientation and purpose would pose regulatory problems. Also, such a consolidation may have a detrimental effect on SEC's ability to provide effective regulation over the securities industry. At the same time, we see a need to make some minor modifications in CFTC's jurisdiction over futures contracts on securities. These modifications would, we believe, improve the regulatory process, have minimal adverse effects on market participants, and be largely prospective in nature.

RECOMMENDATIONS TO THE CONGRESS

We recommend that the Congress reauthorize CFTC for 4 years. At the same time, to promote effective and efficient regulation of the commodity futures markets and to assure that those agencies having legitimate concerns on the regulation of futures on financial instruments are taken into account, we recommend that the Congress amend the act to:

--Have SEC regulate all futures contracts on securities (and indexes thereon) subject to the registration requirements of the Securities Act of 1933.

--Give SEC the right to bring enforcement action under sections 17(a), 20, and 22 of the Securities Act of 1933, subject to CFTC's prior right to act.

--Create a council composed of CFTC, SEC, Treasury Department, and such other agencies as the President may designate to serve as an interagency advisory forum on matters dealing with the designation and regulation of financial futures contracts under the jurisdiction of CFTC and SEC. (See app. IV for suggested language which would amend the act to accomplish these recommended changes.)

CHAPTER 3

CONTRACT MARKET DESIGNATIONS

NOT ADEQUATELY PERFORMED

One of the most important and far-reaching regulatory functions performed by the Commission is the designation of an exchange as a contract market in a particular commodity. We found, however, that the Commodity Futures Trading Commission's initial market designation reviews, done in 1975 under time constraints imposed by the CFTC Act, were not comprehensive enough to assure that only contracts meeting statutory and CFTC requirements were designated. Although CFTC has recognized some deficiencies in its initial contract market designation reviews, it has generally not performed more indepth follow-on reviews of designated contracts to assess whether the contracts and the exchanges now meet the requirements.

To better fulfill its contract market designation responsibilities, CFTC needs to

--follow up on unresolved and outstanding issues relating to its 1975 market designation reviews,

--clarify and reevaluate portions of its market designation guidelines,

--monitor exchange evaluations of the terms and conditions of current contracts, and

--designate additional contracts only when it has unequivocally determined that exchanges meet all statutory and CFTC-imposed market designation requirements.

REQUIREMENTS FOR CONTRACT MARKET DESIGNATION

With the enactment of the 1974 CFTC Act, the responsibility for designating boards of trade, called exchanges, as contract markets was transferred from the old Commodity Exchange Authority in the Department of Agriculture to the Commission. Public Law 94-16, approved April 16, 1975, also amended the Commodity Exchange Act to, among other things, allow the Commission to designate existing exchanges on a provisional basis for periods of up to 90 days, allowing them to remain open on the date the CFTC Act became effective, April 21, 1975.

Soon after it was established, CFTC began issuing 90-day interim designations for those contract markets previously regulated by the Authority and interim designations of 15 days for new markets first coming under Federal regulation. By July 18, 1975, it had granted final designation to 46 contract markets on 10 exchanges which had been operating under interim designations. By September 30, 1975, it had granted designation to 89 contract markets on 11 exchanges. Of the 89 contract markets, 39 were previously regulated by the Authority. One of the 11 exchanges, Pacific Commodities Exchange, Inc., in San Francisco, later ceased operations.

Sections 5, 5a, and 6 of the act list certain conditions and requirements which must be complied with and carried out either for an exchange to be initially designated as a contract market or for it to maintain its designation. The conditions include:

--Enforcing all bylaws, rules, regulations, and resolutions (collectively referred to as rules) made or issued by the exchange which have been approved by the Commission.

--Providing for the prevention of false or misleading crop reports by the exchange or any member which affect or tend to affect the price of a commodity in interstate commerce.

--Preventing the manipulation of prices or cornering of any commodity by dealers or operators on the exchange.

--Demonstrating that the transactions for future delivery in the commodity for which designation is sought will not be contrary to the public interest.

--Being located at a terminal market where the cash commodity is sold in sufficient volume and under other conditions or, if not so located, providing for the delivery of commodities at point or points and upon terms and conditions approved by the Commission.

Before designating an exchange, CFTC required each exchange to submit an application containing information CFTC needed to determine whether the exchange complied with statutory contract market designation provisions. The information listed in CFTC's market designation guidelines, referred to as guideline 1, included

--the exchange's rules,

--its rule enforcement program,

--documentation establishing the commercial viability of the contract and justifying its terms and conditions, and

--evidence that the contract would be used for pricing and hedging purposes and an affirmation that it would not be contrary to public interest.

CFTC's regional offices reviewed exchange applications.

EXCHANGES DESIGNATED DESPITE INADEQUATE RULE ENFORCEMENT PROGRAMS

To determine if an exchange is enforcing all bylaws, rules, regulations, and resolutions made or issued by the exchange which CFTC has approved CFTC does rule enforcement reviews. (See ch. 4 for a more detailed discussion.) CFTC's initial rule enforcement reviews were hurriedly performed and were not comprehensive. In most cases they were essentially desk audits. As a result, numerous deficiencies in rule enforcement programs went unnoticed until revealed by later CFTC reviews. Despite their shortcomings the 1975 reviews did uncover deficiencies at four New York and two Chicago exchanges. However, the Commission designated these exchanges anyway.

We also found that the Commission has designated additional contract markets on exchanges even though subsequent rule enforcement reviews have shown that the exchanges' rule enforcement programs needed improvement. In the case of the Chicago Board of Trade, CFTC designated additional contract markets without first comprehensively evaluating the exchange's rule enforcement program.

CFTC regulation 1.51 (17 CFR 1.51, 1977) (see p. 35) cites eight areas which must be included in an exchange's rule enforcement program, such as performing market surveillance to prevent manipulation, investigating customer complaints, and monitoring trading practices to detect and prevent illegal, noncompetitive trading.

The following section describes our evaluation of the rule enforcement reviews conducted by CFTC at the time of initial contract market designation in 1975.

Chicago exchanges

Mid America Commodity Exchange

CFTC's review of the exchange's rule enforcement program consisted of a review of an exchange submission which described the program and interviews with exchange officials. CFTC's review revealed that the exchange did not perform all market surveillance activities, as required by regulation 1.51. Without such surveillance an exchange cannot detect and prevent an adverse situation--such as manipulation--before the market is disrupted. CFTC also expressed concern about the existence of a potential conflict of interest on the part of the president of the exchange. However, on July 18, 1975, CFTC designated the exchange as a contract market in silver, silver coins, and gold.

CFTC's review did not disclose deficiencies in the exchange's monitoring of trade practices, procedures in handling customer complaints, discipline of members, and the exchange's recordkeeping (documentation of its rule enforcement activities). Deficiencies in these and other areas surfaced during CFTC's subsequent, more indepth, review in 1976. (See ch. 4.)

Chicago Mercantile Exchange

CFTC's review was based on interviews with exchange officials, a brief review of the exchange's rules relating to its rule enforcement program, and a prepared statement submitted by the exchange describing its program. CFTC did not independently verify whether the exchange was actually carrying out the program as described in its prepared statement. Nevertheless, CFTC concluded that its review

> " * * * disclosed no evidence of an inadequacy in CME's [Chicago Mercantile Exchange's] rule enforcement program which would justifiably serve as a basis for not designating CME as a contract market * * *."

Because CFTC's review was not thorough, it did not disclose deficiencies in the exchange's (1) trade practice investigation program, (2) surveillance of trading in commodities on a branch exchange (the International Monetary Market), (3) surveillance of floor trading practices, and (4) recordkeeping system. These deficiencies surfaced during CFTC's subsequent review which was completed in August 1977. (See ch. 4.) Also, despite the deficiencies disclosed

during the 1977 review, CFTC designated the exchange as a contract market in platinum (July 1977) and in stud lumber (October 1977).

Chicago Board of Trade

CFTC's review of the exchange's rule enforcement program consisted primarily of CFTC staff interviewing three exchange officials on 2 days in the summer of 1975. CFTC did not independently verify the information obtained from the exchange officials by examining investigative files and other supportive records at the exchange. However, on the basis of these interviews, CFTC's Chicago staff concluded that the exchange did not have an affirmative program to detect and prevent trading abuses and a formal written program for market surveillance. Also, the exchange did not submit to CFTC a written rule enforcement program.

Because of these deficiencies, CFTC's Chicago regional office recommended that the exchange's designation be made conditional on its (1) submitting a written rule enforcement program and (2) establishing and implementing a program for surveilling floor trading practices. However, in a July 18, 1975, letter the Commission advised the Board of Trade that it was designated as a contract market in various commodities without conditions. Although the Commission apprised the Board of Trade of the deficiencies in its program, it stated that it believed designation of the exchange would not be detrimental to the public interest.

In July and August 1977, CFTC designated the exchange as a contract market in two additional commodities--commercial paper and U.S. Treasury bonds. However, at the time CFTC had not (1) determined whether the deficiencies cited in the 1975 report had been corrected or (2) performed a thorough review of overall rule enforcement at the exchange.

CFTC's Division of Trading and Markets first started an indepth rule enforcement review on the exchange on July 25, 1977. On January 23, 1978, the Division submitted to the Commission a report of its findings, which are discussed on page 39. Essentially, the report concluded that there were serious deficiencies in the exchange's rule enforcement program.

New York exchanges

CFTC's reviews of the rule enforcement programs of five New York exchanges in June 1975 were primarily based on discussions with exchange officials and reviews of exchange submissions. Exchange records were not analyzed. However,

the reviews disclosed a number of common deficiencies at four 1/ of the exchanges as shown below:

Deficiencies	New York Coffee and Sugar Exchange	New York Cocoa Exchange, Inc.	New York Cotton Exchange	Commodity Exchange, Inc.
Insufficient staff assigned to rule enforcement	X	X	X	X
Inadequate surveillance of trading practices	X	X	X	X
Inadequate examinations of member's records	X	X	X	X
Inadequate market surveillance	-	X	X	X
Lack of adequate procedures for taking disciplinary actions	-	X	-	X
Lack of adequate examination of apparent violations of exchange rules	-	-	X	-
Failure to maintain required records	-	-	X	-

In addition to designating the above exchanges as contract markets for various commodities in 1975, CFTC designated the Commodity Exchange as a contract market for zinc in October 1977. This was done despite the fact that a CFTC review of the exchange's program in 1976 showed that the original deficiencies were not corrected. (See ch. 4.)

Lack of prompt followup

CFTC's regional offices did not promptly follow up on the deficiencies noted in the exchanges' rule enforcement

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1/ CFTC's review of the fifth exchange, the New York Mercantile Exchange, did not reveal any deficiencies.

programs in 1975 but waited until 1976 and 1977 to perform more comprehensive reviews. The Chicago regional office claimed it lacked adequate staff to perform the necessary followup, and the New York regional office wanted to give the exchanges ample time to acquire staff to implement CFTC's guidelines on rule enforcement. However, as discussed in the next chapter, CFTC's 1976 reviews disclosed that rule enforcement at the New York and Chicago exchanges had not improved.

PROBLEMS IN THE REVIEW OF CONTRACT TERMS AND CONDITIONS

According to CFTC's Advisory Committee on the Economic Role of Contract Markets, properly drafted contract terms and conditions reduce the potential for manipulation, congestion, or control and promote greater hedging and pricing benefits to commercial users of the futures markets. However, CFTC approved trading in previously regulated commodities without carefully reviewing whether the contract terms and conditions used by the applicable exchanges complied with the act or CFTC guidelines.

CFTC's 1975 reviews of the terms and conditions of previously unregulated commodities were also not thorough. In some cases, CFTC designated exchanges despite known contract deficiencies. Further, although exchanges have continuing responsibility to ensure that contract terms and conditions reflect changing market conditions, CFTC has not monitored exchange programs to accomplish this or established its own programs for contract reviews.

The importance of properly drafted contract terms and conditions was underscored by the CFTC advisory committee. In its July 1976 report, the Committee concluded that " * * * proper contract terms and conditions can be more effective in preventing market abuse than any regulatory action after an abuse has occurred." The report added that one of the most productive areas for investment of Commission resources is in assuring that the exchanges constantly work to improve the terms and conditions of their contracts.

Some examples of contract terms and conditions considered important under CFTC's market designation guidelines include whether

--the number of delivery points is sufficient to assure orderly liquidation of contracts,

--transportation and storage facilities are adequate and whether the public has access to such facilities,

--grading or inspection services are easily accessible,

--access to a cash market is adequate so that deliveries can be resold,

--public or private market news is reliable,

--price differentials arising from different delivery locations are reasonable, and

--grade differentials of commodities are reasonable.

The importance of proper contract terms and conditions is amplified by various provisions of the act. Under section 5, CFTC approval of contract terms and conditions is a prerequisite for market designation. 1/ Section 5a requires that exchanges, after initial designation, assure that contract terms and conditions are adjusted when necessary to recognize changing market conditions over time. CFTC is authorized by section 5a to investigate an exchange's contract terms and conditions and, if necessary, require the exchange to revise them.

Reviews of contract terms and conditions before designation not made or not thorough

CFTC did not review the contract terms and conditions of the 39 futures contracts previously regulated by the Secretary of Agriculture because of severe time constraints and CFTC's heavy workload. CFTC intended to review these contracts later pursuant to section 1.50 of its regulations, which required contract markets to submit evidence at least once every 5 years that they continue to comply with the provisions of sections 5 and 5a of the act. 2/ However, as of April 1978, CFTC had reviewed only 8 of the 65 active contracts traded on the 10 national exchanges.

1/ The act provides that exchanges located at terminal markets can be exempted from this provision.

2/ In December 1977 the Commission issued proposed changes to its regulation 1.50 which would eliminate the mandatory 5-year filing requirement and the requirement that submissions demonstrate compliance with sections 5 and 5a of the act. Instead, exchanges would be requested to submit such reports as the Commission may specify.

To allow uninterrupted trading, in April 1975 CFTC provisionally designated contract markets for the previously unregulated commodities without a review of contract terms and conditions. CFTC gave the respective exchanges a few months to submit the required market designation applications and supporting documentation. CFTC's reviews of the submissions were performed hurriedly and were of limited scope. Nevertheless, CFTC found deficiencies in some of the contracts but designated them all in July 1975.

For example, CFTC's New York office noted deficiencies with regard to the terms and conditions of contracts in silver coins, palladium, gold, and silver which are traded on two New York exchanges. Nevertheless, CFTC approved the contracts, stating it would perform indepth reviews of these and the other previously unregulated contracts in more detail later. However, as of April 1978, CFTC had not reviewed these or other newly regulated contracts. A CFTC official told us that "higher priority work" on proposed options trading and a potato default case on the New York Mercantile Exchange prevented them from performing the followup reviews.

Need to monitor contracts after designation

As previously mentioned, the act requires that terms and conditions of the futures contracts adequately and continuously reflect prevailing conditions in the cash market. Exchanges that do not comply are subject to CFTC enforcement action. However, our review showed that CFTC has not closely monitored exchange performance in this area. CFTC's general practice has been to wait for the exchange to submit contract changes to the Commission for approval rather than to systematically monitor the quality of exchange contract review activities. For example, between July 1, 1975, and March 31, 1977, CFTC reviewed proposals by CME and CBT to change the terms and conditions of 12 of their contracts. Although exchange officials contend that their committees continuously review all their contracts, CFTC did not monitor committees' activities to determine the frequency and quality of such reviews. CFTC Chicago officials told us that they were unfamiliar with exchange activities in this area.

During our review of CFTC files, we noticed that in February 1977 CFTC had advised CBT that its soybean futures contract was susceptible to manipulation because Chicago is the only point at which contract deliveries can be made. Chicago soybean receipts have declined over the last 20 years, while nationwide soybean production and soybean

futures trading have trebled. In August 1975 CBT proposed St. Louis and Toledo as additional delivery points for soybeans, but the proposal was withdrawn by mutual agreement. Recently, CFTC concluded that the volume of soybeans entering the Chicago market is inadequate to support the futures contract and recommended that CBT consider adding additional delivery points. The exchange, however, saw no need for additional delivery points. As of April 1978 the issue had not been resolved.

In New York we found that CFTC identified some contracts that needed revision but CFTC had not obtained the necessary changes. For example, in August 1976 CFTC found that the New York Cocoa Exchange's cocoa contract did not conform to normal commercial practices because of fundamental changes in production and delivery conditions which have occurred since the contract was established 35 years ago. Although over 60 percent of all cocoa delivered between 1949 and 1975 on the New York Cocoa Exchange contract was from the Dominican Republic, it represented only about 3 percent of the total world production in that period.

On the basis of the August 1976 study, CFTC recommended that the Cocoa Exchange change some of the terms and conditions of the cocoa contract. The exchange objected but set up a special committee to study the matter. However, as of April 1978 the matter had not been resolved.

We discussed CFTC's efforts to review contract terms and conditions with agency officials responsible for such reviews. They described CFTC's efforts as virtually inoperative and at a standstill. A CFTC official agreed with our observation that CFTC's limited work in this area has been reactive rather than deliberate.

We also learned that the extent of future CFTC efforts to systematically review contract terms and conditions is uncertain. A December 1977 memorandum to the Commission from the office responsible for the review program stated that during fiscal year 1978 the office planned to revitalize CFTC's efforts in this area. However, the office also stated that the program is one which would likely be postponed to accommodate higher priority needs, such as new contract market designations and the proposed options pilot program. We have serious reservations concerning CFTC's policy of considering options and new contract market designations as being higher priority than assessing the adequacy of the existing contracts it regulates.

ECONOMIC PURPOSE AND PUBLIC INTEREST NOT ADEQUATELY DEMONSTRATED

CFTC has not strictly enforced its requirement that exchanges pass an economic purpose test by proving that proposed contracts can reasonably be expected to be used for pricing or hedging purposes. Also, CFTC needs to clarify its market designation guidelines and better explain the type and quantity of evidence that exchanges need to submit to pass the test. Further, CFTC may not be fully implementing section 5(g) of the act, which specifically requires that exchanges must demonstrate before market designation that futures trading in proposed contracts would not be contrary to the public interest.

CFTC interpreted the act, based on the legislative history, to include the concept of an "economic purpose test." Accordingly, CFTC required in its guideline 1 that exchanges provide CFTC with evidence that

--prices of the commodity for which designation is sought can be expected to be generally quoted and disseminated as a basis for determining prices to producers, merchants, or consumers or

--the futures contract can be expected to be used by producers, merchants, and consumers as a means of hedging themselves against possible loss through fluctuations in price.

Guideline 1 also states that to pass the economic purpose test an exchange must establish "* * * that something more than occasional use of the contract for hedging or price base exists, or can reasonably be expected to exist." The guidelines do not indicate the specific type or quantity of evidence which must be submitted. However, CFTC's practice is to allow an exchange to pass the test if it can obtain more than one letter from potential commercial users which are in favor of the contract. Concerning public interest, CFTC only requires that exchanges affirm that trading in the proposed contract will not be contrary to the public interest.

In applying its economic purpose test and in considering a contract's public interest, CFTC has taken the position that a futures contract which is likely to be traded actively on an organized futures market can be presumed to provide economic benefits, such as hedging and price discovery, unless it has a fundamental flaw. Therefore, CFTC maintains it should approve all contracts that do not contain obvious flaws. CFTC refers to this as the "why not?" test.

Because we questioned whether CFTC's economic purpose test was sufficiently thorough and whether its "why not?" test and the affirmation it requires of exchanges met the intent of section 5(g) of the act, we discussed these matters with CFTC officials. A high-ranking CFTC economist told us that in his opinion the economic purpose and the public interest tests are "shams" and that he had told this to the Commission. The so-called economic purpose test is not a test at all, according to this official, because it consists merely of soliciting some evidence that commercial sources which participated in the development of the contract have expressed an interest in its hedging potential.

According to the official the public interest test is even more deficient because it consists merely of an affirmation from the exchange proposing the contract. He pointed out that it might reasonably be asked how anyone could expect an exchange which is proposing a contract to say anything else.

Another CFTC official told us that the Commission's "why not?" test was conceived because the Commission did not want to question the theoretical arguments underlying the economic merits of futures trading. She believed, however, that it was the Commission's statutory responsibility, before designating a contract, to establish whether in fact a contract would be in the public interest. She stated further that the Commission should reexamine the economic purpose and public interest requirements contained in guideline 1 as they pertain to initial and continued designation of contracts.

As part of our review of CFTC market designation procedures, we examined CFTC's designation of selected futures contracts, including long term U.S. Treasury bonds and commercial paper (CBT, August and July 1977) and platinum (CME, July 1977). Our examination of CFTC market designation files and discussions with CFTC officials disclosed that the exchanges did not submit sufficient evidence that the three proposed contracts could reasonably be expected to be used for pricing or hedging purposes. Therefore, according to CFTC headquarters officials, CFTC regional staff contacted industry representatives to develop such evidence and thereby independently establish the economic purpose of the three contracts. However, CFTC regional staff were not successful.

For example, evidence CFTC obtained for the U.S. Treasury bonds contract consisted of interviews with officials of three banks, one department store, and one brokerage firm; however, none of the officials indicated

their firms would use the contract for pricing and hedging purposes. As support for the platinum contract, CFTC interviewed a number of metal processing companies and traders. However, most of these firms and traders were using a platinum contract traded on the New York Mercantile Exchange. While several of these firms were in favor of the larger CME contract which called for delivery of 100 troy ounces vs. New York's 50 troy ounces, they did not confirm they would use CME's contract.

Because the exchanges did not supply evidence as required by CFTC "* * * that something more than occasional use of the contract for hedging or price basing exists, or can reasonably be expected to exist," we asked CFTC officials why the three contracts were designated. They replied that the Commission takes a very liberal view when it considers the economic purpose of contracts. According to one of the officials who was present at the Commission meeting at which it decided to approve one of the contracts, the Commission expressed concern over the lack of evidence on the contract's purpose but not enough concern to delay approval of the contract until the economic purpose was satisfactorily established.

In New York we reviewed CFTC's designation of the New York Mercantile Exchange as a contract market in industrial fuel oil and designation of the New York Cotton Exchange as the contract market for crude oil. Concerning industrial fuel oil, we found that CFTC's New York regional office recommended to CFTC headquarters that the contract not be designated by the Commission because, among other things, the exchange did not comply with CFTC's request that it provide letters from industry members indicating the potential or actual use of the contract for hedging or pricing purposes. Also, CFTC interviews with industry representatives failed to identify a hedging or pricing purpose for the contract. Further, CFTC found that the oil referred to in the contract's terms and conditions did not meet U.S. Environmental Protection Agency air pollution standards throughout most of the northeastern and southeastern regions of the United States.

CFTC's New York regional office review of the New York Cotton Exchange's submission for designation as a contract market in crude oil also revealed a lack of evidence that the contract could be reasonably expected to be used for hedging or pricing purposes. Further, the regional office's reviews of actual trading in the contract did not turn up any evidence of hedging in the contract. Accordingly, the regional office recommended

to CFTC headquarters that the exchange not be given a permanent designation. However, despite the regional office's recommendations, the Commission designated the above contracts in July 1975, deciding to pursue the economic purpose problems later.

In its July 1975 designation letter to the New York Cotton Exchange, the Commission expressed concern about the lack of trading of the crude oil contract and the fact that contracts with low volume, such as crude oil, tend to be more susceptible to manipulation and other practices which are contrary to public interest. In the summer of 1976, a New York grand jury with assistance from CFTC initiated an investigation of alleged violations of State fraud and tax laws through prearranged trading in crude oil futures. In July 1976 CFTC's Chairman acknowledged that if the contract was used primarily for tax avoidance, it served no economic purpose and that CFTC would consider whether to terminate it after the investigation was completed. In April 1978 a Federal grand jury indicted five brokers and a New York grand jury indicted six brokers on charges of fraud and tax evasion stemming from trading in crude oil futures on the New York Cotton Exchange. According to a Justice Department official, the investigation was continuing.

NO FOLLOWUP ON DEFICIENCIES DISCLOSED DURING REVIEW OF EXCHANGE RULES

Before designating exchanges in 1975, CFTC performed a limited review of exchanges' rules to determine whether the rules conformed to provisions of the act or CFTC regulations. CFTC looked at exchange rules on preventing fradulent and other illegal transactions, recordkeeping, contract terms and conditions, segregation of customer funds, and various other exchange duties. CFTC's reviews disclosed a number of deficiencies in exchange rules. However, CFTC did not always promptly follow up to get the exchange to change the rules.

For example, CFTC asked CBT to revise a rule allowing floor brokers trading in silver and iced broilers (chickens) to continue trading during the closing call. This gave floor brokers an advantage over customers, according to CFTC reviewers. The exchange claimed that revising the rule would not eliminate a broker's advantage over customers. As of January 1978, the dispute had not been resolved.

In another case CFTC asked CBT to pass a rule requiring its members to file certain reports on cash and futures

transactions that would satisfy section 5(b) of the act. The exchange opposed such a rule because it believed it was the Commission's responsibility and not an exchange's to implement congressional policy and interpret and enforce the act. However, it was not until December 1977, or about 18 months after its review of CBT, that the Commission issued a proposed regulation which addressed the issue. The regulation would require that when the Commission so directs, CBT, as well as all other exchanges, will conduct investigations or proceedings as may be necessary to enforce requirements of the act.

Our reviews of CFTC's designations of five selected futures contracts traded on New York exchanges also disclosed that CFTC did not require exchanges to make revisions in some of their rules. For example, CFTC's rule reviews showed that one exchange needed to clarify a rule on the exchange's procedures for allocating trades under certain market conditions. In another case CFTC found that an exchange's rules apparently permitted the exchange to amend its rules without prior CFTC approval. As previously mentioned, the act requires such approval. As of January 1978 these rule deficiencies and others remained unresolved.

In its market designation letters to the New York and Chicago exchanges, the Commission stated that due to time constraints imposed by the act, it was unable to conduct indepth reviews of exchanges' rules and that eventually the Commission would actively and aggressively conduct reviews of exchanges' rules. In January 1978, 30 months after initial market designation, a CFTC official advised us that CFTC had just started reviews of some of the New York exchanges. CFTC officials cited higher priorities as the reason CFTC waited so long to perform the reviews.

CONCLUSIONS

CFTC's initial market designation reviews were clearly inadequate to assure that exchanges met statutory and CFTC designation requirements. The reviews were performed hurriedly and were incomplete and often superficial. Although our review concentrated on CFTC's 1975 initial market designation reviews, our review of some recently designated contracts showed that improvements in CFTC procedures are still needed.

In the rule enforcement portion of the contract market designation process, CFTC's reviews were superficial and did not uncover many deficiencies in exchanges' programs. Also, exchanges were later designated as contract markets in additional commodities even though CFTC did not determine

whether original deficiencies or those disclosed by subsequent rule enforcement reviews had been corrected.

In view of the central role rule enforcement plays in the self-regulatory theme of the act and in CFTC's regulatory philosophy, CFTC should adopt a strict policy of only designating an exchange as a contract market in a new commodity when CFTC has determined through its rule enforcement reviews that the exchange has a viable affirmative rule enforcement program.

While properly drafted contract terms and conditions are considered the most effective way of preventing market abuse, CFTC did not review the terms and conditions of the previously regulated contracts in 1975 and has only performed a few such reviews since then. Also, CFTC reviews of newly regulated contracts were limited. In cases where its reviews did uncover deficiencies, it did not follow up with the exchanges to obtain timely resolution of the problem.

Although exchanges have a continuing responsibility to ensure that contract terms and conditions reflect changing market conditions, CFTC has not monitored exchange programs to accomplish this or established its own program to review contracts. Also, CFTC plans for increased effort in this area may fall victim to options work and other "high priority" items. We question whether CFTC should consider designating new contracts or, as discussed later in this report, embarking on a new area of regulation--commodity options--until it has a firm grip on existing commodities under its regulatory umbrella.

Another neglected area in CFTC's market designation process is the absence of a meaningful public interest test. Although the act expressly requires exchanges to demonstrate that trading in a particular commodity will not be contrary to the public interest, CFTC has not required exchanges to do so. Instead, it relies on its "why not?" test and a simple affirmation from the proposing exchange. We have serious reservations about whether CFTC's approach fulfills the statutory requirement that proposed contracts not be contrary to the public interest.

Also, our review of selected contracts designated by CFTC showed that it did not adequately enforce its economic purpose requirements aimed at determining whether the contract would be used by producers, merchants, or consumers for hedging or pricing purposes. Further, CFTC needs to clarify its market designation guidelines to better explain

the type and quantity of evidence exchanges must provide CFTC to establish that contracts will be used for pricing or hedging purposes.

Finally, we found that CFTC did not perform indepth systematic reviews of exchange rules to determine whether they conform to CFTC regulations and the act. Although CFTC told the exchanges in 1975 that it would subsequently perform such reviews, CFTC has only recently started to perform them.

RECOMMENDATIONS TO THE CHAIRMAN, CFTC

To ensure only those contracts meeting statutory requirements are designated and remain designated as contract markets, the Commission should:

--Promptly follow up on all unresolved and outstanding issues pertaining to the 1975 initial designations. This should include performing indepth, across the board reviews of exchanges' rules, especially those dealing with contract terms and conditions of actively traded contracts.

--Clarify and enforce CFTC's market designation guidelines dealing with the economic purpose test and consider establishing and adding to the guidelines a meaningful public interest test.

--Establish a program to monitor how well the exchanges are carrying out their continuing responsibility to ensure that contract terms and conditions reflect changing market conditions. If such monitoring reveals that exchange activities are deficient, then the Commission should take appropriate action to obtain compliance by the exchanges.

--Establish and implement a strict policy of only designating additional contracts when the Commission unequivocally determines [illegible] the proposing exchange meets all statutory and [illegible] imposed requirements, especially the requirement that exchanges maintain an affirmative rule enforcement program.

CHAPTER 4

CFTC'S RULE ENFORCEMENT

REVIEW PROGRAM NEEDS IMPROVEMENT

While the Commodity Futures Trading Commission reviews have identified many weaknesses in the rule enforcement programs at the eight New York and Chicago exchanges, the effectiveness of the reviews is questionable. We found that CFTC needs to upgrade its rule enforcement review program, including establishing uniform guidelines for performing reviews and better criteria for evaluating exchange performance and requiring its staff to better document its review work, so that CFTC can better assess, monitor, and improve exchange compliance with statutory and Commission requirements on rule enforcement. Also, CFTC needs to more effectively and promptly follow up on deficiencies it finds at exchanges. Additionally, CFTC needs to determine whether exchange rule enforcement deficiencies violate the act or regulations and should establish policy for taking enforcement action--cease and desist orders, fines, suspensions, or revocations of trading--against violators. Furthermore, CFTC needs to better address potential conflict-of-interest situations at exchange disciplinary committees.

Exchanges are required by section 5a(8) of the act to enforce all of their rules, bylaws, regulations, and resolutions 1/ which CFTC has approved. Exchange enforcement of these rules is the key to the self-regulatory process which the Congress envisioned when it established CFTC. CFTC monitors exchange rule enforcement through its rule enforcement review program. However, CFTC reports evaluating rule enforcement at the New York and Chicago exchanges, including a January 1978 report on the Chicago Board of Trade--the Nation's largest--show that effective self-regulation in the commodity markets is not yet a reality.

Although CFTC officials believe that some exchanges have or are in the process of correcting program weaknesses, CFTC has either not performed or completed followup reviews at the exchanges to independently verify whether substantial improvements have been made in their rule enforcement programs.

1/ We refer to all of these collectively as rules.

REQUIREMENTS FOR EXCHANGE RULE ENFORCEMENT

The statutory requirement that exchanges must enforce their own rules is amplified by CFTC regulation 1.51. The regulation requires that exchanges must maintain a continuing affirmative action program to enforce their rules. Specifically, the regulation provides that the exchange program must include:

1. Surveillance of market activity for indication of possible congestion or other market situations conducive to possible price distortion.

2. Surveillance of trading practices on the floor of such contract market.

3. Examination of the books and records kept by contract market members relating to their business of dealing in commodity futures and cash commodities on such contract markets.

4. Investigation of complaints received from customers concerning the handling of their accounts or orders.

5. Investigation of all other alleged or apparent violations of rules.

6. Such other surveillance, record examination, and investigation as necesary to enforce rules.

7. A procedure which results in taking prompt, effective disciplinary action for any violation which is found to have been committed.

8. A complete and systematic recordkeeping of all actions involving the above requirements.

In May 1975, CFTC issued advisory guidelines, referred to as guideline 2, explaining the objectives behind each of the above eight requirements as well as outlining the components of an adequate rule enforcement program.

When CFTC finds that an exchange has not enforced its rules, section 6 of the act grants CFTC authority to suspend or revoke the exchange's designation as a contract market, thereby halting trading. Also, section 6b of the act grants CFTC authority to issue cease and desist orders and to assess a civil penalty of up to $100,000 for each violation of the act or CFTC regulations.

CFTC's Trading and Markets Division is responsible for reviewing rule enforcement programs at exchanges. As mentioned in the previous chapter, CFTC performed very limited rule enforcement reviews during its review of exchange market designation applications in 1975. Since then it has completed full-scale rule enforcement reviews at 9 1/ of the 10 commodity exchanges. The division plans to start a review of the Minneapolis Grain Exchange in 1978.

BETTER RULE ENFORCEMENT AT EXCHANGES NEEDED

CFTC's rule enforcement reviews have shown that self-regulation in the commodity futures industry has not reached an acceptable level. CFTC officials believe that many of the deficiencies cited in their reviews of the Chicago and New York exchanges have been or are in the process of being corrected. However, this belief is not based on independent verification by CFTC at exchanges. Therefore, the extent of deficiencies actually corrected will not be known until CFTC completes followup reviews at the exchanges.

Chicago exchanges

MidAmerica Commodity Exchange

The exchange was the first CFTC reviewed in Chicago. Its December 8, 1976, review report cited significant deficiencies in nearly every aspect of the exchange's rule enforcement program. Specific deficiencies uncovered by the CFTC review included:

Market surveillance:

--The exchange's market surveillance programs were virtually nonexistent.

--Exchange prices were not being disseminated. There was no program to detect situations conducive to price manipulation and abnormal price movements.

Trading surveillance:

1/ Includes a review of the Board of Trade of Kansas City, Missouri, Inc. As noted in ch. 1, our review was limited to CFTC's regulation of exchanges in Chicago and New York.

--The exchange's program to detect abusive trading practices was minimal. Also, floor trading surveillance was almost nonexistent. This, coupled with the exchange's delay-ridden investigatory and disciplinary processes, created the danger of abuses occurring almost unchecked, with substantial injury to the public.

Review of members' records:

--The exchange generally had no program to regularly review members' books and records for compliance with exchange financial and recordkeeping requirements.

Customer complaints:

--An exchange member firm had allegedly received preferential treatment regarding customer complaints because the firm's president was a high-ranking exchange official. The exchange had not investigated customer complaints against the firm, apparently allowing the firm to resolve complaints without a formal record of investigation.

Disciplinary actions:

--There were no prompt and effective disciplinary actions. During the 1-year period covered by CFTC's review, the exchange took no such actions despite the existence of 113 disciplinary cases.

In a memorandum to the Commission transmitting the review report, the Director of the Division of Trading and Markets stated that the situation at the exchange was serious and recommended that:

1. The exchange's economic justification for contract market designation be reevaluated.

2. Its administrative and governing bodies be reorganized.

3. Its present rule structure be revised and enforced to accommodate the exchange's obligation as a public institution.

4. CFTC consider instituting proceedings against the exchange for, among other things, failure to enforce its rules.

After its December 8, 1976, report on the exchange, CFTC negotiated with the exchange to improve its rule enforcement program. On August 15, 1977, about 8 months later, the exchange, without admitting or denying any wrongdoing, agreed to pay a fine of $50,000 and to implement most of CFTC's recommendations. CFTC has not yet performed a followup review to determine whether the exchange has implemented its recommendations.

Chicago Mercantile Exchange

CFTC began a review of the exchange, the Nation's second largest, in November 1976. CFTC's August 8, 1977, report characterized the exchange's rule enforcement program as generally aggressive, innovative, and prompt and the most effective examined to date. However, the report cited various deficiencies in the exchange's program, including:

--Little attempt was made to detect various types (noncompetitive) of abusive trading practices even though two CFTC investigations had shown that abusive practices were occurring on the exchange.

--Not placing enough emphasis on surveillance of commodities on a branch exchange--the International Monetary Market.

--No routine floor surveillance of trading practices was performed.

--Recordkeeping of rule enforcement activities was inadequate.

--Time required to complete investigations of customer complaints was often excessive.

--More staff was needed for enforcement of exchange rules.

In an August 8, 1977, memorandum transmitting the review report to the Commission, the Division of Trading and Markets cited examples of corrective action taken or planned by the exchange in response to CFTC's findings. However, CFTC has not independently verified--through followup review--that the exchange has taken corrective action.

Chicago Board of Trade

CFTC began a review of the exchange on July 25, 1977. 1/ The Division of Trading and Markets presented its report to the Commission on January 23, 1978. In the report the division cited numerous deficiencies in the exchange's rule enforcement program, and in some cases the division cited violations of Federal regulations. However, the division stated that it was not recommending "* * * at this time * * *" that the Commission undertake any formal enforcement action against the exchange or any of its members. Some of the deficiencies and violations cited in the report were:

Market surveillance:

--There was little concern by the exchange for "* * * price artificiality and uneconomic movement of the cash commodity caused by attempted manipulation * * *." Also, there was a lack of independence on the part of the exchange's staff which impeded an effective market surveillance program.

Trading surveillance:

--The exchange was in violation of regulation 1.51 (a) (2) because it did not perform surveillance to detect various types of abusive trading practices. Additionally, the exchange was found to be in violation of regulation 1.35 (e) and was "* * * unable to adequately police its markets * * *" because it did not have a single record which contains accurate trade data maintained in computer-readable form. Compounding these and other trading surveillance deficiencies "* * * is the fact that the Board of Directors [of the exchange] has shown comptemptuous disregard of its rule enforcement responsibilities * * *" under the act and CFTC guidelines by delaying improvements in its surveillance activities.

Customer complaints:

1/ The review did not cover the exchange's compliance with regulation 1.51 (a)(3)--examination of books and records kept by exchange members--because CFTC's rule enforcement review staff was unable to obtain the services of CFTC auditors during the time of the review.

--The exchange's program contained seven significant deficiencies including the failure to form conclusions on cases or consider rules which may have been violated.

Disciplinary action:

--The exchange was found to be in violation of regulation 1.51 (a)(7) which requires that exchanges take prompt and effective disciplinary action for any violation found to have been committed by a member. Disciplinary action was taken by the exchange in only 4 percent of disciplinary cases and most of these actions involved either warning letters or cease and desist orders as opposed to fines or trading suspensions. The exchange's disciplinary committees set no standards for evaluating evidence and gave no reasons for their decisions.

On February 1, 1978, the division sent a letter to the president of the exchange informing him of the deficiencies and violations uncovered by the review. The division also advised the exchange that it was required to take certain actions designed to improve the exchange's rule enforcement program and compliance with applicable regulations. Among other things, the exchange was required to

--submit a plan for improvement of its market surveillance program,

--submit a plan for compliance with regulation 1.51 (a)(2)--surveillance of trading activity,

--implement division recommendations to improve handling of customer complaints, and

--set uniform standards for evaluating evidence in disciplinary cases and require disciplinary committees to articulate and record reasons for all disciplinary actions.

New York exchanges

In the spring of 1976, CFTC performed rule enforcement reviews at the five New York exchanges. In a July 12, 1976, report on the five exchanges, CFTC concluded that none of the exchanges had adequate rule enforcement programs. The report stated that the two previously regulated exchanges--the New York Mercantile Exchange and the Cotton Exchange--

had better programs than the three previously unregulated exchanges. Examples of deficiencies cited in CFTC's report were:

New York Mercantile Exchange

--Inadequate procedures for examining members' books and records to determine whether members were complying with the exchange's recordkeeping and margin requirements.

--Limited inquiry into customer complaints.

--Inadequate recordkeeping of its rule enforcement procedures.

Commodity Exchange, Inc.

--Insufficient staff to conduct an effective rule enforcement program.

--No evidence of meaningful daily surveillance of market activity.

--No surveillance of trading practices.

--No examination of member firms' records.

--Inadequate procedures for handling customer complaints.

New York Cocoa Exchange

--No program to examine members' books and records.

--Inadequate program for investigation of customer complaints.

--Inadequate recordkeeping of its enforcement procedures.

New York Cotton Exchange

--Inadequate customer complaint program.

--Inadequate examination to detect trading abuses.

--Deficient market surveillance program.

--Inadequate recordkeeping of the exchange's rule enforcement procedures.

New York Coffee and Sugar Exchange

--Insufficient staff to conduct a rule enforcement program.

--No program to examine members' books and records.

--Inadequate market surveillance program.

--Inadequate program to detect trading abuses.

On July 22, 1976, CFTC sent letters to the five exchanges notifying them that they must upgrade their rule enforcement programs. The letters instructed each exchange to submit to CFTC, within 30 days, a detailed timetable setting forth the measures the exchange planned to take to comply with statutory and CFTC requirements on rule enforcement. According to the letters, once CFTC reviewed and approved the timetables, the exchanges were to submit monthly status reports advising CFTC of the progress made in each area. However, according to CFTC officials, the exchanges submitted their timetables, but CFTC never officially approved them or contacted the exchanges concerning the adequacy of their submissions. Also, CFTC decided not to request monthly status reports from the exchanges.

To follow up on exchange actions to correct deficiencies cited in the July 22, 1976, letters, CFTC's staff at the New York regional office visited each of the exchanges during the months of November 1976 through February 1977. These visits, referred to by CFTC officials as "minireviews," only covered the exchanges' procedures for handling customer complaints and disciplinary actions but not other areas in which the CFTC 1976 rule enforcement review uncovered deficiencies.

In May 1977 CFTC's New York office started followup reviews of the five exchanges. As of March 20, 1978, CFTC had not completed its review of two of the exchanges and had not prepared final review reports for the other three. According to a CFTC New York official, the New York exchanges have improved their rule enforcement programs. This was supported by preliminary reports prepared by CFTC regional staff. We also made limited test checks at four of the exchanges which confirmed that improvements are being made. The fifth, the Cocoa Exchange, denied us access to its records. CFTC headquarters officials responsible for reviewing the New York regional office's work stated that although improvements have been made by the exchanges, self-regulation in New York is still not up to par.

CFTC'S RULE ENFORCEMENT REVIEW PROGRAM CAN BE IMPROVED

Our review showed that CFTC needs to establish uniform guidelines and improve how it reviews and assesses the quality of exchanges' rule enforcement programs. CFTC also needs to more promptly follow up on deficiencies noted and establish criteria on when to take enforcement action against exchanges which violate the act or regulation 1.51. Further, CFTC needs to better address potential conflict of interest situations on exchange disciplinary committees.

We noted that in addition to procedural problems encountered by CFTC, its rule enforcement program has undoubtedly been hampered by staff turnover. Some of the most qualified and capable headquarters and regional staff involved in rule enforcement have left the agency. The problem of staff turnover is discussed in chapter 14.

Need for uniform guidelines on performing rule enforcement reviews

CFTC does not have uniform guidelines for performing rule enforcement reviews. CFTC staffs follow their own procedures when performing reviews at the various exchanges. Because of this and additional deficiencies we noted in CFTC reviews, CFTC cannot assure that its reviews are sufficiently thorough or are accomplished in an effective manner.

CFTC's review of the Chicago Mercantile Exchange was performed without any audit guidelines. For its review of the Chicago Board of Trade, the CFTC staff prepared a two-page outline but no audit guidelines or program on how it was to perform the review.

A task force composed of staff from CFTC's New York and Washington offices performed the 1976 rule enforcement reviews of the New York exchanges. No formal guidelines were used to perform the reviews. Most of the field work for the current followup reviews of the New York exchanges was performed by New York CFTC staff, which prepared its own guidelines.

Need to better document its reviews

CFTC regulation 1.51 requires exchanges to "* * * keep full, complete, and systematic records * * *" of its rule enforcement program. Without good records CFTC claims it is not able to review the adequacy of an exchange's program. We agree. An auditor or investigator should obtain sufficient evidence to support his opinions, conclusions, and

recommendations and should maintain working papers which reflect the details of the evidence he relied on.

Maintaining sufficient documentary records is especially important to CFTC if it is to exercise its authority under the act and bring enforcement actions against exchanges which violate the act or CFTC regulation 1.51. Without complete and systematic documentation to support its review findings, CFTC may find itself unable to prove an exchange's program is in violation of the act or the regulation.

We examined the workpapers CFTC maintained to support the findings and conclusions appearing in its rule enforcement review reports and found that the papers generally consisted of depositions and interview records. CFTC had little documentation to show that it examined and analyzed exchange records and files during its rule enforcement reviews.

For example, CFTC officials told us that on its 1976 rule enforcement reviews of the New York exchanges, CFTC staff reviewed records at each New York exchange. However, we found CFTC had no documentation--workpapers--to substantiate this. A New York CFTC official informed us that the staff only makes scratch pad notes on exchange records it examines. After the staff has written its reports these notes are destroyed, according to the official. We also found little or no workpapers in support of the minireviews CFTC performed in the winter of 1976-77 or its current review of the New York exchanges.

In Chicago, we found essentially the same thing existed on CFTC's reviews of the MidAmerica and the Chicago Mercantile Exchanges. Other than depositions and interview records, CFTC often did not maintain workpapers documenting the conclusions and recommendations appearing in its rule enforcement reports. Many of the workpapers consisted of copies of exchange files and computer runs. However, there was no indication on the copies that CFTC performed any verification of the records to determine their accuracy and reliability or whether the files and computer runs were used according to exchange procedures. Some of the workpapers attempted to describe CTFC's review of selected aspects of an exchange's rule enforcement program. However, the workpapers were incomplete and disorganized and generally did not adequately describe the actual CFTC staff work or how the work supported the findings and conclusions appearing in CFTC's review report.

For example, CFTC's report on the MidAmerica Exchange concluded that the exchange's "* * * investigation reports

were generally thorough * * *." However, CFTC had no workpapers to show that it had in fact reviewed the exchange's reports. CFTC's review report also concluded that the exchange had an inadequate market surveillance program. To demonstrate this CFTC's report contained the following record of conversation:

CFTC official	Q.	How about surveillance with respect to price movements? Do you personally do anything with respect to that?
Exchange official	A.	Mid-America is a secondary market following closely the fluctuations of the Chicago Board of Trade and that of the Chicago Mercantile Exchange. On that basis, the fluctuations are, not in all cases, but, in most cases, parallel to those of those two other markets, and, therefore, surveillance in the area you refer to would not be a primary concern.
CFTC official	Q.	. . . then you do some surveillance?
Exchange official	A.	We're aware, I think, of when a dangerous situation is developing and we will look at it on our open interest sheets and watch brokers and possibly become alert to who may be creating this situation. It's not a primary concern.

CFTC's report did not state whether it independently verified the degree to which MidAmerica prices parallel those on the other Chicago exchanges on a daily basis. Nor did the report state whether CFTC looked at any cases of "dangerous situations" to determine what actions the exchange had taken. CFTC workpapers also did not address these issues.

At the Chicago Mercantile Exchange, CFTC reported that the exchange was slow in completing investigations of customer complaints. The report contained the following

statement to explain the exchange's justification for having some complaints open for long periods:

> "The CME attributed these lengthy investigations primarily to situations where the customer lost interest in the Exchange's resolution of the complaint. This ordinarily occurs when a monetary settlement is agreed upon by the customer and the member. According to [the official] who has the major staff responsibility for customer complaints, if a customer does not continue to pursue his complaint, the case loses its attraction and priority among [Exchange] investigations."

CFTC's workpapers did not indicate whether CFTC determined how many prolonged cases were the result of customers' losing interest or whether there were additional reasons why cases remained open so long.

Concerning disciplinary actions, CFTC's files showed that during 1976 CME took actions against firms and individuals which violated exchange rules. The exchange's actions varied from issuing warning letters to fines and suspension of trading privileges. CFTC's report states that the exchange imposed the penalty which it felt would most effectively deter future violations, taking into consideration the intent of the individual and the nature of his business. However, CFTC workpapers did not show how CFTC determined that the exchange followed these criteria when it assessed penalties.

Concerning CME's examinations of members' books and records, CFTC concluded that the exchange was complying with CFTC regulation 1.51. CFTC's report states that:

- --The exchange audits its member firms on a "regular" basis and performs followup audits on an as-needed basis.

- --The exchange requires an annual certified public accountant audit of the financial status of members, which is reviewed by the exchange's staff and which supplements the information gathered by the exchange.

However, the report did not state, nor did we find workpapers which showed, how CFTC reached these conclusions. Verification of the second item is particularly important since CFTC's report also concluded that it would have been very concerned with the exchange's surveillance of the

financial status of its members if annual certified audits were not required to be submitted and were not reviewed by exchange auditors.

Our review of the program CFTC used to perform financial audits at exchanges (see ch. 7) showed that CFTC's audit staff performed an audit at the Chicago Mercantile Exchange during the first 3 months of 1977. CFTC's audit report, issued on August 16, 1977, just 8 days after the rule enforcement report, disclosed numerous deficiencies in the exchange's audit program, including:

--Insufficient number of financial audits performed by the exchange of member firms.

--Incomplete audit reports prepared by the exchange.

--Lack of documentation by the exchange indicating it informed its members of the results of the exchange audits.

While CFTC's rule enforcement report briefly mentioned CFTC audit efforts at the exchange, the report did not disclose the specific deficiencies uncovered by the audit.

CFTC's rule enforcement report also concluded that the Chicago Mercantile Exchange was complying with a regulation (1.51(a)(6)) requiring exchanges to perform other surveillance, record examination, and investigations as necessary to enforce exchange rules. However, while the CFTC report went to great length to describe the exchange's procedures in the above matters, we found that generally neither the report nor the workpapers showed how CFTC verified that the exchange actually carried out its procedures and whether CFTC evaluated the quality of the exchange's actions in this area.

CFTC headquarters officials told us that the CFTC staff which had performed the rule enforcement review of CME had left CFTC. Therefore, they told us they could not determine whether CFTC reviewers verified the accuracy and reliability of the exchange's records or whether exchange procedures were actually followed as described by exchange officials.

Our review of CFTC's review of the Chicago Board of Trade showed that in most cases CFTC adequately documented the work it performed. However, our review of CFTC's workpapers and our limited tests of the exchange's own records showed that while CFTC's report cited deficiencies in exchange investigation procedures, the report did not adequately disclose weaknesses in the thoroughness of exchange

investigations. Our review of investigation cases at the exchange showed that the investigations were not always sufficiently thorough to detect improper trading practices and other violations of exchange rules.

Concerning market surveillance, CFTC's report identified six deficiencies at the exchange which limited program effectiveness. However, our review of CFTC's review showed that CFTC conclusions were based primarily on depositions from exchange officials. With the exception of an inquiry into several traders' positions in soybean futures, CFTC did not review any cases of expired futures to evaluate the quality of the exchange's surveillance of market activity.

Need for more specific criteria to measure exchange performance

CFTC officials told us they use CFTC guideline 2 as criteria for assessing the quality of an exchange's rule enforcement program. Guideline 2 is an expansion of CFTC regulation 1.51; however, the guideline, like the regulation, is fairly general and does not always contain objective criteria for evaluating an exchange's performance. It was hurriedly prepared in 1975 and has not been revised since then. CFTC officials agreed with our observations that the guideline was in need of major overhaul.

For example, guideline 2 states that as part of surveillance of market activity exchanges should survey "* * * concentration of positions among clearing members." The guideline does not define concentrations of positions or explain how they should be surveyed.

Guideline 2 also states that periodically exchanges should examine members' books and records to determine whether members are complying with exchange rules. Does periodically mean semiannually, annually, or biennially, or some other interval? The guideline does not explain. However, in one of its rule enforcement reports, CFTC criticized an exchange for auditing only about a third of its members in 1 year. The report did not specify how frequently audits should be performed. Without specific criteria, CFTC does not have an objective basis to evaluate exchange performance.

Prompt and effective disciplinary action for violations of exchange rules is the capstone of an exchange's rule enforcement program. Regarding the disciplinary actions, guideline 2 states that in cases where penalties are warranted, the sanctions imposed should be sufficient to deter future violations. However, the guideline does not offer

guidance as to the type of sanction which would be most appropriate under a particular set of circumstances.

In comparing disciplinary actions of the Chicago Board of Trade and the Chicago Mercantile Exchange for 1976, we found they imposed different sanctions on what appears to be violations of similar rules.

Subject	Examples of sanction imposed	
	CBT	CME
Customer margins	Letter of reprimand	Cease and desist order
Use of discretionary accounts	Letter of reprimand and cease and desist order	10- and 30-day suspension
Buying and selling ahead of customer	20-day suspension	Fines of $100 to $5,000, cease and desist order or suspension of 3 to 30 days

The exchanges' preferences for different types of sanctions are also indicated by the following schedule:

	Number of sanctions in calendar year 1976	
Sanction	CBT	CME
Fine	-	a/ 59
Suspension	2	13
Warning letter	-	2
Letter of reprimand	4	-
Cease and desist order	13	58
Total	19	b/ 132

a/Ranged from $100 to $15,000.

b/ More than one sanction was imposed on certain firms or individuals.

In an April 4, 1978, memorandum to the Commission, the Director of the Office of Policy Review encouraged the Commission to strengthen its rule enforcement review program. The Director noted that over the past 3 years CFTC had gained valuable experience through its rule enforcement reviews. However, the Director indicated it was time for CFTC to perform a complete assessment of guideline 2 and regulation 1.51. The Director noted that although "* * * the rule enforcement program is one of its most important activities, it is weak in terms of standards and criteria."

Need to institute uniform followup procedures

CFTC has not performed and lacks formal procedures requiring prompt and affirmative followup by its staff to determine whether exchanges corrected deficiencies disclosed by CFTC rule enforcement reviews. Because of this, CFTC has no assurance that exchanges have acted quickly on CFTC recommendations to improve their rule enforcement programs.

New York exchanges

As mentioned in chapter 3, CFTC's 1974 reviews of exchanges' applications for market designation showed that four New York exchanges had inadequate rule enforcement programs. CFTC officials told us that there was no followup to assure that the deficiencies were corrected until CFTC began its second round of rule enforcement reviews at the New York exchanges in April 1976. CFTC's July 1976 report on these reviews showed that almost all the deficiencies continued to exist even though 15 months had passed since the 1975 reviews. In addition, CFTC uncovered new deficiencies.

After CFTC completed its 1976 reviews, it notified the exchanges that they must submit detailed timetables setting forth measures they planned to take to improve their rule enforcement programs. Also, CFTC stated that it would request monthly status reports from the exchanges. Although the exchanges submitted timetables, CFTC never notified them of the results of its review of their submissions and terminated its plan for requesting monthly status reports.

CFTC did not start comprehensive followup on the deficiencies uncovered by the 1976 reviews until May 1977, when it began its current round of rule enforcement reviews of the New York exchanges. CFTC did perform minireviews at New York exchanges in late 1976 and early 1977; however, they were of limited scope, covering only two of eight components of rule enforcement. Also, the results of these minireviews were never disclosed to the exchanges.

We discussed these events with the Chairman of CFTC, who agreed that CFTC's failure to follow up on its criticism of the New York exchanges' rule enforcement programs has tended to undermine CFTC regulatory credibility. A former high-ranking CFTC official described the Commission's failure to respond to the exchanges' submissions and its overall handling of the reviews as an example of the Commission's failure to follow through on important matters.

Chicago exchanges

CFTC's review report of the MidAmerica Exchange was submitted to the Commission on December 8, 1976. On December 13, 1976, after considering the report and its numerous recommendations for improving the exchange's rule enforcement program (see p. 36), the Commission directed the Division of Trading and Markets to negotiate a settlement with the exchange. A settlement was reached on August 16, 1977, over 8 months after the review report was presented to the Commission.

CFTC headquarters officials told us that during the 8-month period, apart from the negotiations, CFTC took no action to require the exchange to improve its rule enforcement program. The exchange did not take steps to improve its program, according to the officials, until a settlement was reached. One of the officials added that she thought the exchange had recently made progress in improving its program and that CFTC will visit the exchange in 1978 to confirm this.

In July 1975 CFTC performed a limited review of the Board of Trade's rule enforcement program as part of CFTC market designation reviews (see p. 21). Although the review was not thorough--it was based primarily on interviews with three exchange officials--CFTC's report cited deficiencies in the exchange's efforts to prevent and detect abusive trading practices and price manipulation and congestion. Concerning the need for CFTC to perform a thorough review of the exchange's rule enforcement program, the report stated:

> "Merely on the basis of interviews of CBT officials, it cannot be said that the CBT's rule enforcement program is adequate and that the CBT is complying with section 5a(8) of the Act and section 1.51 of the regulations. Such a determination could be made only after a thorough audit of each exchange program which would include, besides interviews, extensive examinations and analyses of * * * [exchange] records."

Because of these conclusions and because the Board of Trade accounts for about half of the Nation's futures trading, we believe a thorough review of the Board's rule enforcement should have been among CFTC's top priorities. Instead, CFTC performed reviews of eight other exchanges and waited until July 25, 1977, 2 years later, before starting a thorough review at the Board.

Need to determine whether violations occur

Rule enforcement review reports are the primary mechanism by which CFTC determines whether exchanges are complying with or violating rule enforcement requirements of the act and of CFTC's regulation 1.51. Our analysis of CFTC's reports shows that while they often cite deficiencies in exchange programs, they generally do not contain conclusions on whether an exchange is complying with or violating regulation 1.51. Without such conclusions from the staff, the Commission may not be able to adequately assess the status of exchange rule enforcement.

Regulation 1.51 lists eight requirements for exchanges to follow. Therefore, at MidAmerica and the 5 New York exchanges there were a total of 48 subsections, or areas of regulation, for CFTC to review and comment on its reports. However, while these reports cited deficiencies in 39 areas, they only characterized 6 of these as violations of regulation 1.51. For the remaining 33 areas, the reports did not indicate whether the exchanges were complying with or violating the regulation.

Similarly, we found that in its July 22, 1976, letters to the New York exchanges, CFTC generally did not inform the exchanges whether the deficiencies cited constituted a violation of the regulation and also did not adequately describe the deficiencies cited in the review report. Of the 34 deficiencies cited in the letters, only 4 were characterized as violations of the regulation. The remaining 30 were not described in terms of a regulation violation. We believe exchanges need to know whether, in the opinion of the Commission, a violation of a regulation has been committed and the action the Commission believes is necessary to assure that compliance is achieved.

Top officials of four New York exchanges told us that CFTC's July 22, 1976, letters were not sufficiently specific concerning the nature of the deficiencies CFTC uncovered or the actions which the exchange should take to correct its deficiencies. The vice president of the fifth exchange was

a former CFTC employee who was involved in the 1976 rule enforcement reviews and had drafted the letters.

Need to establish enforcement criteria

The Commission has no formal, objective criteria for judging when and under what circumstances to institute enforcement actions against exchanges which violate the rule enforcement requirements of the act or CFTC regulation 1.51. A Commissioner told us that after completing a rule enforcement review, the Trading and Markets Division makes a recommendation to the Commission on the type of action it should take. He stated further that the Commission relies heavily on the division's advice. However, we found that the division also has no formal, objective criteria on judging when and under what circumstances it should recommend that the Commission consider initiating enforcement action against exchanges which have deficiencies in their rule enforcement programs. The division relies on the subjective judgment of its top staff and its experience in other rule enforcement reviews.

For example, the division presented its report on the 1976 review of the New York exchanges at a Commission meeting and recommended that letters be sent to the New York exchanges criticizing their rule enforcement programs. The division did not present as an alternative that the Commission consider asking its Enforcement Division to review the report to determine whether there were grounds for enforcement.

In the case of the MidAmerica Exchange, a division official told us that when the division presented its report to the Commission in December 1976, it pointed out that if CFTC initiated an enforcement action against the exchange, the unfavorable publicity produced by such an event would probably force the exchange to close. Apparently, relying on this advice and not having any formal or objective criteria to assess the seriousness of the deficiencies cited in the division's report, the Commission decided not to initiate an enforcement action but rather to negotiate a settlement with the exchange.

As part of our review we attended a Commission meeting on January 31, 1978, at which the Commission considered the division's report on the rule enforcement activities of the Chicago Board of Trade. Division officials summarized for the Commission the results of its review. In response to questions from Commissioners, the division director told the Commission that "we have not just found deficiencies but

gross deficiencies * * *" at the exchange. The director added that "* * * the Division is telling you [the Commission] that the exchange is not in compliance with various provisions of the regulations."

Another division official told the Commission that the division believes that no enforcement action should be instituted against the exchange at this time because better results could be achieved "through cooperation." The division did not offer and the Commission did not discuss or consider the alternative of initiating enforcement action against the exchange. In our opinion such an alternative should have been considered by the Commission in view of the division's opinion that the exchange had violated CFTC regulations on rule enforcement.

We believe the Commission's actions should be guided by formal, written criteria which, as a minimum, should indicate the types of violations which will automatically trigger the Commission to consider bringing enforcement action, including suspension or revocation of market designations. We recognize that there will always be a degree of judgment in a decision to initiate enforcement action; however, the Commission's regulatory credibility and its responsibility to the public demand that decisionmaking should also be guided by objective and uniform criteria.

Need to review exchange
disciplinary committee membership

During its rule enforcement reviews, CFTC generally did not examine whether conflict-of-interest situations existed on exchange disciplinary committees. Such committees are an integral part of an exchange's rule enforcement program and are responsible for determining whether a violation of exchange rules occurred and for punishing violators where appropriate. Committee members are generally floor brokers and as such review cases involving other floor brokers. There is a question whether committee members can render unbiased decisions knowing that tomorrow they might be the accused.

Adding to this potential conflict of interest are situations in which the committee members hearing a particular case are associated with the member firm charged with the violation. Our review of a disciplinary committee's minutes at one exchange showed that this situation occurred on 4 of the 20 disciplinary cases heard before the committee during a 10-month period in 1976. CFTC's rule enforcement review of the exchange did not address this question, apparently,

because CFTC had no regulations covering potential conflict of interest on disciplinary committees.

In January 1978 we discussed this matter with a Division of Trading and Markets official. He advised us that the division is in the process of revising proposed CFTC regulations, first issued in February 1977, which deal with exchange disciplinary procedures. The revised regulations will, according to the official, forbid disciplinary committee members from taking part in disciplinary committee deliberations when they have a financial interest in firms appearing before the committee. The official stated that because of staff turnover the division has not been able to act promptly on the proposed regulation. As of March 20, 1978, the proposed regulations had not been submitted to the Commission for its consideration.

We support the thrust of the proposed revision dealing with conflict-of-interest situations. Also, because of the importance disciplinary procedures play in the effectiveness of an exchange's rule enforcement program, CFTC should carefully review exchange committee proceedings and be alert for potential conflict-of-interest situations during its rule enforcement reviews.

CONCLUSIONS

To monitor the progress of self-regulation and at the same time insure that exchanges comply with statutory requirements for rule enforcement, CFTC must place greater priority on performing comprehensive and frequent rule enforcement reviews of exchanges. When CFTC reviews uncover deficiencies, prompt, aggressive followup by CFTC is needed. This should include setting deadlines for corrective action and imposing penalties on exchanges which fail to meet them.

CFTC's reviews have uncovered numerous deficiencies in the rule enforcement programs of the five New York exchanges and the MidAmerica Exchange. The long overdue review at the Chicago Board of Trade showed that the Nation's largest exchange, with over half of all futures trading, also needs to significantly upgrade its rule enforcement program. The Chicago Mercantile Exchange program, while described by CFTC as being the best program, also needs improvement. CFTC's reports show that exchange self-regulation has a long way to go befor it can be relied on as an effective tool for regulating the futures market. According to CFTC officials, exchanges are taking steps to improve their programs. However, because followup reviews at exchanges either have not been performed or have not been completed, it is too

early to determine whether CFTC has made significant progress in improving self-regulation at exchanges.

To assure maximum effectiveness, CFTC's reviews should be thorough and well documented. However, presently no uniform guidelines exist, and documentation to support review conclusions is spotty at best. Also, CFTC relies too much on interviews and not enough on testing exchange procedures and records.

For CFTC to do a proper evaluation of an exchange's rule enforcement program, it needs clear and objective criteria or standards. However, the standards CFTC uses--its guideline 2--are often imprecise and subjective. Furthermore, CFTC's review reports and related transmittal letters generally do not indicate whether an exchange deficiency violates the act or a CFTC regulation. The Commission and exchange officials need to know this if they are to carry out their respective responsibilities.

The Commission also lacks formal, objective criteria to guide itself in determining whether to bring enforcement action against exchanges which staff reports show committed Federal violations. Without such criteria, the Commission will find itself hard pressed to establish a reputation of regulatory integrity and protector of the public interest.

Finally, because exchange disciplinary actions are at the heart of rule enforcement, CFTC should finalize regulations, first proposed in February 1977, which would ban certain conflict-of-interest situations on exchange disciplinary committees. Also, during its rule enforcement reviews CFTC should review exchanges' disciplinary committee proceedings and be alert for potential conflict-of-interest situations.

RECOMMENDATIONS TO THE CHAIRMAN, CFTC

To improve the effectiveness of CFTC monitoring of exchange rule enforcement programs and to assure affirmative self-regulation of the commodity futures industry, we recommend that the Chairman of CFTC:

--Place greater emphasis on performing comprehensive and timely rule enforcement reviews of commodity exchanges.

--Establish uniform review guidelines which would require CFTC staff to rely more on testing of exchange procedures, records, and files and to better

document the basis for their conclusions concerning the adequacy of exchange rule enforcement programs.

--Revise CFTC's guideline 2 to provide a clear and objective set of standards by which to assess the adequacy of an exchange's rule enforcement program.

--Establish formal followup procedures which would ensure that exchanges promptly correct rule enforcement deficiencies. The procedures should include setting deadlines for corrective action and imposing penalties on exchanges which fail to meet them.

--Require that review reports and letters to exchanges clearly state whether exchange deficiencies violate the act or a CFTC regulation, and if violations have occurred, the corrective action necessary to achieve compliance.

--Establish formal objective criteria for deciding when to bring enforcement action against exchanges which violate the rule enforcement provisions of the act or CFTC regulations.

--Finalize proposed regulations dealing with exchange disciplinary committee procedures and upon issuance closely monitor exchange compliance with the regulations.

CHAPTER 5

REGULATORY ISSUES CONCERNING ABUSIVE TRADING PRACTICES--MUCH REMAINS TO BE DONE

Assuring that the trading public is protected from abusive trading practices on the floor of exchanges is one of the primary reasons for Federal regulation of the commodity futures industry. However, the Commission's efforts on many important regulatory issues related to curbing such practices have been inadequate.

Floor brokers on the floor of an exchange generally trade for themselves and proprietary accounts as well as for customers. Futures commission merchants and their representatives also often trade for themselves and for customers. These practices are referred to as dual trading.

Resolution of the question of whether to continue to permit dual trading by brokers and commission merchants, as required by the 1974 act, was one of the pressing issues facing the new Commission. However, the Commission's approaches to dual trading and the related areas of trading record accuracy and time sequencing were neither comprehensive nor systematic. The Commission needs to develop and analyze empirical evidence to determine whether dual trading is necessary for trading liquidity or whether it promotes trading abuses--key considerations in resolving dual trading questions. Also, the Commission generally has been lax in enforcing and/or implementing regulations on trading standards and time sequencing of transactions aimed at minimizing abusive practices which may result from dual trading.

A most effective weapon to deter and detect trading abuses is the reconstruction of trading by means of trade practice investigations. However, CFTC has only performed six such investigations and has no formal plans for comprehensive and periodic reviews of trading at each of the exchanges. Without an expanded trade practice investigation program, unscrupulous brokers or FCMs have little to fear that CFTC will detect abusive trading practices.

Finally, CFTC does not have an effective program for performing floor observations on exchange trading floors. Although floor observations are another potentially potent procedure for spotting abusive trading, CFTC officials concede that they do not have the expertise to effectively perform such observations.

DUAL TRADING--A STUDY IN COMMISSION DECISIONMAKING

In 1965, and again in 1974, we reported to the Congress that although the floor broker was subject to exchange and Federal rules, he is nevertheless in the unique position of being able to trade for his own gain or loss on one trade and for another person's gain or loss on the next trade. Thus, he may at times be directly competing with his own personal objectives. FCMs and their representatives often face a similar situation.

We pointed out that members of a commodity exchange who trade for their own accounts enjoy special privileges and advantages over the trading public. They are able to react instantly to market situations and to take prompt advantage by executing their own trades. In addition, the fees charged the broker for executing personal trades are much less than the fees charged to the general public; thus, he can profit from smaller price changes.

Dual trading was one of the primary issues discussed at House and Senate hearings establishing CFTC. Many concerns were raised on possible trading abuses which may result from dual trading practices. Because of this concern, the act, as amended by the 1974 CFTC Act, required CFTC to determine within 9 months whether or not floor brokers and FCMs shall be permitted to dual trade, and if so, under what conditions and circumstances. Sections 4 j(1) and (2) of the act stipulate that any such determination shall, at a minimum "* * * take into account the effect upon the liquidity of trading of each market * * *."

CFTC study of dual trading

Dual trading was one of three subjects studied by CFTC's Advisory Committee on the Regulation of Contract Markets and Self Regulatory Associations, established August 5, 1975, under the chairmanship of one of CFTC's Commissioners. Of the committee's 16 members, 13 were directly or indirectly associated with the futures industry. The committee met three times in late 1975 and early 1976.

The chairman's report, which was submitted to CFTC's Chairman on December 23, 1976, stated that the consensus of the committee was:

1. The Commission should continue to permit dual trading.

2. The Commission should require contract markets to promulgate rules to control the potential abuses of dual trading, with such rules to be developed on an exchange-by-exchange basis.

3. Dual trading can best be policed by a recordkeeping system which permits transactions to be time sequenced. 1/

4. No effective time sequencing system now exists, and the Commission should conduct a study looking toward devising such a system.

5. The Commission should continue and expand its studies of the extent of dual trading and the effect of dual trading on liquidity and on other aspects of the markets.

Committee members associated with the futures industry felt strongly that dual trading was necessary for market liquidity. These members believed that dual traders on the exchange floor "* * * provide a large amount of the speculative capital necessary for market liquidity." However, academic members, according to the report, "* * * pointed to a lack of hard data on the issue of the need to permit dual trading to provide liquidity." They felt additional studies were necessary before making a final determination.

Concerning the ability of exchange recordkeeping to indicate whether dual trading causes trading abuses and whether it is needed for trading liquidity, the report concluded:

> "The current record generating systems of the exchanges are inadequate to determine to what extent dual trading abuses have occurred or are occurring. Further, they are inadequate to permit the making of meaningful studies of the need for dual trading to provide liquidity."

Concerning deficiencies in exchange recordkeeping, the report stated that

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1/Federal regulations had required customer orders to be time stamped to the nearest minute or better but had not required timing information on the majority of trades, those executed for a house account, or by an officer or employee of the firm.

> * * * no contract market presently has the facilities to adequately detect dual trading abuses. No exchange has a record keeping system which readily permits the retrievability of data to reestablish the sequence of transactions and enable it to determine whether a floor broker had taken advantage of his customer. No exchange has a record keeping system which enables the reconstruction of trading in time sequence to enable it to determine exactly what happened during the course of a trading session and how a broker traded for his own account while trading for customers. Certain data are available but, for the most part, it is contained in numerous documents and, where it is available, cannot be assembled without laborious effort."

On December 18, 1975, CFTC published proposed regulations on dual trading which would have basically:

1. Required all contract markets that want to continue to permit dual trading after June 30, 1976, by floor brokers and FCMs to adopt and obtain Commission approval of certain rules to regulate dual trading.

2. Banned dual trading by floor brokers after January 16, 1977, on any contract market that has not submitted by that date a plan for developing a method to permit reconstruction of the sequence of futures transactions executed on the contract market.

3. Banned dual trading by floor brokers on a contract market on or after April 17, 1977, or such later date, unless a plan of the contract market permitting reconstruction of the sequences of trades has been declared effective by the Commission.

The decision not to ban dual trading

On January 20, 1976, the Commission announced that it decided to permit dual trading to continue but that because its authority under section 4j of the act was ongoing, the decision would be continually reviewed. Also, the Commission stated it would hold hearings in March 1976 on the December 1975 proposed regulations.

The hearings resulted in a suggestion for an interim step toward the sequencing of all transactions referred to as "bracketing"--a system enabling identification of transactions as having been executed during a specific time

segment of the trading day. Many industry witnesses testified that time sequencing would seriously hamper the efficient execution of transactions, but bracketing within 30-minute intervals was possible. Further, such a system was looked at as a step toward policing dual trading.

On April 8, 1976, the Commission appointed a task force to evaluate the feasibility of a bracketing system. On July 12, 1976, the task force reported the results of its study to the Commission.

1. Bracketing is feasible on all exchanges.

2. Most exchanges can implement bracketing without major disruptions or costs or already have systems that are better than bracketing.

3. Bracketing is a step toward the ultimate goal of time sequencing of trades for those contracts which are currently not amenable to time sequencing.

4. Inaccurate information is an important problem of recordkeeping for most exchanges. Such inaccuracies require time-consuming cross references of data in the course of trade practice investigations and economic studies. Therefore, without concurrent improvements in the accuracy of data, the benefits of bracketing or any other system of time sequencing of trades will be significantly diminished. Steps to identify and improve these other aspects of recordkeeping are important and should be pursued.

5. In order to assure effective utilization of bracketing or other time information, a time indicator must be on the exchanges' trading records and should be retrievable for at least 30 days.

6. Neither the exchanges nor the task force have comprehensively assessed the feasibility of time stamping or other methods besides bracketing to achieve full sequence reconstruction capacity.

Lack of empirical
evidence on liquidity

The relationship between dual trading (by floor brokers and FCMs) and market liquidity was discussed at CFTC hearings and by the advisory committee. The committee generally limited its consideration of empirical evidence to a March 14, 1976, report by CFTC's chief economist, which focused on the relationship between liquidity and dual trading by floor brokers, but not dual trading by FCMs.

The report's findings and conclusions were based largely on an analysis of trading at the Chicago Mercantile Exchange during the 3-month period November 1975 through January 1976 and, to some extent, on trading at the Chicago Board of Trade during the same period. Concerning the magnitude of dual trading, the report disclosed that

--only about one-third of the trading on the two exchanges was for customers and most trading was for members who were present on the floor of the exchange,

--dual traders represent about one-fifth of all traders, and

--dual traders execute about one-half of all trades.

Concerning market liquidity, the chief economist analyzed the 3-month trading data of the Chicago Mercantile Exchange and reviewed a study of the subject performed by the exchange. The chief economist concluded that:

"In summary both the CME [Chicago Mercantile Exchange] and CFTC analyses support the contention that a large percentage of the transactions executed on the floor of the CME are done by dual traders. Neither of the studies, however, provide much reliable evidence that the level of activity by dual traders in a market is related in any significant and consistent way to liquidity. Before such a relationship can be established or refuted, however, further and more sophisticated studies need to be conducted."

In late March 1978 CFTC officials told us CFTC had not performed any additional studies to establish the relationship between dual trading and liquidity.

Dual trading regulations

After considering the reports of the advisory committee and the bracketing task force and considering testimony given at the March 1976 hearings and written comments to the proposed regulations, the Commission, on December 23, 1976, published regulations on dual trading. In the Federal Register Notice accompanying the regulations, the Commission stated that the regulations were designed, to a large extent, to prevent the possible conflict of interest inherent in dual trading and that it had not made a final determination on the issue of dual trading but would continue to study the matter. The interim nature of the regulations was due primarily to the lack of factual data concerning the extent of dual trading abuses and the effect of dual trading on market liquidity. The regulations, according to the Commission's statement, were also designed to generate that data and to aid the Commission as it continues its study of dual trading.

The regulations were basically composed of two parts--trading standards for floor brokers and FCMs (17 CFR 155.2 and 155.3) and time sequencing (17 CFR 1.35). With respect to floor brokers, the regulations required that by March 16, 1977, 1/ exchanges adopt and submit for CFTC approval rules prohibiting floor brokers from

--trading for themselves ahead of customers;

--executing any discretionary account order, except by placing the order with another member for execution;

--disclosing customers' orders or from taking the other side of customers' orders without the customers' prior consent and in conformity with approved contract market rules; and

--making prearranged sales, allocating trades among accounts, and withholding or withdrawing customer orders for the convenience of other members.

According to a CFTC official, the exchanges submitted the subject rules to the Commission by March 1977. CFTC's Division of Trading and Markets reviewed them and sent them

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1/The original effective date was February 14, 1977, but was changed by the Commission on January 24, 1977.

back to the exchanges for revision. Exchanges submitted revised rules, but as of March 27, 1978, the Commission had only approved rules for two exchanges--the Kansas City Board of Trade and the Minneapolis Grain Exchange. Section 5a of the act prohibits exchanges from enforcing rules not approved by the Commission.

Concerning trading standards of FCMs, regulation 155.3 required that effective March 16, 1977, FCMs associated with exchanges must

--establish and enforce internal rules, procedures, and controls to ensure that customer orders receive priority in transmission to the floor of the exchange and

--stop handling accounts of employees of other FCMs without written authorization, require that all orders for such accounts be time stamped, and provide regular statements for the accounts to the employee's firm.

These rules, unlike those for floor brokers, did not require CFTC approval prior to implementation. However, as of late March 1978, CFTC had not taken any action to assure that FCMs had adopted and were enforcing such rules.

The Commission's regulations on time sequencing--regulation 1.35--required, among other things, that effective June 13, 1977, each exchange, for each of its contract markets, show on a single record of the exchange's clearing organization the mechanically or electronically verified time of execution of each trade to the nearest minute or better as well as date of trade, commodity, quantity, price, opposite floor broker or floor trader, clearing members, and type of customer. Thus, for the first time exchanges would be required to time sequence noncustomer as well as customer-generated orders--the former representing the majority of all transactions. The regulation provided that contract markets which could not comply by June 13, 1977, with the 1-minute time recording requirement without seriously disrupting the functions of its marketplace could petition the Commission for an extension of up to 1 year at a time. Petitions were to be submitted by April 14, 1977, and were required to include

--an explanation of why the 1-minute or better time recording could not be implemented without seriously disrupting the marketplace,

--a plan with a timetable for implementing a 1-minute or better time recording, and

--an interim plan representing substantial progress towards an accurate record of the time and sequence of execution of each trade.

Concerning the availability of extensions, the preamble to the December 1976 Federal Register Notice stated that:

> "The Commission emphasizes that the availability of any extension of time to comply with the requirements of regulation 1.35 (g) (1) will <u>be extremely limited</u>. No such extension will be granted in the absence of a comprehensive study by the contract market * * *. No extension of time will be granted where the Commission determines that a contract market has failed to do <u>all that it was feasible</u> for it to do to attain the required recordkeeping capability or to formulate an acceptable plan * * *." (Underscoring provided.)

All 10 exchanges filed petitions for extensions, 7 of them filing in June 1977, about 2 months late. The Commission had planned to complete its review of petitions and respond to the exchanges within 2 months; however, it did not inform the exchanges of the results of its review until November 15, 1977--about 5 months after the 1-minute time sequencing was to begin and 5 months after the last petition was filed.

The Commission found that the Kansas City Board of Trade and the Minneapolis Grain, New York Mercantile, and New York Cocoa Exchanges met the requirements of the regulation and granted their petitions. The Commission determined that the petitions from the remaining six exchanges did not comply with the requirements for an extension of time, and therefore, the exchanges were violating the regulation. Despite this and the December 1976 warning by the Commission on how limited and difficult the availability of extensions would be, the Commission, in its November 15, 1977, letters, informed the six exchanges that no enforcement action would be taken against them.

The letters to the six exchanges directed them to institute for actively traded commodities a 30-minute bracketing system by December 1, 1977--as opposed to a 1-minute time sequencing system originally required by June 13, 1977. Lightly traded commodities--approximately a dozen low-volume contracts--were required to be time verified to at least the nearest minute by February 1, 1978. Also, trading of some commodities on the Chicago Mercantile Exchange which are not traded in the pits but are listed on blackboards were required to be time verified to the

nearest minute or better on December 1, 1977. In addition, the letters to the six exchanges directed them to submit, by April 1, 1978, a new petition for an extension of time to comply with 1-minute time sequencing. According to a CFTC official, the other four exchanges met or exceeded the CFTC-imposed 30-minute bracketing requirement or had plans to to so shortly.

Because no enforcement action was taken against the six noncomplying exchanges and because they were not required to implement 1-minute time sequencing on most commodities, including the popular heavily traded commodities, the Commission, in effect granted the six exchanges extensions of time to comply with the regulation. In May 1977, while discussing with us CFTC's time sequencing regulations, one Commissioner said he thought the regulations would be essentially ineffective because they would allow exchanges to postpone indefinitely the implementation of 1-minute time sequencing.

Evaluating Commission action on dual trading issues

To evaluate the Commission's performance, we explored the answers to the following questions which we believe are at the heart of dual trading issues.

Did the Commission adequately consider liquidity and trading abuses?

No. The primary argument for dual trading is that it promotes trading liquidity. The 1974 act expressly directed CFTC to consider the effect dual trading has on the liquidity of each contract market when it determined whether to permit or ban dual trading by floor brokers and FCMs. However, CFTC only analyzed empirical data on the dual trading of floor brokers on the Chicago Mercantile Exchange. Furthermore, CME's data proved to be insufficient to establish a positive relationship between dual trading by floor brokers and market liquidity.

CFTC made no attempt to gather empirical evidence to determine whether the dual trading by FCMs was necessary for trading liquidity. Although the act directed CFTC to consider liquidity of trading by FCMs as well as by floor brokers, the Commission's decision to permit FCMs to dual

trade was apparently based on the same information it used in deciding to permit dual trading by floor brokers--theoretical arguments put forth by industry sources and inconclusive and incomplete empirical evidence on floor broker trading.

The primary argument against continuing dual trading is that it can lead to abusive practices by floor brokers and FCMs. However, in reaching its decision to permit dual trading, CFTC did not attempt to determine how frequently dual trading causes trading abuses. For example, CFTC did not examine its customer complaint files, those of exchanges, or Commodity Exchange Authority files to determine to what extent, and how frequently, dual trading was directly related to alleged abusive practices cited in complaints.

Was sufficient priority given to related issues of trade records and time sequencing?

No. The need for better recordkeeping and time sequencing of all trades to detect and measure possible dual trading abuses was known before the Commission was established. In hearings before a House Subcommittee on Small Business Problems in 1973, the Administrator of the Commodity Exchange Authority testified that because of recordkeeping problems the Government found it was impossible to prove that abuses occurred in most cases of suspected dual trading abuses. Also, in our June 1975 report we pointed out that the lack of time sequencing of trades and the poor condition of exchange trading records seriously hampered our ability to detect trading abuses. We recommended that CFTC take steps to improve trading records and require time sequencing of all trades.

Concerning time sequencing, 3 years have passed since the effective date of the CFTC Act, April 21, 1975, and exchanges still do not time sequence most trades. While CFTC issued regulations which required that by June 1977 all trades be time verified to at least the nearest minute, the Commission did not use its authority to obtain exchange compliance. No enforcement action was taken against the six exchanges which violated CFTC's time sequencing regulation by failing to record trades to the nearest minute and by not meeting the requirements for an extension.

According to CFTC officials, the Commission's decision not to take enforcement action against the six exchanges was based, in no small measure, on the lack of CFTC staff ability

to evaluate the truthfulness of the information in exchange petitions. Concerning this lack of ability, one Commissioner told us that:

> "We [the Commission] are a little weak on our ability to judge the truthfulness of what the exchanges tell us concerning what they can and cannot do in the areas of recordkeeping and time sequencing."

CFTC officials also stated that the Commission was concerned that bringing any enforcement action would prompt at least one large exchange to challenge such actions in court. One official, in discussing with us the Commission's attempts to evaluate the exchanges' petitions, concluded that "the Commission was in over its head."

The need for complete, accurate, and easily accessible exchange trading records was one of the issues discussed in our 1975 report. Our review showed that at five exchanges which in fiscal year 1973 accounted for about 84 percent of the Nation's trading, the exchanges' trading registers (the primary trading record) contained numerous errors in identifying executing brokers, customer types, transfer trades, and trades cleared on dates other than the execution date.

Such errors cause 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 trading activity. To improve the trading records, we recommended, among other things, that the Chairman:

1. Require each exchange to implement a program of periodic review to insure the accuracy of the trading records.

2. Monitor the exchanges' review programs, using penalties when necessary, so that the trading records can be used effectively for surveillance.

Until recently the Commission had not taken any steps to implement our recommendations. In its November 15, 1977,

letters to the exchanges, the Commission directed each exchange to conduct tests on the accuracy of key trading data and beginning with January 1978 to report monthly to CFTC the results of these tests. CFTC had not performed any comprehensive or systematic studies of the quality of exchange trade records and before November 1977 had not required exchanges to do so.

In conjunction with its review of the Chicago Board of Trade's rule enforcement program, CFTC performed a study of the exchanges' trade records. According to a draft CFTC report, preliminary results showed that error rates for certain key trade register data reached as high as 40 percent. A CFTC official told us that the records were so bad that it might be impossible to effectively investigate possible abusive trading.

In evaluating the Commission's performance in the areas relating to dual trading, CFTC's Chairman told us the Commission had not placed a high enough priority on dual trading research. Another CFTC official told us that the Commission's interest in getting better recordkeeping at exchanges was "haphazard and inconsistent." Still another official told us the Commission had no overall plan for dealing with dual trading.

Does CFTC know enough about time sequencing?

No. CFTC did not have in December 1976, when it issued the time sequencing regulations, and does not now have sufficient expertise and information concerning time sequencing of trades. For example, CFTC has not performed or contracted out for any study to determine whether the technology exists for precise time sequencing of all trades and if so what the costs and benefits would be to both the industry and the public.

A CFTC Commissioner told us that in December 1975 he suggested the Commission perform such a study. However, the Commission turned down the suggestion because it questioned the propriety of the Government paying for a study of a system to be used by exchanges, and it was concerned that the cost to contract out such a study might approach several hundred thousand dollars. On the contrary, we believe that an independent study was needed and who, if not CFTC, the independent regulatory agency, should supervise such a study. As for the cost of contracting out for such a study, CFTC could have performed it in-house with the help of outside experts. Such an effort could have provided CFTC staff with

expertise and information on time sequencing and other related regulatory issues. In discussing this issue with CFTC officials they agreed that before issuing the time sequencing regulations CFTC should have performed such a study.

As mentioned previously, CFTC was not in a position to independently evaluate the petitions submitted by the exchanges for an extension of the 1-minute time sequencing requirement of regulation 1.35. One of the problems the CFTC staff faced in reviewing the petitions, according to a CFTC official assigned that task, was that although the regulation allows for petitions when exchanges demonstrate, among other things, that they are making "substantial progress" toward accurate time sequencing of trades, the Commission did not establish any criteria as to what constitutes substantial progress. The official also told us that CFTC had no empirical data to analyze the petitions. This official conceded that it was poor management on the Commission's part to issue regulations without first determining whether they could be implemented and without first establishing specific criteria to evaluate petitions for extensions.

The Commission also lacks expertise in the area of bracketing. Although in November 1977 it directed exchanges to start 30-minute bracketing by December 1, 1977, the Commission's limited empirical evidence--a July 1977 report by the chief economist--showed that a 30-minute bracket was too long to permit trading sequence reconstruction. Without such reconstruction ability it is difficult to effectively and efficiently identify trading abuses.

The July 1977 report summarized empirical evidence gathered by CFTC's chief economist in a limited study of bracketing on the Cotton Exchange. His report was submitted to the Commission in July 1977, about 5 months before the Commission's November 1977 decision to require 30-minute brackets. The report, which made no attempt to determine the costs or feasibility associated with bracketing, concluded that:

> "[P]reliminary analysis suggests that bracket lengths of less than five minutes would have to be employed on the New York Cotton Exchange cotton contract in order to achieve substantial gains in the ability to reconstruct the sequence of trades * * *."

* * * * *

"If the pattern observed in cotton is in fact sustained in other markets, moderate length brackets--say 30 minutes--would not accomplish reasonable objectives in terms of sequencing trades * * *."

Is CFTC prepared to use time sequencing data required of exchanges?

No. Regulation 1.35 requires that exchanges keep trading data, including the time verification, in computer-readable form on compatible magnetic tapes or discs for 60 days. The purpose of this requirement is to allow for the reconstruction of trades so that computerized trade practice investigations and analyses can be performed. However, according to CFTC officials, including one of its Commissioners, CFTC had done very little to prepare itself to use the time sequencing data. CFTC officials told us that CFTC has not acquired the computer software and does not have the necessary staff resources.

Also complicating the issue is the requirement that computerized trading records be kept for only 60 days. If and when CFTC develops a computerized trade practice investigation capability, it may find that 60 days is insufficient lead time to perform such investigations. A CFTC official agreed that 60 days is probably insufficient lead time for CFTC to act.

Has the Commission protected the trading public from possible dual trading abuses?

No. The Commission's January 1976 decision not to ban dual trading left the trading public susceptible to possible dual trading abuses by floor brokers and FCMs. Realizing its responsibility to protect the public, the Commission issued trading standards regulations aimed at mitigating abusive practices. However, the public may be largely unprotected because the Commission has not enforced its regulations.

As previously mentioned, as of March 1978 the Commission had not yet approved the rules submitted by 8 of the 10 exchanges (including the largest exchanges) on trading standards for floor brokers and, therefore, the exchanges could not implement them. CFTC's regulations on trading standards for FCMs were effective on March 16, 1977. However, according to its own staff, CFTC has not taken

any steps to ensure FCM compliance. As of late March 1978, CFTC had not reviewed FCM operations to determine whether they have established and are enforcing internal rules, procedures, and controls required by the regulation to ensure that customer orders receive priority over their own orders.

NEED FOR COMPREHENSIVE TRADE PRACTICE INVESTIGATION PROGRAM

Protecting the trading public from abusive trading practices is one of the primary reasons for Federal regulation of the commodity futures industry. Reconstructing trading by means of a trade practice investigation is the primary method to detect and deter trading abuses. To adequately protect the trading public, CFTC needs to expand its current limited trade practice investigation program.

Abusive practices generally involve some form of noncompetitive trading in the trading pit, such as:

--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 or make wash trades.

--Brokers' or FCMs' taking the opposite side of their customers' order for their own account or an account in which they have an interest.

--Brokers' or FCMs' 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).

--Brokers' buying or selling for their own account while having customers' orders to buy or sell at the same price or at the prevailing market price.

The act and CFTC regulations forbid noncompetitive trading, except in certain cases where provided for by Commission-approved exchange rules.

A trade practice investigation, as the term is most commonly used, is an attempt to reconstruct trading in a particular market for a particular period of time. Another type of trade practice investigation involves an evaluation of an exchange or industrywide practice which on the surface does not appear to be very competitive or efficient.

In making the common type of 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.

Trade practice investigations are the responsibility of CFTC's Division of Trading and Markets. Generally, the division has limited its trade practice investigations to evaluations of exchange or industry practices. Since inception the division has completed only six trade practice investigations involving reconstruction of trading to identify possible trading abuses by individuals. One of these was limited in scope, involving only a review of 30 minutes of trading. Each of the six investigations was started because CFTC staff suspected or was informed that trading abuses may have occurred in that particular contract. The division did not randomly initiate investigations at exchanges.

Periodically the Division of Enforcement has reconstructed trading as part of its investigations into customer complaints or referrals from within CFTC. However, the division does not have responsibility for and does not perform self-initiated trade practice investigations.

Without a vigorous and comprehensive trade practice investigation program, CFTC cannot protect the trading public from abusive trading and effectively detect and punish violators of the act or regulations. This problem is not new to Federal regulation of commodity futures. In 1975 we

reported that the Commodity Exchange Authority had performed insufficient trade practice investigations to monitor futures trading and that investigations were not geared to aggressively seeking out abusive trading. We recommended that CFTC use a modified marketwide approach involving a computerized trade practice investigation capability. Also, we concluded that before computerized investigations can be effective, errors and omissions in exchange trading records--including an absence of time sequencing of all trades--must be corrected.

As mentioned earlier in this chapter, CFTC has done little to ensure that trading records are made more accurate and reliable or to require that exchanges time sequence trades. Because of this, CFTC has been unable to use computers to assist in trade practice investigations. All CFTC trade practice investigations were performed manually and as such generally required considerable staff resources. It is not suprising, therefore, that CFTC regional and headquarters officials told us that they do not have sufficient staff to perform trade practice investigations.

CFTC's ability to perform effective and efficient trade practice investigations without time sequencing and accurate exchange trading records was the subject of an October 20, 1977, status report prepared by a CFTC task force on management information systems. The report, addressed to the Commission, stated that:

> "Computer assisted TPI's [trade practice investigations] will not be feasible until (1) all aspects of [exchange] clearing house records are accurate and (2) substantially improved reconstruction capacity [time sequencing] exists."

Concerning the present status of CFTC trade practice investigations, the report stated that:

> "Under present data and programming limitations, TPI's remain time consuming, costly, and ineffective. Nevertheless, TPI's remain as the primary analytical tool for detecting, prosecuting, and preventing noncompetitive trading practices. Progress in this program is urgently needed."

CFTC has cited lack of resources, inadequate exchange records, and the absence of time sequencing as reasons for not performing more trade practice investigations involving reconstruction of trading. However, because the Division of Trading and Markets has performed only 6 trade practice investigations, unscrupulous brokers and FCMs have little

to fear that abusive practices will be noticed, let alone be punished by CFTC. Indeed, CFTC needs to take steps to eliminate technological handicaps to effective trade investigations; meanwhile, it must assign more resources to this essential regulatory program so that the trading public is better protected.

In discussing the division's trade practice investigation efforts, a division official told us that in December 1977 the division decided that such investigations be given a higher priority than in the past. However, the division did not establish plans for comprehensive and periodic reviews of trading at each of the exchanges. Also, the official conceded that the division does not have sufficient staff to effectively carry out its responsibilities for trade practice investigations, rule enforcement reviews, and other matters.

FLOOR OBSERVATIONS NEED TO BE UPGRADED

Floor observations of trading can also provide an effective deterrent for floor brokers to refrain from abusive trading and other violations of CFTC and exchange regulations. However, to effectively monitor trading through floor observations, the observer must be thoroughly knowledgeable with the trading practices and procedures involved in the commodity futures industry.

CFTC floor surveillance in Chicago was initiated in early 1977 and consisted of a trading and market official visiting each of the three exchanges for about an hour each day. The official in charge of the program told us that the visits were more educational than investigative and that the observers have had no formal training. CFTC New York started an observation program in July 1977. There too, CFTC observers have not received any formal training.

In discussing the programs with CFTC officials in Washington, we were told that, aside from one of the Commissioners, only one CFTC employee is thoroughly knowledgeable with the "nuts and bolts" of trading to effectively conduct floor observations. The officials stated that this employee, who had worked in the futures industry, will be used to help other employees perform effective floor surveillance. The employee had been stationed in Washington and was recently transferred to the Chicago regional office.

We met with the employee and asked him his opinion of the effectiveness of CFTC's floor surveillance program. He essentially described it as inadequate. He said when he

visited the floors of various exchanges he generally spotted violations of provisions of the act or CFTC regulations. For example, he said he would often see floor brokers executing orders for customers without first preparing written records of such orders, as required by regulation 1.35.

Because of the lack of a comprehensive trade practice investigation program, floor surveillance has taken on added importance in CFTC's regulatory scheme. We believe CFTC needs to augment the number of employees capable of performing effective floor surveillance. To achieve this objective, the Commission should consider starting a formal floor surveillance training program.

CONCLUSIONS

The Commission had no overall plan for and gave insufficient priority to resolving the long debated question of whether floor brokers and FCMs should be permitted to continue the practice of dual trading. The underlying questions that had to be answered were (1) is dual trading necessary for market liquidity and (2) does dual trading promote abusive trade practices? It had been well known, before the Commission became operational, that to answer these questions once and for all one had to have empirical evidence. Moreover, it was recognized that unreliable and incomplete trading records and the inability to reconstruct trading through some means of time sequencing were stumbling blocks to gathering empirical evidence and answering dual trading questions.

Trade practice investigations, the primary tool for detecting trading abuses, are also heavily dependent on accurate records and the ability of the investigator to quickly reconstruct trading by virture of a time sequencing system. Again, this thought is not new; it was expressed in our 1975 report.

It is clear to us that the Commission should have from the onset placed among its highest priorities:

--Performing a comprehensive study of time sequencing and related trade reconstruction issues, including the costs and benefits to the industry and the trading public, so that the need for and feasibility of time sequencing regulations could be assessed.

--Assuring that exchange trading recordkeeping was complete and accurate.

However, the Commission did not pursue this path. It has not performed such a study and until November 1977 did not take action on trade record reliability. Although 1-minute time sequencing regulations were to be made effective in June 1977, the Commission, not having the expertise and knowledge to grapple with industry opposition, generally has not enforced them.

Given this chain of events, the Commission's action on dual trading was most predictable--allowing dual trading to continue by explaining that the empirical evidence is just not there to prove or disprove the question of liquidity and trading abuses. Such reasoning is circular. CFTC's general inaction on trading recordkeeping and its plodding on time sequencing assured that the empirical evidence could not be developed. We must conclude, therefore, that the Commission's decisionmaking process on the dual trading questions was not conducted in a comprehensive, systematic manner.

Concerning CFTC's recent time sequencing and recordkeeping regulation, our review showed that CFTC is ill prepared to effectively use computerized trading data it requires from the exchanges. According to its own staff, it does not have the necessary staff resources and computer software. Further, a 60-day requirement for maintaining records in a computer-readable form may provide insufficient lead time to perform trade practice investigations.

The Commission has not gone far enough in its long overdue November 15, 1977, request to exchanges that they report on the reliability of the data in their trading records. To assure that trading records are reliable, the Commission should set reasonable standards for records reliability and vigorously enforce such standards by monitoring exchange recordkeeping and enforcing penalties for noncompliance.

CFTC has been remiss in not expediting the process for approving exchange rules establishing trading standards for floor brokers. Without CFTC approval, exchanges are not allowed to implement their standards. Although CFTC required FCMs to establish trading standards, which could be enforced without CFTC approval, CFTC has not taken action to determine whether FCMs have actually established and are enforcing such standards.

CFTC's trade practice investigations have generally involved inquiry into an exchange or industrywide practice or have resulted from customer complaints or inhouse referrals. CFTC has not aggressively sought out noncompetitive trades by individuals. In addition, CFTC has not established a plan for a periodic review of the trading at each exchange.

Reasons CFTC officials cited for the low number of trade practice investigations were insufficient staff, poor exchange recordkeeping, and lack of time sequencing of non-customer trades. As we pointed out earlier, CFTC needs to act firmly to improve exchange trader recordkeeping and time sequencing. Meanwhile, it needs to devote more resources to performing trade practice investigations. Without an expanded and improved trade practice investigation program, unscrupulous brokers or FCMs have little to fear that they will be detected and punished by CFTC.

CFTC also has not developed a sophisticated program for performing floor observations, another potentially effective means of spotting abusive trade practices. CFTC lacks the expertise to perform meaningful observations. It needs to augment the number of employees capable of performing effective floor surveillance by starting a formal training program, possibly with assistance from industry representatives.

RECOMMENDATIONS TO THE CHAIRMAN, CFTC

To carry out the Commission's responsibility under the act to evaluate the need for dual trading, to increase its expertise in the area of time sequencing, and to improve its ability to perform trade practice investigations, the Chairman should:

--Constitute a task force to study the feasiblity, costs, and benefits of a system for precise time sequencing of all trades. If the study shows time sequencing to be feasible and cost effective, then the Chairman should enforce the current time sequencing regulations. If the study shows otherwise, then the current regulations should be revised accordingly.

--Develop and analyze empirical evidence to determine whether, or to what extent, dual trading is necessary for trading liquidity and whether, or to what extent, it promotes trading abuses.

To protect the trading public from abusive practices which can stem from conflicts of interest inherent in dual trading, the Chairman should assure the approval and enforcement of exchange trading standards for floor brokers and assure that trading standards for FCMs have been established and are being enforced.

To improve its investigative capability in the area of preventing and detecting trading abuses, the Chairman should:

--Establish and enforce reliability and accuracy standards for exchange trading records.

--Develop a computerized capability to perform trade practice investigations.

--Develop a comprehensive plan to perform periodic trade practice investigations at each exchange and devote the necessary resources to carry out the plan. When violations are disclosed, timely followup should be made to assure that corrective action has been taken.

--Determine whether the present 60-day requirement for exchanges to keep computerized trading records provides sufficient lead time to perform computerized trade practice investigations.

--Increase CFTC capability to perform floor observations of trading at exchanges by providing appropriate training to surveillance personnel.

CHAPTER 6

CFTC'S REGISTRATION PROGRAM CAN BE MORE EFFECTIVE

In its present state the Commodity Futures Trading Commission's registration program may be ineffective in preventing unfit and unqualified individuals and firms from registering with CFTC. To protect the trading public against unscrupulous and unfit individuals, CFTC should fingerprint registration applicants--something it does not now do--and it should significantly upgrade its screening of applicants for reregistration. Until these improvements are made, CFTC may be routinely registering and reregistering applicants with records of criminal convictions or violations of the act, CFTC regulations, or exchange rules.

CFTC's Chairman frankly acknowledged that "some potential or actual crooks" may have been registered. He attributed it to insufficient staff to weed out the "bad guys."

CFTC also has no procedures to ensure that firms and individuals required to be registered are, in fact, registered. Further, no qualification standards have been set to aid the Commission in assuring that registrants are qualified to deal with the trading public. Finally, our review showed that registration fees charged by CFTC may be unreasonable as they are not based on recent, actual costs incurred by CFTC and that it should consider tightening up its liberal refund policy.

CFTC SHOULD FINGERPRINT APPLICANTS

CFTC does not fingerprint applicants for registration. As a result, CFTC screening procedures appear to be inadequate to weed out applicants who are unfit to deal with the trading public and use an alias when applying to CFTC.

To protect the trading public, the act forbids individuals to act as futures commission merchants, associated persons, floor brokers, commodity trading advisors, or commodity pool operators unless they are registered with the Commission. Section 8a authorizes the Commission to refuse to register or to revoke a registration if, after a hearing, it finds that an applicant or registrant

--has violated the act,

--has been convicted of a felony,

--has been restricted by a Federal agency from contracting with the Federal Government,

--has willfully falsified or omitted material information on an application for registration, or

--in the case of an FCM has not met established minimum financial requirements.

The schedule below shows the number of persons and firms registered with CFTC and workload statistics for fiscal year 1977.

	Futures commission merchants	Floor brokers	Associated persons	Commodity trading advisors	Commodity pool operators	Total
Registered at 9/30/77	333	2,574	32,509	593	404	36,413
Applications processed:						
Initial registrations	90	409	11,601	501	243	12,844
Reregistrations	265	2,152	13,978	446	301	17,142
Fitness checks performed at FBI and SEC	1,007	385	12,007	745	184	14,328
Investigations performed	1	7	350	22	1	381

The Trading and Markets Division is responsible for carrying out the Commission's registration program. Registration procedures are basically as follows. Applicants submit their application forms to CFTC's New York or Chicago regional offices. There the information contained in the application is entered into CFTC's computer. A computer tape of the information contained on the application is prepared and a copy is sent to SEC in Washington where a fitness check is performed against SEC records of persons or firms which have committed securities-related violations. At the same time copies of the application are sent to the Federal Bureau of Investigation (FBI) for fitness checks against FBI arrest and conviction files. Most applicants are registered within 4 to 6 weeks if name checks at SEC and FBI and CFTC's review of the application itself do not uncover any possible grounds for denial.

If any information is found indicating possible grounds for denial, it is examined at CFTC headquarters and, if warranted, an investigation is launched on the individual. Most investigations are performed on a contract basis by the Department of Agriculture's Office of Inspector General.

The results of the investigation are evaluated by division headquarters staff, and a decision is made whether there are sufficient grounds to refer the case to the Enforcement Division where it is in turn reviewed and, if warranted, referred to the Commission for denial consideration.

According to a CFTC official, about 1,700, or 12 percent, of the 14,328 fitness checks performed in fiscal year 1977 initially revealed some questionable information on the applicant. After review by headquarters division staff, 381 of these were referred to Agriculture for investigation; the remainder were determined to be satisfactory and were registered. Of these 381 applicants investigated, about 116 subsequently withdrew their applications, 43 cases were referred to Enforcement for denial or revocation action, 1/ and the remainder were cleared and were subsequently registered.

Aside from the examination CFTC performs on the information the applicant includes on the application, CFTC's primary screening consists of having the FBI and SEC check on the fitness of the applicant by comparing the application against their files. Although these checks are useful in weeding out potentially unfit applicants, we believe CFTC screening would be more effective if applicants were fingerprinted and the prints were checked against FBI records. Without fingerprinting, applicants with something to hide could use an alias to disguise their true identities when applying for CFTC registration. For example, an FBI fingerprint check of a recently arrested president of a commodities options firm revealed that the man was working under an assumed name, had an arrest record, and was a fugitive. Prior to his arrest the Commission had denied the firm's request to be registered as an FCM. However, the denial was not based on the man's criminal record.

We discussed this with a CFTC registration official, who agreed that fingerprinting would greatly improve the

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1/ A CFTC official could not readily determine whether all these 43 cases were part of the 381 cases.

effectiveness of CFTC screening procedures. Fingerprinting is used by State and local governments and private industry for sensitive positions. It has also recently been adopted by the National Association of Securities Dealers in the registration of securities salesmen.

The need for CFTC to improve its screening of applicants was discussed by CFTC's Chairman in a speech before an association of financial writers in June 1977. He stated that:

> "What bothers us [the Commission] is that some potential or actual crooks may be getting registered because we simply do not have the staff to cull out the bad apples * * * We will register [annually] 600 to 1,000 people who are borderline cases."

REREGISTRATION TOO AUTOMATIC

Generally, CFTC automatically reregisters applicants. During the reregistration process it does not (1) screen applicants against FBI or SEC files, (2) consider information in employee termination reports which FCMs must file with CFTC, or (3) consider an applicant's historical record of violations of exchange rules which are often similar to provisions of the act or regulations. Rather it relies primarily on the information in the applicant's reregistration application which usually reflects only any violations committed in the past year. Therefore, CFTC may be automatically reregistering applicants who may have committed recent crimes, been terminated for good cause, or been found guilty of violating exchange rules, without first considering whether they are fit to be registered.

Registrations of all FCMs and floor brokers expire December 31 of each year; those of all commodity trading advisors and pool operators expire on June 30. Associated persons' registrations expire every 2 years on a staggered basis. During fiscal year 1977 CFTC reregistered 17,142 applicants.

Because CFTC does not again screen applicants against FBI or SEC files, applicants might exclude derogatory information on their applications. To protect against this, CFTC should periodically perform name (and fingerprint) checks against SEC and FBI files and make any necessary investigations before reregistering applicants. It may not be cost effective to perform such screening each time an applicant applies for reregistration. However, to weed out unfit applicants and to provide credibility to CFTC's reregistration procedures, CFTC should consider performing

such indepth screening at set intervals, such as every other or every third time an applicant reapplies.

Our review also showed that CFTC does not effectively use two sources of information it already has on file concerning applicants. We found that although CFTC requires exchanges to submit reports of disciplinary actions taken against FCMs or floor brokers and FCMs to submit reports on the termination of employees registered with CFTC, it generally does not consider these reports when determining whether to reregister an applicant. According to a CFTC registration official, there is a shortage of staff to review these reports.

For example, FCMs are required to report the termination of any of their associated persons or floor brokers, including the reasons for the termination. However, we found CFTC does not use the reports for evaluating the applicant's fitness for reregistration. Our review of selected termination reports filed with CFTC showed that associated persons were terminated for such offenses as unauthorized trading for customers' accounts, fraud, and misrepresentation. However, CFTC does not consider such reports during the reregistration process and generally reregisters all individuals.

The second source of information not being effectively used by CFTC in its reregistration process is reports of exchanges' disciplinary actions against floor brokers or FCMs. We found that CFTC generally does not consider these reports when reregistering applicants. As a result, FCMs and floor brokers with histories of exchange rule violations have been automatically reregistered.

For example, a floor broker and an FCM, who were members of the Chicago Mercantile Exchange, had the following history of violations of exchange rules but were routinely reregistered by CFTC on December 31, 1976.

Example A

Rules violated	Date of violation	Exchange's disciplinary action
Acted as both buyer and seller in the same transaction and simultaneously bought and sold orders for the same principals.	8/71	$300 fine and 6 months probation effective August 1, 1971

(Example A)

Took the opposite side of a customer's trade.	5/ 8/74	$1,000 fine and a cease and desist letter
Engaged in dishonest conduct and traded ahead of his customers.	2/11/75	$5,000 fine and 5-day suspension
Failed to appear before an investigative committee.	2/11/75	$5,000 fine
Took the opposite side of a customer's order.	2/ 3, 6, & 11/76	$3,000 fine and 5-day suspension
Traded ahead of his customers.	4/12/76	30-day suspension and ordered to adjust customer's account by $1,260

Example B

Rules violated	Date of violation	Exchange's disciplinary action
Failed to request an initial and a second margin; failed to follow exchange commission charge table; violated the same rules a second time.	11/16/70	$25,000 fine
Violated rules regarding release of advertising material.	4/21/71	Must submit advertising material to exchange for approval before release.
Accepted controlled, managed, and discretionary accounts in violation of exchange rules.	11/27/74	$1,000 fine and a cease and desist order
Failed to maintain written records of customer orders.	5/28/75	Warning letter

(Example B)

Rules violated	Date of violation	Exchange's disciplinary action
Exceeded exchange position limits in pork bellies.	9/23 & 9/24/75	Warning letter
Errors, delays, and omissions in clearing house data processing cards and other memoranda.	9/17/75	Cease and desist order

We discussed these and other cases with a CFTC registration official, who stated that the registration staff has insufficient resources to investigate the circumstances surrounding exchange disciplinary actions. He pointed out that his staff had compiled lists of exchange rule violators and as of December 22, 1977, had identified 31 serious cases which raised questions about the fitness of the applicable registrants. However, because of limited staff the investigation of these cases had a low priority.

NO PROCEDURES TO ENSURE COMPLIANCE WITH REGISTRATION REQUIREMENTS

CFTC has no procedures to verify that those individuals and firms engaged in the commodity futures industry and who are required to be registered with CFTC are in fact registered. For example, it does not perform periodic test checks at FCMs and exchanges to determine whether all associated persons and floor brokers employed by the firms have registered with CFTC. The probability of unregistered persons and firms conducting futures business is made more apparent due to the dropout rate of registrants. According to CFTC statistics, about 13 percent of the floor brokers, 7 percent of the FCMs, and 16 percent of the associated persons do not reregister with CFTC when their registrations expire.

We believe verification procedures are vital for ensuring compliance with the registration requirements of the act and in protecting the public from unscrupulous and unfit individuals. CFTC has attributed the lack of such procedures to a shortage of personnel. However, we believe CFTC could do some verification checks fairly quickly when it performs rule enforcement reviews of exchanges and financial audits of FCMs.

The need for periodic tests at FCMs was demonstrated by a one-time CFTC audit of five Chicago FCMs in October 1975. CFTC found that some associated persons of two of the FCMs had solicted and accepted orders for the purchase or sale of commodity futures but had not registered with CFTC as required by its July 1975 regulations. The audit also disclosed that the FCMs had not reported to the Commission, as required by regulation, all terminations, new hires, and the openings and closings of branch offices thereby making it difficult for CFTC to determine whether all new associated persons had registered.

QUALIFICATIONS AND PROFICIENCY STANDARDS NOT ESTABLISHED

The need for qualification and proficiency standards to help CFTC rid the futures industry of unqualified individuals was suggested by one of its advisory committees in August 1976. Recent discussions with CFTC officials lead us to believe that such standards are urgently needed. However, the Commission has not established them.

Section 4p of the act authorizes the Commission to develop and implement rules and regulations on training, experience, and other qualifications, including administration of a proficiency examination, when the Commission believes they are necessary or desirable to ensure the fitness of floor brokers, associated persons, and other persons associated with the futures industry. The act allows the Commission to transfer responsibility for the proficiency examination to contract markets, or a title III self-regulatory organization.

In August 1975 the Commission established the Advisory Committee on Commodity Futures Trading Professionals to, among other things, consider and recommend to the Commission necessary training and fitness standards for trading professionals. The committee's report, issued on August 5, 1976, recommended that CFTC or the exchanges establish the following requirements:

--Associated persons pass a proficiency examination developed and administered by the futures industry.

--Exchanges establish minimum financial and competency standards for floor brokers.

--Principals of FCMs who are not registered as associated persons pass a competency examination as a prerequisite of their being associated with the firm.

--Commodity trading advisors pass a basic commodities examination as a condition of registration.

CFTC has not implemented any of the advisory committee recommendations.

In the area of qualifications and standards, the exchanges have varying requirements. In Chicago, CBT requires associated persons to pass an examination administered by the National Association of Securities Dealers unless they have prior industry experience. The MidAmerica Commodity Exchange, while not requiring the examination, estimates that 80 percent of the associated persons employed by its members have passed the test. Also, CME and MidAmerica provide new members with a brief orientation on the mechanics of commodity futures trading.

The five New York commodity exchanges do not have requirements for associated persons but have left it up to their member FCMs to establish and enforce qualifications standards. Many of the FCMs have house rules requiring a demonstration of proficiency and qualifications. The larger ones have their own education and training courses and their own examinations. Others require associated persons to take an examination given by the Futures Industry Association, Inc. However, many FCMs have no qualification requirements.

In discussing the need for industrywide qualification standards, a top-level CFTC enforcement official advised us that without such standards CFTC cannot effectively weed out unfit and unscrupulous individuals now being registered. He also stated that the Enforcement Division receives many calls from customers who claim they have been "ripped off" by persons registered with CFTC and who ask what qualification standards CFTC requires. They are (unpleasantly) surprised to learn that CFTC has none. A CFTC registration official told us that when applicants contact CFTC concerning registration requirements they are (pleasantly) surprised to learn that CFTC does not have educational or testing requirements.

Other CFTC officials told us that establishment of qualification and proficiency standards would substantially increase CFTC's workload. They suggested that a title III self-regulatory association be delegated the responsibility for establishing such standards as well as for administering registrations. However, because of recent Department of Justice objections, the likelihood that CFTC will approve such an association in the near future is doubtful. On October 11, 1977, the Department urged CFTC to drop an industry proposal to establish a self-regulatory association

because, according to the Department, the proposal would violate antitrust laws and may be unconstitutional. The Department cited the following major defects in the industry proposal:

- --Compulsory membership to be required by the association raised serious constitutional questions.

- --Lawmaking powers to be delegated to the association are "arguably vested solely in Congress."

- --The proposal is inconsistent with the statutory requirement that the association be "the least anticompetitive means" of complying with the act.

REVISED REGISTRATION FEES NEEDED

Registration fees charged applicants are not based on recent actual registration costs incurred by CFTC. Our review of limited recent CFTC cost data shows that fees charged associated persons, as well as other registrants, may be inequitable.

Section 8a of the act authorizes the Commission to "fix and establish from time to time reasonable fees and charges for registrants and renewals * * *." According to our review of the act's legislative history, the Congress authorized the setting of fees so that the Government could recoup the cost of registering applicants. Fees charged by CFTC include $200 for FCMs (plus $6 for each branch office and $6 for each authorized agent), $20 for floor brokers and associated persons, and $50 for commodity trading advisors and pool operators.

The Commodity Exchange Authority set the current fees for floor brokers and FCMs in 1974. Fees for associated persons, commodity trading advisors, and commodity pool operators were set soon after CFTC was established. CFTC officials told us that these fees were based on Agriculture investigation costs and salaries of CFTC registration employees, excluding related overhead costs.

The most recent CFTC analysis of registration costs and fees was performed in March 1977. The analysis, shown below, showed that on the basis of first quarter results, estimated fiscal year 1977 registration costs exceeded projected income from fees for all categories of registrants except for associated persons. However, the cost figures were incomplete because they excluded overhead and costs incurred by personnel not directly involved in registration.

	FCMs (note a)	Floor brokers	Asso- ciated persons	Com- modity trading advisors	Com- modity pool operator	Total
Estimated fees	$75,212	$53,900	$501,220	$ 32,550	$ 29,750	$692,632
Estimated costs	83,116	57,752	165,600	70,108	56,676	433,252
Excess of fees over costs	$-7,904	$-3,852	$335,620	$-37,558	$-26,926	$259,380

a/Includes branch offices and agents.

In view of the above data and the statutory requirement that the registration fees be reasonable, the Commission should review its present fee schedule with a view toward setting reasonable fees based on recent actual costs of registering applicants.

Another aspect of CFTC fee collection procedures which needs reexamining is the refund policy. CFTC refunds the entire registration fee when an applicant withdraws his application or is denied registration. In fiscal year 1977 CFTC refunded about $13,000 to applicants. However, because CFTC generally incurs costs in processing these applicants, it should reexamine its liberal refund policy.

CONCLUSIONS

CFTC needs to signficantly upgrade its registration program if the program is to be relied on to weed out unfit and unqualified individuals from dealing with the trading public. As recognized by its Chairman, CFTC presently may be registering "potential or actual crooks."

To start with, CFTC needs to fingerprint applicants. Without this, persons with something to hide could use an alias to prevent CFTC from detecting derogatory information about them. Fingerprinting, which has recently been adopted by the securities industry, would enable CFTC to better identify individuals whose applications should be denied because of prior criminal activities and would ease CFTC's job of enforcing the registration provisions of the act.

Secondly, CFTC needs to stop automatically reregistering applicants. It should periodically rescreen applicants

using FBI and SEC checks and the information it already collects from exchanges and FCMs concerning disciplinary actions and terminations.

A third stumbling block to an effective registration program is the absence of CFTC procedures to ensure that individuals and firms dealing with the trading public are, in fact, registered. Without such procedures CFTC's registration program lacks credibility.

CFTC's ability to protect the public can also be improved by exercising its statutory authority to set qualifications and proficiency standards for registrants. With such standards CFTC should be able to better cull out unscrupulous and unqualified individuals from dealing with the trading public.

Our review also showed that fees charged registrants may be inequitable because they are not based on recent CFTC cost data. Accordingly, CFTC should review its present fee schedule recognizing recent registration costs and revise the schedule as necessary. This should be done periodically. Also, because it generally incurs costs in processing applications which are subsequently withdrawn or denied, CFTC should reexamine its policy of providing a total refund of fees on such applications.

RECOMMENDATIONS TO THE CHAIRMAN, CFTC

To better protect the trading public from unfit and unqualified individuals and firms, the Chairman should:

- --Fingerprint registration applicants and submit the prints to the FBI for record checks.
- --Review the fitness of registrants on a continuing basis by periodically screening reregistration applications against SEC and FBI files and reviewing and considering information in exchange rule violation and FCM termination reports.
- --Perform periodic test checks to ensure that individuals and firms required to be registered with the Commission are, in fact, registered.
- --Establish and enforce qualification and proficiency standards for registrants.

To assure that registration fees are reasonable, the Chairman should review CFTC's fee schedule to determine

whether fees adequately reflect the actual costs of registration and revise the schedule as necessary. The schedule should be reviewed periodically. Also, the Chairman should consider changing the policy of refunding the total amount of fees paid on those applications which are withdrawn or denied.

CHAPTER 7

NEED TO REDIRECT AND IMPROVE THE AUDIT FUNCTION

The Commodity Futures Trading Commission has been slow in implementing our 1975 recommendation that it redirect its audit effort to a strong oversight role and transfer the primary responsibility for enforcing required financial provisions of the regulations to the exchanges and require that futures commission merchants engage independent public accountants to audit their financial statements. Our latest review showed that CFTC does not audit FCMs often enough to assure that customers' funds are adequately safeguarded.

Also, CFTC needs to take stronger action against FCMs which violate financial and recordkeeping provisions of the act and CFTC regulations. CFTC sanctions against FCMs have not always been effective in deterring further violations. In addition, CFTC should send written reports to exchange officials on the results of its audits of FCMs.

Although CFTC, SEC, and exchanges have duplicative requirements for auditing FCMs and for the filing of financial statements by FCMs, CFTC is taking steps to eliminate or minimize the problem. This is especially important in view of CFTC's limited resources and its increasing workload.

Finally, CFTC needs to strengthen its oversight of the two largest Chicago exchanges to ensure that they adequately enforce their federally approved minimum financial requirements.

NEED TO REDIRECT THE AUDIT FUNCTION

To protect customers' funds, sections 4f(2) and 4d(2) of the act require that FCMs meet minimum financial requirements at all times, account separately for customers' funds, and not commingle such funds with other FCM funds. The act is supplemented with a set of complex regulations which include stringent requirements for FCMs to segregate customers' funds from their own. CFTC periodically performs segregation audits of all FCMs to ensure their compliance with segregation and certain recordkeeping requirements, such as the maintenance of ledger accounts, journals, and other supporting books and records, evidencing that customers' transactions are kept separately from house or other FCM accounts. CFTC believes that segregation audits are the most effective means of safeguarding customers' funds and enforcing the regulations.

To ensure compliance with minimum financial and related reporting requirements, CFTC relies in part on its own audits and those of certain exchanges. Exchanges with CFTC-approved minimum financial requirements--currently the Chicago Board of Trade and the Chicago Mercantile Exchange--have primary responsibility for enforcing the requirements, with CFTC assuming an oversight role by monitoring exchanges' activities. CFTC has set minimum financial requirements for FCMs belonging to other exchanges and, during its segregation audits of these FCMs, determines whether they are complying with the requirements. CFTC calls these combined audits of segregation and minimum financial requirements general audits. In addition to segregation and general audits, CFTC performs limited audits of firms initially applying to be registered as FCMs.

During fiscal year 1977 CFTC had not completed audits, segregation or general, of 97 FCMs, or about 33 percent of the estimated 296 FCMs registered with CFTC during the year. CFTC's chief accountant told us that to assure that FCMs are complying with the segregation requirements of the act, CFTC should audit each FCM annually and perform three to four spot checks during the year. However, CFTC currently performs segregation audits on an 18- to 20-month cycle and generally performs no spot checks. The chief accountant characterized the 18- to 20-month cycle as "clearly insufficient." He also stated that because of staff shortages the audits are not as comprehensive as they should be and that CFTC has been fortunate that there have been no major defaults of FCMs. According to this official, CFTC would have to double the size of its audit staff, currently at 33, to be able to annually audit FCMs.

CFTC's difficulty in providing the trading public minimal protection against the possible financial insolvency of FCMs has been severly aggravated by the Commission's decisions and actions with respect to the trading of foreign options, which is discussed in chapter 12. 1/ Options trading has attracted many firms to seek registration as option FCMs. Because many option FCMs were undercapitalized according to a CFTC audit official, CFTC had to divert much of its audit resources to police these firms to assure that they complied with statutory and CFTC regulations. The official advised us that in an effort to provide resources to audit option firms, CFTC had decreased its audit work at some large

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1/ On Apr. 5, 1978, the Commission finally voted to suspend the sale of most options as of June 1, 1978.

commodity FCMs with good records of compliance with CFTC financial requirements. However, CFTC found that without direct and frequent Federal audits, problems and patterns of noncompliance with CFTC requirements have developed at some of these FCMs. The official stated that because of options-related work, CFTC's current 18- to 20-month audit cycle will probably widen.

In our 1974 and 1975 reports, we addressed the problems the Commodity Exchange Authority faced in auditing FCMs. We pointed out that in carrying out its responsibilities for regulating securities broker-dealers, SEC, which has responsibilities similar to those of CFTC, directed its auditing work to an oversight role and placed primary responsibility for this function with the securities exchanges. We recommended in the 1975 report that CFTC's 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 that customers' funds are protected, we recommended that the Chairman:

--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.

CFTC has not implemented our recommendations. In October 1976 CFTC issued proposed revisions to its regulations which would, among other things, require that exchanges assume a major role in monitoring the financial stability of member FCMs and that FCMs be audited annually by independent public accountants. However, the proposed revisions, now planned for implementation in the summer of 1978, would not require public accountants to perform segregation audits now performed by CFTC auditors. According to an agency official, while the proposed public accountant audits will reduce CFTC's audit workload, it is uncertain whether the workload will be reduced sufficiently so that CFTC can perform enough segregation audits to provide an adequate level of customer protection.

We believe CFTC should redirect its audit function to an oversight role because

--segregation audits, which are at the heart of customer protection, are not being performed by CFTC in an acceptable frequency and

--it is unreasonable to expect the Government to continue bearing audit costs which an FCM could consider a necessary expense of doing business.

The primary responsibility for auditing FCMs should be delegated to the exchanges. To assist the exchanges in assuming this responsibility, the Commission should require FCMs to engage independent public accountants to make the required audits and furnish reports on the results to the cognizant exchange and to CFTC. CFTC 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 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 discussing the need for CFTC to redirect its audit role with CFTC officials, we were advised that if the Congress enacts the proposed revision and codification to the Bankruptcy Act, the need for CFTC to continue performing detailed segregation audits of FCMs will be reduced. As mentioned previously, the purpose of segregation audits of FCMs is to ensure that they are complying with regulations aimed at protecting customers' funds, such as in the event of the FCM's bankruptcy. The proposed revision and codification, according to CFTC, would provide specifically for the protection of customers' funds in bankruptcy and, therefore, if enacted would eliminate the need for many of CFTC's present complex segregation regulations. Eliminating many of the regulations would reduce the need for CFTC to perform detailed segregation audits of FCMs, according to a CFTC official. CFTC would be able to rely primarily on the independent public accountants and other financial controls envisioned by the proposed CFTC regulations to satisfy CFTC's regulatory responsibility for financial surveillance of FCMs.

NEED TO TAKE STRONGER ACTIONS AGAINST VIOLATORS

When CFTC audits showed that FCMs violated segregation and financial provisions of the act or regulations, CFTC generally issued noncompliance or warning letters to the FCMs rather than seek stronger punitive actions, such as fines or suspensions. However, our review showed that CFTC needs to be more forceful with violators, especially repeat violators.

In looking at CFTC audit files of eight FCMs in the New York region, we found that each firm had a history of of violating segregation and recordkeeping provisions of the act or regulations. CFTC repeatedly sent warning or noncompliance letters to the firms, but CFTC initiated enforcement proceedings in only one case.

CFTC's most recent audit in August 1976 of one of the FCMs 1/ disclosed that it was undersegregated 2/ on 39 business days between December 1975 and September 1976 in amounts ranging from $1 million to $34 million. Three previous audits of the FCM showed the following segregation violations as well as violations of other regulations:

Audit date	Number of days undersegregated	Amounts undersegregated
11/ 8/74	8	$34,000 to $5.5 million
12/ 2/74	14	$70,000 to $3.3 million
8/28/75	26	$14.3 million to $36.2 million

A December 1976 CFTC audit report of another FCM showed that it was undersegregated by from $400,000 to $4.7 million for 240 consecutive business days between April 1975 and March 1976. Prior audits showed that the firm was also undersegregated or had commingled customers' funds on four occasions between 1972 and 1974. After the current audit, CFTC sent the firm a warning letter but did not start enforcement proceedings.

1/ This case was referred to the Enforcement Division only after the latest audit.

2/ An FCM is undersegregated when it has not segregated sufficient funds to comply with CFTC regulations.

Our review of six CFTC audits of FCMs in Chicago disclosed similar instances where the CFTC sanctions were inadequate. For example, one FCM had a history of violations dating back to 1972 involving failing to segregate, undersegregation, filing inaccurate reports, and failing to prepare and maintain various required records. After each audit, compliance or warning letters were sent to the firm as follows.

Audit date	Violation of act or Federal regulation	CFTC action
6/30/72	Commingled house and customer accounts Filed inaccurate reports	Compliance letter
8/31/73	Undersegregation	Warning letter
11/29/74	Commingled house and customer accounts	Compliance letter
12/31/75	Failed to segregate customers' funds Failed to maintain required records	Compliance letter
1976 (exact date not known)	Failed to file required records	Compliance letter
1/31/77	Failed to maintain required records	Compliance letter

We believe that in the above case CFTC should have taken stronger action against the firm.

In reviewing CFTC's procedures for distributing compliance or warning letters, we noticed that CFTC does not provide copies of such letters to exchange officials. However, some of the exchange officials we spoke to stated that they would like to receive copies of the letters to assist their enforcement of exchange rules and to prevent duplication of audit effort. To help the exchanges in their self-regulatory responsibilities, CFTC should consider informing the exchanges of the results of CFTC audits of member firms.

NEED TO REDUCE DUPLICATION IN FINANCIAL REPORTING AND AUDITING

There is considerable duplication in Federal and exchange financial reporting requirements imposed on FCMs. Also, CFTC, SEC, and exchanges audit activities overlap. Firms which deal both in securities and commodity futures must file financial reports with SEC, CFTC, and exchanges of which they are members and may be subject to periodic audits by each of these organizations.

For example, a CME member is required to file with the exchange the following financial statements to comply with the exchange's minimum financial requirements:

--Interim financial statement.

--Annual financial statement certified by a certified public accountant.

--Interim and annual statements of financial condition.

--Interim and annual statements showing computation of capital position.

--Interim and annual statements showing segregation of customer funds.

--Interim and annual statements showing the member firm's positions in the commodity futures market.

If the firm is also a Chicago Board of Trade member, and many are, it would be required to file similar statements with that exchange.

The firm is also required to furnish copies of each of the above listed reports to CFTC. In addition, if the firm is a securities dealer and a member of the various stock exchanges, it would file reports required by SEC and the exchanges.

Concerning duplicative auditing of FCMs, one of the FCMs we visited in Chicago was being audited simultaneously by five different organizations, as shown below.

Type of audit	Organization performing audit
Segregation audit	CFTC
Annual	An independent public accounting firm
Margin audit	Chicago Board of Trade
Segregation, margin, and financial audit	An independent public accounting firm doing an audit collectively for four New York exchanges and SEC
Compliance audit	New York Mercantile Exchange

Frequently, audits by CFTC, SEC, the exchanges, and independent public accountants cover the same areas. In Chicago alone there are about 60 firms that are under the jurisdiction of both CFTC and SEC. Each agency has its own financial reporting and audit requirements.

Futures industry participants we interviewed agreed that there is a need for a uniform, single financial reporting statement that FCMs could use to meet the CFTC, SEC, and exchange requirements. They believe that overlapping audit responsibilities could also be eliminated or minimized by establishing a self-regulatory association under title III of the act. Such an association could establish uniform reporting requirements and take over the audit functions, limiting the various agencies' roles to that of monitoring.

CFTC has addressed the problems of duplication and has proposed changes to its financial regulations. If implemented, these revisions would:

--Increase the frequency and expand the content of FCM financial reporting and require that reports be audited by independent public accountants.

--Make reporting requirements uniform throughout the futures industry.

--Allow FCMs who are also broker-dealers to file the same financial reports with CFTC and SEC.

--Establish an early warning system designed to give notice of an FCM's financial deterioration.

--Enable the delegation to a single self-regulatory organization the responsibility for monitoring and auditing any FCM which is a member of more than one exchange or self-regulatory association.

The Commission believes that the implementation of these proposals, targeted for the summer of 1978, will help achieve the Commission's goal of industry self-regulation, increase regulatory efficiency, and reduce the burden of multiple financial monitoring, auditing, and reporting imposed on FCMs which are members of more than one exchange. Also, the changes should reduce CFTC's audit workload according to a CFTC official.

We agree that, if properly implemented, the above changes would reduce the financial reporting and auditing burden placed on the futures industry and, therefore, increase regulatory efficiency. CFTC should strive to implement the proposed changes as soon as possible, as we recommended the first of the proposed changes in prior reports and in August 1976 the Commission's Advisory Committee on Commodity Futures Trading Professionals recommended some of the others.

NEED FOR BETTER CFTC OVERSIGHT OF EXCHANGE-ENFORCED MINIMUM FINANCIAL REQUIREMENTS

Section 5a(9) of the act requires that each exchange enforce, when approved by the Commission, minimum financial standards and related reporting requirements for FCMs which are members of such exchanges. As mentioned previously, only CBT and CME have such federally approved minimum financial requirements for their members. Members of other exchanges must follow requirements set by CFTC.

CFTC anually reviews the enforcement programs of the two exchanges to determine whether they are adequately monitoring their members' compliance with minimum financial requirements. CFTC examines each exchange's early warning system, 1/ financial statements submitted by FCMs to the exchange, and selected workpapers the exchange keeps for auditing members' financial conditions.

CFTC has not set minimum acceptable auditing standards or guidelines for the exchanges to follow. The need for

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1/ A system designed to give CFTC sufficient advance notice of the FCM's financial deterioration.

such guidelines and standards is made more apparent because of the history of deficiencies uncovered by both CFTC and the Commodity Exchange Authority reviews of exchanges' audit programs.

For example, in 1971 and 1973, the Authority concluded that both exchanges had to improve their audit programs. The Authority characterized CBT's audits as meager because the exchange seldom went beyond a desk review of member firms' financial statements and other documents. The Authority reported that CME needed to increase the number of financial audits it performed.

Because of the deficiencies the Authority found in exchanges' audit programs, we recommended in our 1974 report that the Authority establish guidelines on acceptable performance standards for exchanges' audit functions and that penalties be imposed for exchanges' failure to meet such standards within a specified period. However, our recommendations have not been implemented.

CFTC's most recent audit of CME, completed in August 1977, disclosed continued deficiencies in the exchange's program. CFTC found that 30 of the exchange's 81 FCMs which were registered by CFTC had not been audited in the past 3 years. In calendar year 1976, the exchange had completed only 25 financial and segregation audits, 52 percent less than the previous year.

CFTC also found that CBT started only 47 financial audits during calendar year 1976, even though at the time the exchange had about 108 registered FCMs. CFTC officials told us that the 47 audits were a considerable increase over the number of audits performed in prior years.

Our review of CFTC oversight procedures showed that CFTC does not test the reliability and accuracy of the exchanges' audit program by periodically auditing selected FCMs. Without performing such test audits, CFTC is not in the best position to reach conclusions concerning the quality of the exchanges' audit programs. The chief accountant agreed with our observations on the need for CFTC to better evaluate the quality of exchange audit programs.

CONCLUSIONS

CFTC audits have not been sufficiently frequent and may not be complete enough to ensure that customers' funds are adequately protected. Although CFTC has recognized this, it has not implemented our previous recommendations

that it assume an oversight role and direct the exchanges to enforce minimum financial and segregation fund requirements.

We believe it is both practical and desirable, and in line with CFTC's goals for self-regulation, to have the exchanges assume primary responsibility for enforcement. CFTC should assist the exchanges by working with them to develop the necessary staff capability and by requiring FCMs to furnish the exchanges and CFTC with reports on audits of segregation of funds and financial requirements attested to by independent public accountants. Also, CFTC should work with the exchanges to develop detailed guidelines to assist public accountants in performing these audits.

The approach should be similar to that of SEC, whose practice is to make 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 an FCM should consider a necessary expense of doing business.

However, amendments to the Bankruptcy Act have been introduced which according to CFTC will reduce the need for detailed segregation audits of FCMs. Because of this we are not, at this time, offering recommendations concerning the redirection of the segregation audit responsibility to exchanges.

CFTC's practice of generally sending warning or noncompliance letters has been ineffective in stopping some firms from repeatedly violating segregation and financial requirements of the act or the regulations. To ensure FCM compliance, CFTC should take prompt and aggressive enforcement action against violators, including fines, revocations, or suspensions.

While we believe that CFTC should turn over the primary responsibility of auditing FCMs to the exchanges, we recognize that there will be instances where CFTC needs to perform such audits itself. In these cases, to assist exchanges in their self-regulatory responsibilities and to prevent possible duplication of audit effort, CFTC should inform the exchange officials of the results of CFTC audits of exchange firms.

CFTC has issued proposed regulations which, when properly implemented, should eliminate or minimize duplicative reporting requirements and overlapping audit responsibilities

among CFTC, SEC, and exchanges. Because of the proposed regulations, we are not offering recommendations in this area.

Finally, CFTC needs to improve its oversight of CBT's and CME's enforcement of federally approved minimum financial requirements. Commodity Exchange Authority and CFTC reviews have shown that the exchanges need to upgrade their audit programs. However, as with the Authority, CFTC has not acted vigorously to ensure the adequacy of the exchanges' programs. CFTC needs to establish standards of acceptable performance and should impose penalties for failure to meet the standards within a specified period of time. To test the quality of the exchanges' programs, CFTC needs to periodically audit selected FCMs. The need for the Commission to improve its oversight procedures will be amplified with the implementation of the proposed regulations requiring all exchanges to assume primary enforcement responsibility for their members' compliance with minimum financial requirements.

RECOMMENDATIONS TO THE CHAIRMAN, CFTC

To assure that customers' funds are adequately safeguarded and to increase regulatory efficiency, the Chairman should:

--Delegate to the exchanges the primary responsibility of ensuring that member FCMs comply with the minimum financial requirements and require the FCMs' financial statements to be certified annually by independent public accountants. To assist the public accountants, the Commission should provide them with detailed auditing guidelines. The Commission also should assume a strong oversight role, including periodically testing the adequacy of the public accountant audits.

--Take prompt and aggressive action against firms which violate the financial provisions of the act or the regulations.

--Provide exchanges with written reports on the results of CFTC audits of member firms.

--Establish standards for exchanges' enforcement of minimum financial requirements, set deadlines for compliance, and impose penalties for failure to meet the deadlines. To assist in evaluating exchange performance, the Commission should periodically audit selected FCMs.

CHAPTER 8

CFTC'S MARKET SURVEILLANCE

PROGRAM NEEDS IMPROVEMENT

Because the act requires exchanges to prevent price manipulation and to enforce their rules and because the Commodity Futures Trading Commission needs to monitor exchange self-regulation, CFTC and exchanges independently maintain an ongoing market surveillance program, 1/ resulting in duplicative activities. For example, CFTC and the Nation's two largest exchanges--the Chicago Board of Trade and the Chicago Mercantile Exchange--duplicate each other's market surveillance activities in various respects. At the time we performed our review of market surveillance both of these exchanges had not agreed to provide us access to their records. Therefore, we were unable to test their surveillance programs to determine to what extent duplication can be reduced or eliminated. Notwithstanding this, CFTC needs to study the interrelationship between its market surveillance programs and that of exchanges with a view toward reducing or eliminating unnecessary duplication, improving coordination, delineating responsibilities, and sharing market information.

Accurate, complete, and timely market data is the backbone of a successful market surveillance program. Agency studies have shown that there are various problems with CFTC market surveillance data. Furthermore, CFTC's market surveillance functions are manually oriented and should be automated. CFTC has recognized many of the weaknesses and proposed changes to correct them. However, because CFTC had not established an adequate plan for implementation, some remain unresolved.

Further research and corrective action are also needed in several areas to improve CFTC's surveillance of the futures markets. Cash price data, in particular, is deficient for various commodities. CFTC has recognized the cash price data problem but has yet to take corrective action.

1/The purpose of market surveillance is to detect and prevent market disruption. It is a multifaceted process, involving, among other things, collecting, analyzing, and comparing various market data.

NEED FOR MARKET SURVEILLANCE

Market surveillance is needed to monitor the performance of futures markets and to detect and prevent adverse market conditions, such as price manipulations, from disrupting the markets. It involves collecting, analyzing, and comparing market data, such as:

--Futures positions--the number of futures contracts held by a party.

--Cash positions--the quantity of the physical commodity which futures traders own, are committed to buy, or are committed to sell.

--Open interest--the number of contracts which remain to be settled.

--Volume of trading and deliveries.

--Futures prices and cash prices.

--Deliverable supply--supply which is available for delivery in settlement of futures contracts.

The above data, along with other factors, is analyzed and compared to determine whether (1) any unusual futures price movements or any concentration of or unusual changes in futures positions have occurred, (2) contracts are being liquidated in an orderly fashion, and (3) any fundamental market situation is developing that might cause a disorderly market.

When a potential problem is detected, CFTC intensifies its surveillance which may include contacting traders to ascertain their trading and delivery intentions or persuading them to take appropriate action for an orderly liquidation. If the Commission believes an emergency exists, such as threatened or actual manipulations or corners, it can under section 8a(9) of the act direct the exchange to take action needed to maintain or restore an orderly market.

DUPLICATION BETWEEN CFTC AND EXCHANGES

CFTC and the exchanges are independently performing market surveillance, resulting in duplication of effort. Opinion varies as to whether such duplication is unavoidable and necessary. We believe that CFTC, with assistance of exchanges, should study this area to determine whether this

is a serious problem and if so what can be done to reduce unnecessary duplication and to increase coordination among itself and the exchanges.

Exchanges are required by section 5(d) of the act to provide for the prevention of price manipulation and the cornering of any commodity. Section 5a(8), as implemented by regulation 1.51(a), requires exchanges to have an affirmative action program to enforce their rules. As discussed in chapter 4, one of the components of a rule enforcement program is market surveillance.

CFTC on the other hand needs to monitor and periodically evaluate the quality and magnitude of exchange self-regulation, including market surveillance. CFTC also needs to maintain a market surveillance capability to continuously oversee the exchange's procedures and to quickly step in if potential market problems are not being handled adequately by an exchange. Therefore, to fulfill these regulatory responsibilities, CFTC and the exchanges maintain an ongoing market surveillance program to monitor futures markets.

When two or more parties perform similar tasks, some duplication becomes inevitable. To examine the extent of duplication, we selected the Nation's two largest exchanges--CBT and CME--because they jointly account for about 70 percent of the total trading volume in 1976.

CBT and CME each had two staff members in their market surveillance sections. CFTC's Chicago regional office has seven surveillance economists who spend most of their time monitoring commodities traded on these two exchanges.

Using CFTC's guidelines 1/ on market surveillance as a baseline and through discussions with CFTC personnel we determined which activities performed by CFTC were also performed by the two exchanges. We found that for the expiring futures 2/ CFTC and the exchanges individually monitor futures price movements, changes in relationships of futures to cash prices, open interest and changes, volume of trading, deliverable supplies, actual deliveries, and concentrations of trading positions.

1/ Those intended to assist exchange to perform surveillance and others which are used by CFTC staff.

2/ The nearest future month in a commodity.

The following table shows the duplication in the above activities.

Market Surveillance Activities of the

CFTC and Two Chicago Exchanges

Surveillance activity	CFTC	Exchanges CME	CBT
1. Price movements:			
a. Review daily changes in futures prices.	X	X	X
b. Monitor futures prices during the day for expiring futures.	X	X	X
2. Changes in price relationships:			
a. Compare futures prices to cash prices.	X	X	X
b. Compare futures prices of different future months.	X	X	X
3. Open interest and changes in open interest:			
a. Compare changes in open interest from the previous day.	X	X	X
b. Compare changes in open interest from a year ago.	X	X	X
4. Concentrations of positions among clearing members:			
a. Compare open positions of large clearing members to total open interest.	X	X	X
b. Examine the changes in positions of large clearing members.	X	X	X
c. Know whether a clearing member is a principal in the trade or is exclusively a broker.	X	X	X

Surveillance activity	CFTC	Exchanges CME	CBT
5. Volume of trading and changes therein:			
a. Compare volume to the previous day's amount.	X	X	X
b. Compare volume to the amount a year ago.	-	X	X
c. Compare volume to total open interest.	X	X	X
6. Trading liquidity and the magnitude of successive price changes.	X	(a)	-
7. Deliverable supplies:			
a. Compare deliverable supplies to total open interest.	X	X	X
b. If information on deliverable supplies is not available, ascertain the amount of total supplies.	X	(a)	N/A
8. Deliveries--Is there any apparent concentration in the making or taking of deliveries?			
a. Monitor deliveries of clearing members.	X	X	X
b. Monitor deliveries of large traders.	X	X	N/A
9. Market news and gossip:			
a. Keep abreast of market developments through information supplied by sources, such as Agriculture and the wire services.	X	X	X
b. Have surveillance members on the trading floor routinely talking with trade people.	X	(a)	X
10. Other activities:			
a. Monitor the positions of large traders.	X	X	-
b. Monitor the changes in positions of large traders.	X	X	-

Surveillance activity	CFTC	Exchanges CME	CBT
c. Contact trade people to learn why prices are unusual.	X	(a)	X
d. Contact large traders or clearing members regarding their open positions and intentions.	X	X	X
e. Require clearing members to reduce large open positions, if necessary.	-	X	X
f. Require traders to trade only for liquidation, if necessary.	-	X	X
g. Inform clearing members or large traders of their responsibility for an orderly liquidation.	X	X	X
h. Contact clearing members with short positions to determine whether sufficient supplies are available for deliveries.	X	X	X

X Activity performed

\- Activity not performed

(a) Not able to ascertain

N/A Not applicable

In addition to surveillance functions shown in the above table, CFTC and the exchanges also separately collect information on futures positions of individual traders. CFTC gathers data on commodities traded on futures markets. CME collects information on futures positions on all of the commodities it trades, while CBT collects data on all commodities traded except soybeans and grains (i.e., wheat, corn, and oats).

CFTC set reporting levels for each commodity. For example, wheat is set at 500,000 bushels and coffee 25 contracts (or 6,250 bags). CFTC also requires futures commission merchants to report positions of traders that have reached the reporting level. The two exchanges have established their own reporting levels and as stated above collect similar data from their clearing members. CFTC noted the similarity between its data and that of CME by stating in its 1977 rule enforcement review report of CME that

"* * * the Commission staff computerizes [the reports from FCMs on futures positions] and prepares a listing by firm which shows basically the same information as the CME [reports on futures positions]."

Opinion varies as to whether duplication is necessary. CBT objected to the dual collection of data on traders' futures positions. In June 1977 CBT submitted to CFTC a proposal that the exchange abandon its reporting requirements covering trader positions. In the proposal, CBT stated that the duplication results in both wasteful and unnecessary costs and places an undue burden on exchange members. It added that self-regulation in many other areas would be increased if CFTC would share trader information with the exchange. As of January 1978, CFTC had not yet issued a decision on the proposal. A CME official told us, however, that duplication is necessary to back up the exchange's surveillance program. A CFTC official advised us that obviously some duplications can be consolidated and a study of the area is needed.

To some extent, the duplication is intended and therefore may not be entirely avoidable. The regulatory approach embodied in the law and adopted by CFTC emphasizes exchange self-regulation with a strong oversight and backup role for CFTC. We were unable to determine if any duplication can be eliminated without downgrading the overall market surveillance program because CBT and CME declined us access to examine and test their operations during our field work.

Duplication could be minimized and coordination improved if CFTC understands and is familiar with all facets of exchange operations. However, on the basis of our discussions with CFTC's surveillance group, it appears that CFTC's knowledge of the surveillance programs at the largest exchanges is limited. For example, a CFTC surveillance official said he only has general knowledge of CBT's surveillance program and has never seen the reports which the exchange uses for surveillance. He also stated that he is not familiar with CME's surveillance operations. Another CFTC surveillance official said he is not well acquainted with the exchanges' data collection systems on futures positions.

CFTC's surveillance economists could become knowledgeable of exchanges' market surveillance programs through their participation in rule enforcement reviews. However, their involvement during these reviews in assessing exchanges' market surveillance programs has been limited.

CFTC's New York surveillance staff did not participate at all in the 1976 rule enforcement reviews of New York exchanges. Similarly, CFTC's Chicago surveillance staff participated only in a general consultation role in the rule enforcement reviews of Chicago exchanges.

MARKET SURVEILLANCE PROBLEMS RECOGNIZED WITH CORRECTIVE ACTION YET TO BE COMPLETED BY CFTC

A successful market surveillance program requires quick analysis and comparison of accurate, complete, and timely market data. In December 1975 CFTC's chief economist began a study which focused primarily on CFTC's market surveillance data. The chief economist issued his report in June 1976 and a followup report in April 1977. The reports identified the following problems:

--Data on futures positions of traders is not accurate and timely.

--Data on cash positions of traders is inadequate.

--Reporting from foreign interests is troublesome.

--Data on deliverable supplies is not available for certain commodities.

--Computerized market surveillance data is not readily available.

Although the chief economist made a series of proposed changes in the June 1976 and April 1977 reports, CFTC had yet to complete implementing these proposals as of April 1978.

Futures and cash positions not accurate, complete, and timely

Data on the futures and cash positions of individual traders helps to indicate which futures traders could influence prices or could be expected to make or take deliveries. CFTC inherited a reporting system from its predecessor, the Commodity Exchange Authority, which collected such data. One type of data is collected from FCMs, foreign brokers, and futures traders on futures positions. Other data covers cash positions on commodities which have Federal speculative limits. CFTC collects the latter from hedgers and uses it to enforce speculative limits.

Data collected through the reporting system is not always timely, accurate, and complete. Such deficiencies are not new and can be traced back to the Commodity Exchange Authority. The following statements from an Agriculture Department report of August 1974 cited these problems:

> "Among these data inadequacies are lack of accuracy, completeness and timeliness in data produced by the present CEA reporting system. In order to adequately perform market surveillance, large traders' complete positions must be available on a timely basis."

The June 1976 and April 1977 reports from the chief economist disclosed various problems with the data. First, futures position data reported by traders has been untimely, contains excessive errors, and duplicates some data received from FCMs. For example, CFTC estimated that about 23 percent of the data its Chicago office received was rejected during CFTC's audit/edit check, with a majority of the rejections attributed to trader filing errors.

Second, the manner in which futures position data reported by FCMs may also decrease the usefulness of the data as a surveillance tool. An FCM can execute futures transactions for another FCM or a foreign broker. This FCM may handle these transactions as an omnibus account (i.e., transactions of two or more persons carried in aggregate) and may offset the total buying and selling futures positions in the omnibus account and report only the net amount to CFTC. Such offsetting makes it difficult for CFTC to know the actual number of futures positions in the omnibus account.

Third, cash position data reported by hedgers may not be adequate to assist in enforcing speculative limits because these cash reports are essentially unverified and unverifiable. Thus, CFTC could not detect speculative limit violations if traders report false information. From the standpoint of market surveillance, the reports have limited use because, among other things, they cover only commodities with speculative limits.

Troubles with foreign reporting

Another problem, also tied to the reporting system, concerns foreign reporting. Under CFTC's present foreign trader reporting system, problems arise according to the chief economist because:

--Reports from foreign brokers are not timely for market surveillance because they are filed weekly and are also delayed by the foreign and U.S. postal services.

--Futures positions of traders could not be accurately determined because some foreign brokers (notably Swiss banks) refused to furnish customer information. Any domestic and foreign trader thus could hide his positions by going through such a broker.

--Enforcement of foreign reporting requirements is not possible aside from forcing foreign interests to withdraw from U.S. futures markets. For example, if a foreign broker refuses to supply customer information, CFTC would send a compliance letter but undertake no further followup action.

The 1977 followup report also stated that without some type of information on account identification and futures positions held by foreign traders, it may be impossible for CFTC to

--quell congressional concern over foreign interests in U.S. commodities markets;

--act in a timely manner when preventative measures, such as emergency action, must be taken; and

--know who to contact if a violation or attempted violation of the act has occurred.

Deliverable supply information not available

Other important market data for assessing futures markets includes deliverable supply. A commodity's deliverable supply is often essential to determine the degree of market control exerted by a trader or a group of traders.

The 1976 report, however, disclosed that sufficient data might not be available for determining the quantity of deliverable supply for several commodities, such as lumber, coffee, cocoa, rubber, cotton, orange juice, and potatoes. For example, a total picture of deliverable supplies for cotton and orange juice cannot be drawn because data on total stocks at the specified places of delivery is not available.

Need to further computerize
market surveillance data

CFTC uses computers to process market data of futures prices, trading volume, open interest, and deliveries at Chicago and New York. The data is entered into the computer, is verified, and becomes part of CFTC's computerized records which CFTC calls permanent records.

However, computerized market data has not been readily available. According to the CFTC study, the New York CFTC office lacked staff and was not entering market data into the computer, and the Chicago office had a 6-month lag in verifying automated data on futures prices. In addition, cash prices, considered as the most important indices for measuring the performance of futures prices, are not even part of the computer data base. As a result, analyses of price relationships are based on manually constructed charts and non-automated analytical techniques. The study also concluded that surveillance economists should have access to computer-generated graphs, tables, or analyses of futures prices.

Need better planning to implement
CFTC's proposed changes

On the basis of the study, CFTC's chief economist proposed to the Commission five major changes in June 1976 and two in April 1977 as follows:

--Drop reports from traders on futures positions and change the reporting requirements for FCMs.

--Encourage FCMs to submit data on futures positions by using a computer listing which CFTC developed rather than using the more lengthy manual report.

--Limit the present cash position reports from hedgers to grains and require a new detailed cash report from futures traders.

--Require the respective exchanges to furnish more detailed supply data for certain commodities and further study potatoes and lumber.

--Give greater emphasis to maintaining up-to-date computer surveillance data.

--Require long futures positions and short futures positions of omnibus accounts to be reported separately rather than on a net basis.

--Require foreign accounts to be carried by FCMs on a fully disclosed basis, i.e., names of traders and their individual futures transactions must be disclosed to the FCM.

The 1976 study stated that the proposals would, among other things, improve the overall effectiveness of market surveillance, reduce the total number of reports received by CFTC by approximately 40 percent, and appreciably reduce the manpower resources devoted to such reports.

Along with these proposed changes, an overall plan which laid out general steps for implementing and further evaluating the changes was recommended. The plan, however, lacked adequate information on how much time and resources would be needed and how resources would be obtained and allocated to perform the necessary work. These determinations are valuable planning and control tools for (1) compelling continuous reevaluation of stated objectives, (2) providing guides for judging subsequent performance, and (3) promoting communication and coordination among participants. Operating without them may, as CFTC has experienced, forestall progress because insufficient attention or resources may be applied. The Commission had accepted all changes when proposed, but has not implemented all of them. We noted that the Commission did not place a high priority on their implementation. As of April 1978, the proposals were either being implemented, modified, or tested. Appendix V summarizes the status of each proposal.

For example, CFTC had a slow start in updating the computer data. In August 1977, more than a year after the proposal, CFTC's New York office still lacked staff to computerize market data as the CFTC study identified. It computerized market data as time permitted. We noted that that office's backlog of unentered (into the computer) market data had increased from a 1-year to a 2-year backlog. The backlog in CFTC's Chicago office also widened from 8 months to 1 year.

We followed up with various CFTC officials in January 1978 and found that progress had been made. However, the lack of priority setting resulted in different views between the management of CFTC's New York and Chicago offices in

updating automated data. The New York office had not given a high priority to the work. A CFTC New York official said it still lacked staff and was still automating the data as time permitted. In contrast, the Chicago office had assigned a high priority to the updating.

ADDITIONAL STUDIES AND CHANGES NEEDED TO IMPROVE MARKET SURVEILLANCE

Despite CFTC's proposed changes as described in the preceding section, further studies and changes are needed to improve market surveillance. The Commission needs to establish some order of priority since not all markets, questions, or areas can be studied at once. We believe CFTC should give the following two areas a high priority because of their potential for enhancing the market surveillance process.

Obtain daily reports from clearinghouses

In August 1974 the Department of Agriculture proposed to replace the reports from traders and FCMs on futures positions with reports of detailed trade information from clearinghouses. 1/ Agriculture's proposal was the result of a joint Agriculture-industry team study which focused on data needs for regulatory purposes. According to the study, the proposal would provide more accurate, complete, and timely data on commodity futures transactions. Exchanges would be able to share the use of the improved data when needed for their self-regulatory programs. It was recognized that the benefits to be derived from the proposal would not come without costs, but the costs would be offset by substantial benefits to the regulatory agency, the industry, and the public. Using clearinghouse reports has been suggested in other studies, including one sponsored by the Commodity Exchange Authority.

Under the proposed system, FCMs and exchange clearing members would supply daily detailed information on each trade through the clearinghouses to CFTC. The details for both sides of each trade would be combined on a single record at the clearinghouse and submitted to CFTC on magnetic tape,

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1/ A clearinghouse is a central agency set up by an exchange or authorized by it through which futures transactions are closed and financial settlements are made.

punched cards, or other machine-readable media. These details would include the account numbers of traders, the execution time for each side of the trade, quantity, clearing member, and other information used by clearinghouses for clearing a trade.

CFTC's proposed changes to its collection of futures position data discussed in the preceding section did not deal with obtaining data from clearinghouses. Since collection of futures position data from clearinghouses could benefit both the regulatory agency and the exchanges, it would be worthwhile for CFTC to study the benefits and costs of this alternative relative to the changes it proposed.

Quantitative market detection indicators and additional surveillance techniques needed

Market surveillance, as important as it is, is a highly subjective process. There are no hard and fast rules for determining when a market problem exists. CFTC surveillance economists rely on their experience and judgment in detecting market problems. It is generally assumed that one or several traders holding a large percentage of open interest in a particular futures contract can cause market disruptions, such as price manipulations or defaults. However, a measurable indicator to identify what constitutes a large percentage of open interest that can disrupt the market is not available.

In addition, market surveillance data is not always adequate or available. For example, cash price data is considered indispensable for detecting manipulation of futures prices or unusual price relationships. However, available cash price data, as discussed in the next section, has become less and less adequate for market surveillance. Similarly, deliverable supply data, essential for determining the degree of market control exerted by a trader, is unavailable for various commodities, such as coffee, cocoa, and rubber.

Given the subjectiveness of market surveillance and deficiencies in market data, distorted regulatory responses by CFTC may occur. Our June 1975 report had cited a case where deficient cash price data caused a false indication of price artificiality in the futures market, resulting in a fruitless price manipulation investigation.

A program should be established to (1) develop early warning quantitative indicators for detecting developing market problems and (2) explore additional surveillance techniques to

alleviate the problem of inadequate or unavailable market data. Supporting our view, a recent report by a CFTC consultant stated that

> "* * * there is another dimension of the problem that merits recognition, namely, the extent to which surveillance procedures can be developed and employed to detect artificial prices in the making. To investigate this question adequately would require a study of current and potentially feasible surveillance procedures with an eye toward the application of statistical procedures that could be useful * * *. Whatever procedure might be developed, however, would be used to monitor the system searching for signals that something is or may be awry in the market. This aspect of surveillance is important and merits further research."

A March 1977 staff memorandum to the Commission stated that the "development of improved market surveillance indicators" was a high priority but could not be accomplished without more staff resources.

CFTC NEEDS MORE AND BETTER CASH PRICE DATA

To monitor commodity futures prices and detect price manipulation, CFTC needs reliable cash price data. Deficiencies in cash price data, however, have been uncovered for various commodities. Although CFTC has recognized this problem, it has done little to correct it. In addition, although cash prices tend to follow futures prices when futures prices are manipulated, CFTC appears to give limited consideration to this possible futures-to-cash price influence.

Cash price data inadequate for market surveillance

CFTC considers commodity cash prices as the most important indices for measuring the performance of futures prices. The cash price quotations which CFTC uses are developed by different sources, such as Agriculture and private reporting services. Thus, not all cash price quotations are developed under the same method. For example, some cash price quotations are bids and some represent actual cash transactions. Given this variation, some of the cash price quotations are questionable for meeting CFTC's surveillance needs.

We believe that the reliability of cash prices quoted for grains, soybean oil and soybean meal, frozen pork bellies, fresh shell eggs, frozen concentrated orange juice, cotton, sugar, and imported frozen boneless beef, in particular, needs to be improved for market surveillance. Though the problems vary somewhat by commodity, the most noticeable problem is that the cash market for various commodities either is dispersed geographically or has undergone changes, making cash price quotations less and less useful for market surveillance. Illustrated below is a description of the cash price quotations used by CFTC for grains, soybean meal and soybean oil, and frozen pork bellies.

Grains

There are four exchanges designated as futures markets for grains--CBT, the Minneapolis Grain Exchange, the MidAmerica Commodity Exchange, and the Kansas City Board of Trade. 1/ We focused on the cash price quotations used for monitoring grains traded at CBT, because this exchange accounted for 91 percent of the total volume of grains traded in 1976.

CFTC relies heavily on the cash prices quoted for the Chicago location. It places limited emphasis on cash price data from other geographical locations. CFTC uses cash prices quoted for the following locations.

Grain			
Wheat	Oats	Corn	Soybeans
Chicago	Chicago	Chicago	Chicago
Gulf	Minneapolis	Gulf	Gulf
Toledo		Toledo	
		St. Louis	

Our 1975 report pointed out that the cash prices quoted for Chicago were deficient for surveillance purposes. They still are. Even if all the cash price quotations used for each grain commodity are considered on a collective basis,

1/ Kansas City Board of Trade is a designated futures market for all grains except oats.

they still do not satisfy the surveillance needs, because collectively they represent prices for only a small segment of the cash market and may not even represent prices of actual cash transactions.

A measure of whether a cash price quotation satisfies the surveillance need is its representativeness to the operating cash market. This was stated by CFTC's Advisory Committee on Market Instruments in its October 1976 report:

> "During the course of the Commodity Futures Trading Commission's normal market surveillance activities, it is critical that the cash prices used reflect the aggregated supply and demand forces that are operative during the spot price discovery process." 1/

Formerly, cash price data was generated from numerous daily cash sales on terminal markets and was regarded as being representative of aggregate cash market transactions. During the past two decades, however, the cash markets for grains in the United States have widely dispersed, with the terminal market losing its prominence as a widely used central point for cash commodity sales. Several reports have documented this dispersion. For example, a September 1976 Agriculture report describes the following:

> "The markets for grains in the U.S. differ from many commodity markets in that a very large number of traders are involved, ranging from farmers and small elevators to large processors and exporters. The study shows that these traders are geographically dispersed, with most located in the major grain growing areas while some are located at ports and processing and feeding centers in other parts of the country."

The dispersion of the cash grain markets resulted in dispersed pricing locations. Therefore, according to the CFTC advisory committee report "* * * the representativeness of available cash prices for futures market surveillance purposes become less and less useful." Statistics from the Agriculture report provide two factors which indicate that cash price quotations used by CFTC only account for a small segment of the dispersed cash markets and thus lack representativeness.

1/ Spot price is same as cash price. The price discovery process is the process by which buyers and sellers arrive at a specific price.

First, the cash price quotations used by CFTC represent grain traded for immediate delivery. Most cash trading, however, is for deferred delivery. The Agriculture report showed that in 1974 deferred-delivery transactions accounted for 55, 53, and 49 percent of purchases from farmers for corn, wheat, and soybeans, respectively. For country elevator sales, 88, 70, and 84 percent of corn, wheat, and soybean sales, respectively, were for deferred delivery. Also, about 95 percent of terminal sales, such as sales occurring at CBT, were under the deferred-delivery arrangement. A CFTC economist familiar with grains recognized the situation and told us that using cash price quotations on deferred delivery would present a problem of readily adapting these prices to meet the grain specifications required by the futures contracts. He said the cash prices for immediate delivery are easier to work with, though they do not represent many grain transactions.

Second, grain trades are geographically scattered, thus the quantity of grain traded at any location is proportionally small relative to the total market. For example, buyers in two (Chicago and Toledo) out of the four locations where cash prices quoted for corn were used by CFTC only accounted for at most 7 percent of the total estimated purchases.

A third issue is whether the cash price quotation represents actual transactions. As the CFTC advisory committee report stated:

> "Where market quotes are based on a very limited number of transactions, the concern is that these spot prices may not reflect the true state of the market. Frequently such quotes may be only subjective evaluations which would be difficult to substantiate in a manipulation case, and which may be of little value to those monitoring the convergency or divergence of cash and futures prices for surveillance purposes."

According to the above statement, it would be better to have cash prices quoted for actual transactions. However, the cash price quotations used by CFTC for at least three locations--Chicago, Toledo, and the Gulf--are bids. Bids are prices that buyers offer to pay for the commodity and thus may not represent actual transactions. An Agriculture report on the cash grain price reporting pointed out that:

> "* * * the reporting of actual bid prices has its hazards. While the bids put out by reputable firms usually result in transactions at those prices, some

of the persons we talked to suggested that their competitors' bids are often misleading and that the competitor would frequently buy at prices higher than his bid, after negotiation."

Supporting this view, a representative of a private reporting service which disseminates Gulf cash price quotations told us that many times actual transactions do not occur at the quoted price; rather, they occur at a higher price. A CFTC economist also told us that bids may not result in actual transactions.

Soybean meal and soybean oil

CFTC uses one cash price quotation for soybean meal and another for soybean oil. Both of these prices are quoted for Decatur, Illinois. As with grains, the production of soybean meal and soybean oil has dispersed geographically in recent years. At one time Decatur was the center of soybean processing; however, during the past 20 years soybean processing has spread to soybean-producing areas, such as Iowa, Indiana, Arkansas, Missouri, and Minnesota. Given this dispersion, the cash prices for one location are unlikely to represent the total market forces and, therefore, may be inadequate for market surveillance. In concurrence, a CFTC economist and an Agriculture Department agricultural statistician agreed and told us that more cash price quotations from various locations would be desirable for surveillance purposes.

Frozen pork bellies

Cash price quotations used for monitoring frozen pork belly futures contracts are published by a private reporting firm. The prices are deficient from a market surveillance standpoint.

The quotation is for fresh pork bellies, not frozen pork bellies, as are being traded in the futures market. Quotations for frozen bellies, however, are not readily available because they are thinly traded in the cash market. Because the quoted cash price is for a different commodity than the one traded on the futures market, CFTC makes a price adjustment in an attempt to make the quotation meet its surveillance needs. As a CFTC economist agreed with us, CFTC should maintain a program to continuously assess the adequacy of the adjustment. Similarly, CFTC's Advisory Committee on Market Instruments recommended in October 1976 that "a continuous appraisal program on a commodity-by-commodity basis be initiated to keep the market surveillance team current with changing and evolving economic conditions." As of January 1978, CFTC had not maintained such a program.

Need to consider that cash prices tend to follow futures prices

Experts maintain that cash prices tend to follow futures prices when futures prices are manipulated. For example, an Agriculture economist expressed this view in a June 1977 seminar:

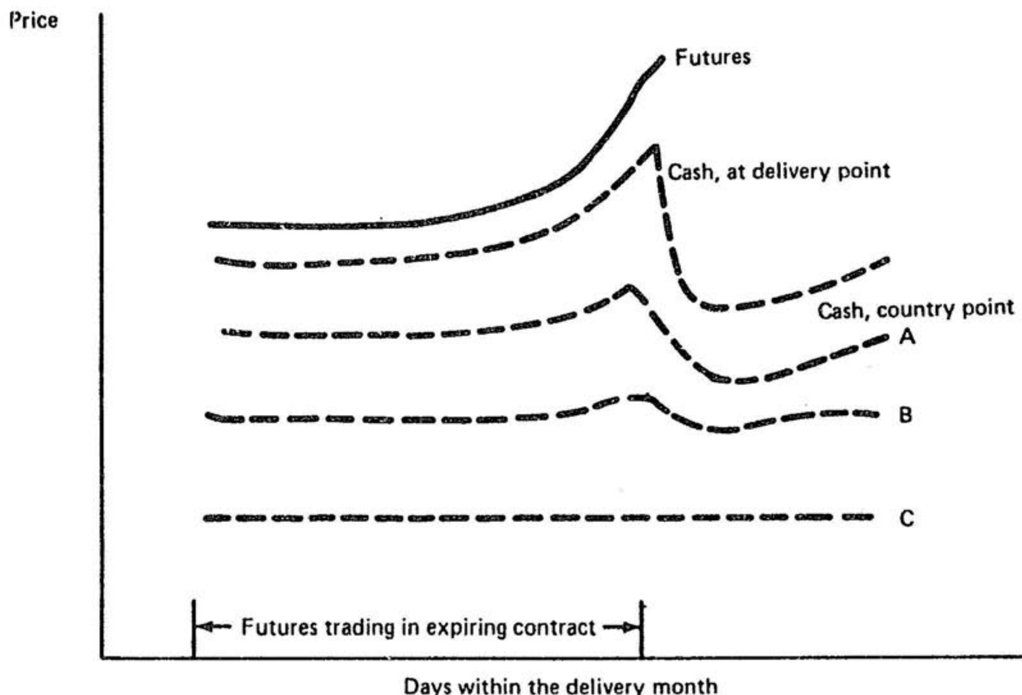
> "Clearly, futures trading can affect cash prices in a deleterious way when there is manipulation of the futures market. Futures price manipulations are typically accompanied by a corresponding warping of cash market prices. Recent experiences with soybeans, potatoes, cotton and wheat suggest that such problems are indeed still with us."

A January 1975 Agriculture report on cash grain prices stated that:

> "* * * the price for spot grain in position that is readily deliverable on the futures is not adequate for detecting manipulation, since it tends to follow the futures prices as the futures is manipulated."

The CFTC advisory committee expressed this view by asking the question: "Under conditions which create the risk of a futures market manipulation (e.g., scarce supply), can 'cash prices' be trusted since they too may be affected by those conditions?"

The extent to which the cash price follows the futures price may decrease as the cash pricing location moves away from the futures market. The following table from an April 1976 Agriculture report demonstrates this.



An increase in maturing futures prices, until the close of trading, is accompanied by a similar increase in cash prices at different locations, but by lesser amounts as the distance between the par delivery point and the cash markets increases. For convenience, the level of cash prices is shown to be lower with increases in distance--an assumption that need not hold.

Because of the futures-to-cash prices influence, we believe, as Agriculture economists also suggested to us, that CFTC should use more than one price quotation and give greater emphasis on cash prices quoted for locations away from the futures market or the par delivery point. CFTC, however, tends to rely heavily on the cash price quoted for the par delivery point or use one cash price quotation for various commodities.

For example, CFTC places heavy emphasis on the cash prices quoted for the grain par delivery point--Chicago--where the futures market is located. A CFTC economist told us that Chicago cash price quotations are heavily relied upon because their basis (i.e., the difference between the

cash and futures price) is more stable (i.e., less fluctuation) than the basis of other pricing locations. Other commodities for which CFTC relies heavily on cash price data for the par delivery point or one cash price quotation are live hogs, live cattle, feeder cattle, potatoes, soybean meal, and soybean oil.

<u>CFTC is aware of deficiencies in its cash price data but has taken limited corrective action</u>

CFTC recognizes that the cash price data it uses for market surveillance may not be reliable. In January 1976 CFTC staff prepared a document stating that the cash price data for most regulated commodities could be improved. They listed numerous commodities, including those discussed in the preceding section, whose cash price data needs improved reliability.

In October 1976 CFTC's Advisory Committee on Market Instruments also expressed concern about the cash price data:

> "The representativeness of data used by the Commission should be of constant concern. Data generated upon input from too few market sources or from too thin a market for a particular commodity may result in distorted regulatory responses by the Commission."

The advisory committee recommended that the Commission set up a flexible system to obtain cash prices needed for market surveillance, with the following order of priorities for obtaining the data:

--Commodities that are actively or fairly actively traded but with no reliable cash price data readily available.

--Commodities, actively or fairly actively traded, for which (1) a "trade accepted" cash price series is available with no indication that the data base (i.e., market transactions on which the cash price is based) is deteriorating and (2) more than one cash price series may be available.

--Commodities which are not actively traded on the futures market.

As mentioned previously the advisory committee also recommended that a continuous appraisal program on a commodity-by-commodity basis be initiated to keep the market surveillance

team current with changing and evolving economic conditions. Further, it suggested that CFTC:

--Continue using Agriculture Department or other Government agency-generated cash price data that is accepted by the trade. Urge the appropriate Agriculture agency to update and improve the methods of collecting and quoting cash prices where deficiencies have been recognized.

--Continue using exchanges' cash price data if it represents a reasonable or representative number of cash transactions. Rely on other trade-accepted prices when appropriate.

--Assess carefully the costs and economic and political ramifications before CFTC develops its own cash price data if a data deficiency cannot be corrected by outside sources.

--Encourage exchanges to develop cash price quotations, with Commission approval.

In January 1978 a CFTC surveillance official told us that CFTC has done the following things to improve cash price data. CFTC has worked with the staffs of the Minneapolis Grain Exchange, the Kansas City Board of Trade, and the New York Coffee and Sugar Exchange on these exchanges' procedures of quoting cash prices on grains and sugar. It also participated with Agriculture in improving the Chicago cash price quotations on grains and made trade contacts to obtain additional cash price information on an "as needed" basis.

We believe CFTC needs to do more work to assure that it has more reliable cash price data for market surveillance. First, CFTC is uncertain whether the work being done on the three exchanges will result in quoting more reliable cash prices. Second, while the Agriculture price reporter at Chicago told us that he has improved the cash price quotations for grains traded for deferred delivery, CFTC does not use such prices for market surveillance. Thus, the improvement has not benefitted CFTC from the standpoint of market surveillance. Third, obtaining additional cash price information on an "as needed" basis is limited to tight market situations, thus the lack of reliable cash price data on a regular basis remains unresolved.

CONCLUSIONS

Because of statutory requirements, CFTC and the exchanges perform market surveillance. On the basis of our

review it appears that such efforts are largely performed independently. We believe, however, that more effective market surveillance can occur in an atmosphere of coordination and mutual understanding and where there are clear-cut delineations of responsibilities. Accordingly, CFTC should initiate a joint CFTC-industry task force to study the interrelationship between the market surveillance programs of CFTC and the exchanges with a view toward improving the present system by (1) reducing or eliminating unncessary duplication, (2) increasing coordination, (3) making better use of the market surveillance data collected by CFTC and the exchanges, and (4) delineating clear lines of responsibility between CFTC and the exchanges.

Our review showed also that while the success of a market surveillance system, to a large degree, hinges on the economists' quick access to timely, complete, and accurate market data, the data CFTC relies on does not always meet these criteria.

CFTC has recognized deficiencies in its data and had proposed changes, including the need to computerize the process of analyzing market surveillance data. Staff proposals were submitted to the Commission and CFTC developed a plan for implementing the proposal.

However, the plan lacked information on how much time and resources would be needed and how resources would be obtained and allocated to perform the necessary work. Operating without such a plan may result in insufficient attention or resources being given to the needed work. As of April 1978, the proposed changes were not completely implemented.

CFTC could also improve its market surveillance program through further study and research. Areas which we believe have potential to produce significant benefits are (1) determining whether daily reporting of detailed trade information from clearinghouses can replace the present system of reports from traders and FCMs, (2) developing an early warning system, using quantitative indicators, to detect developing market problems, and (3) exploring additional surveillance techniques to alleviate the problem of inadequate or unavailable market data.

Our review also showed that cash price data for various commodities is questionable for CFTC's surveillance purposes. Since cash price data is essential to market surveillance, the Commission should give priority to searching for feasible alternatives to improve cash price data and setting up a continuous appraisal program on a commodity-by-commodity basis to keep current with changing and evolving market conditions.

Furthermore, CFTC should consider the tendency of cash prices to follow futures prices when futures prices are manipulated. Because CFTC's market surveillance system overlooks this tendency, the effectiveness of the system may be jeopardized.

RECOMMENDATIONS TO THE CHAIRMAN, CFTC

To improve the overall efficiency and effectiveness of market surveillance, we recommend that the Chairman:

--Conduct a study, with the assistance of exchanges, to (1) identify and eliminate unnecessary duplication, (2) increase understanding and coordination, (3) make better use of market surveillance data, and (4) establish clear lines of responsibility between CFTC and the exchanges.

--Establish a flexible plan which outlines the time and resources needed to implement or further evaluate the changes in the market surveillance program proposed by the chief economist and subsequently approved by the Commission.

--Determine the cost and benefits of replacing the present system of obtaining reports from traders and FCMs with daily reporting of detailed trade information from clearinghouses.

--Develop (1) an early warning system, based on quantitative indicators, for detecting potential market problems and (2) new monitoring or analytical techniques for use as supplemental surveillance steps to alleviate the effect of inadequate or unavailable market surveillance data.

--Search for alternatives to improve cash price data, set up a continuous appraisal program on a commodity-by-commodity basis to keep current with the changing and evolving market conditions, and require that CFTC's market surveillance program give more consideration to the tendency of cash prices following futures prices when futures prices appear to be manipulated.

CHAPTER 9

REPARATIONS PROGRAM INADEQUATE TO MEET DEMAND

In 1974 the Congress added section 14 to the act, creating an administrative forum for adjudicating monetary claims against CFTC registrants who violate the act. The objective of the new procedure, called reparations, was to provide an alternative grievance procedure, midway in complexity and expense between the traditional remedies used in the futures industry of arbitration and civil litigation. The program started in January 1976.

The program would be most effective if it provided relatively fast adjudication to as many aggrieved parties as possible. However, because of a growing backlog problem and seemingly overly complex regulations, the program's effectiveness is jeopardized. Actions needed to correct these problems include

--assigning more staff to review, process, and hear the cases;

--establishing written guidelines to screen the cases to determine whether they meet statutory and CFTC requirements;

--setting reasonable time standards for processing and hearing cases;

--simplifying the reparation regulations; and

--allowing opposing parties to take oral depositions during the adjudication process.

Our review also showed that the Commission needs to significantly increase its involvement in reviewing cases initially decided by administrative law judges. As a further measure to speed up the program, the Congress should increase the ceiling on the amount of damages needed to justify oral hearings before the judges.

HOW THE PROCEDURE OPERATES

Complaints received by the Commission are processed through the reparations unit of CFTC's Division of Enforcement. A reparations complaint must allege a violation

of the act (or a CFTC regulation, rule, or order) by a registrant 1/ and consequent money damages to the trader. 2/ Generally, reparations complaints have alleged violations of the act's antifraud provisions. These include prohibitions against "churning" a customer's account (excessive trading during a short period of time by a broker in control of the account), unauthorized trading (executing trades for a customer's account without his approval), misrepresentation and nondisclosure, and failure to execute trades. About 60 percent of all complaints filed to date have involved the sale of commodity options. If a complaint is received that does not meet the statutory requirements, it is returned to the complainant, with an explanation of the deficiencies, for correction and possible resubmission.

When these requirements are met, the reparations unit forwards the complaint to the applicable registrant, who is required to answer the complaint within 45 days. At the same time, the unit acknowledges the complainant's inquiry and provides him with a copy of its letter to the registrant. The registrant may specifically admit or deny the allegations in the complaint or explain the allegations. He also may counterclaim against the complainant.

After receiving these preliminary documents, the reparations unit reviews them to determine if an adjudicatory proceeding should be started. While there are no written guidelines to help decide if a proceeding should be started, decided cases are used as a guide in determining if later complaints merit consideration. If they do not, the entire matter is closed, with notice to the parties and without prejudice to any alternative remedy that may be available to them. If further action is warranted, the file is transferred to the Office of Hearings and Appeals, an independent branch

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1/ According to the Commission persons or firms who should be registered but are not are also subject to reparation procedures.

2/ A lawsuit is pending in the U.S. Court of Appeals challenging a U.S. District Court's denial of a registrant's request that the reparations program be declared unconstitutional. The complaint alleges that reparations is nothing more than a common law suit for money damages and thus is subject to the 7th Amendment's trial by jury requirement. Rosenthal & Co. v. William T. Bagley et al. No. 77-1635 (7th Cir. 1977).

of the Commission. Upon payment of a $25 filing fee, the complaint is docketed. An oral hearing before one of the office's four administrative law judges is scheduled for claims over $2,500. Under the oral hearing procedure witnesses and documents may be subpenaed, witnesses may be cross-examined, and other "due process" safeguards are observed. For smaller claims, below $2,500, an abbreviated procedure is used, whereby the parties present their cases in writing and an administrative law judge decides them on the basis of the written submissions.

The judge conducting the hearing, or deciding the case under the written procedure if there is no oral hearing, files an initial decision. Under certain circumstances the Commission may review a case, or particular aspects of it, before the judge makes his initial decision. The judge's decision includes a determination, based on the record of the proceeding, whether or not the registrant has violated the act and of the validity and effect of any counterclaims. If a violation is found, he determines damages and orders the registrant to pay. Attorney's fees have also been awarded to successful parties under certain circumstances.

Within 15 days of the decision, parties to the action may apply to the Commission for final review. The Commission has an additional 15 days to decide on its own whether to review a case. 1/ If the Commission does not decide to review the case within 30 days, then the judge's initial decision becomes final and cannot be changed by the Commission.

If the Commission decides a case, the parties have 15 days to appeal the decision to the U.S. Court of Appeals. The party appealing the case must file a bond that is twice the amount of the award before the court can hear the case. Generally, a court will reverse only if the findings of the Commission as to the facts were not based on the weight or preponderance of the evidence or if there are compelling reasons to conclude that the Commission's conclusions of law are wrong.

A successful claimant can sue in the U.S. District Court to compel payment of the reparation award made in the CFTC

1/ Although the Commission has a total of 30 days to decide to review a case, there are no time limits as to when it will actually review the case.

proceeding. If the registrant does not pay or appeal the award within 15 days, he is prohibited from trading on all commodity exchanges and his registration is suspended until he does so.

NEED TO REDUCE BACKLOG OF CASES

Reparation cases are backlogged at each processing step within the Commmission. The reparation unit receives more cases than it can handle and the hearings and appeals office has adjudicated few cases. A schedule showing workload data is presented below.

Workload Statistics for the Reparation Program
(note a)

Reparations unit	Fiscal year 1976	Fiscal year 1977	First 6 months of FY 1978	Total
Complaints received	73	633	680	1,386
Rejected by unit or parties settled	15	229	304	548
Pending in unit at end of period	27	126	414	(b)
Office of Hearings and Appeals				
Received from reparations unit	25	360	150	535
Closed by Hearings and Appeals:				
Adjudicated (decision issued)	-	49	42	91
Settled, party defaulted, or case dismissed	-	72	36	108
Total cases closed	-	121	78	199
Pending at end of period	25	286	356	(b)

a/ Figures do not necessarily total because of unreconciled differences between data obtained from the reparations unit, the Office of Hearings and Appeals, and the Division of Enforcement.

b/ Not applicable.

The reparations unit

Since inception, the unit has received 1,386 cases, of which 414 were pending as of March 31, 1978. This represents

a 329-percent increase of the cases pending on September 30, 1977, just 6 months earlier.

The Office of Hearings and Appeals

This office also has a serious backlog problem. During fiscal years 1976 and 1977, 385 cases were referred to the office for adjudication. Of these only 49 were adjudicated. Seventy-two were closed by settlement, default, or dismissal. A total of 286 cases was pending at the end of the fiscal year. Six months later, on March 31, 1978, the number of cases pending had grown to 356 cases, an increase of about 24 percent. As of that date the office had adjudicated 91 cases, or only 27 percent, of the cases referred to it which had not been dismissed, settled, or defaulted.

In May 1977 the number of judges in the hearings office was increased from three to four. The judges are responsible for hearing enforcement cases as well as reparation cases. Assuming that each judge could close 50 cases a year, an estimate the chief administrative law judge agrees with, the office would close 200 cases annually. At that rate the office's current backlog of 356 represents about a 20-month backlog. Assuming that the Commission receives 800 reparation cases annually 1/ and that the current dropout and settlement rate continues to run at about 40 percent, there will be about 480 new cases to be adjudicated each year. Given the current 20-month backlog and a projected adjudication rate of 200 a year, in 2 years the office's backlog will grow to over 900 cases--a 4-1/2 year backlog.

WHAT CAN BE DONE TO REDUCE BACKLOGS AND IMPROVE PROGRAM EFFECTIVENESS

Presented below are suggestions for reducing reparation backlogs and at the same time improving the effectiveness of of the program.

1/ Based on the rate of filing for fiscal year 1977 and the first half of 1978.

Increase staff

The most crucial problem facing the reparations program is insufficient staff. If more staff are not assigned to the various offices handling the cases it is doubtful that the backlog problem can be eliminated.

The reparation unit consists of two attorneys plus support staff. However, the sheer volume of reparations complaints filed--almost 1,400 to date--impedes the ability of the unit to perform indepth screening of cases. Effective screening of complaints, both when they are filed and after registrants reply to them, can help alleviate backlogs, because cases might be settled more frequently, more cases might be terminated before a hearing, and the issues raised in cases to be adjudicated could be identified at an earlier time.

The hearings and appeals office also needs additional staff. Given the present influx of reparation complaints to the Commission, it is not surprising that the backlog of pending cases has increased by about 24 percent during the past 6 months. The Commission needs to increase the number of judges, presently at four, until the backlog decreases to an acceptable level. As we pointed out earlier, the backlog can be expected to increase to over 900 in the next 2 years unless the Commission takes corrective action soon.

Establish guidelines for screening cases

In addition to increasing the number of staff assigned to screen cases, the Commission should establish written guidelines for reviewing cases to determine whether they merit further processing by the Commission. Currently, the determination as to whether or not a complaint is accepted by the reparations unit is left up to the attorney in charge of the unit, subject to the general direction of the Director of the Division of Enforcement. This is also the case regarding the decision to forward an answered complaint to the Office of Hearings and Appeals for hearing.

The degree of screening done by the reparations unit has been the subject of controversy among attorneys, the press, and complainants. Some claim there is too much; while others, not enough. However, without written criteria it is difficult to evaluate the effectiveness of the screening.

Target dates for processing cases needed

Generally, there are no time limits or target dates for the reparations unit or the Office of Hearings and Appeals to follow in carrying out their functions and responsibilities. 1/ Establishing standard times, periodically comparing actual performance with the standard, and determining the reasons for variances would improve operating efficiency.

There is ample precedent for imposing time constraints or time standards in proceedings to alleviate problems of delay. This procedure has been effective in other agencies, according to a recent Senate Governmental Affairs Committee staff study.

Greater involvement by the Commission needed

Inaction by the Commission itself has adversely affected the program. From January 1976, when the program began until March 31, 1978, 91 initial decisions have been issued by the administrative law judges. Under the regulations the Commission has the authority to review each decision, either on appeal by a party or on its own motion. However, as of March 31, 1978, the Commission has not completed a review of any of the 91 decisions. The Commission has reviewed eight cases which were dismissed by the judges. It sent them back for rehearing. The 91 decisions are broken down as follows.

1/The private parties involved in a reparations proceeding are subject to definite time deadlines in filing material with the Commission.

Pending review by the Commission:

One or more of the parties has requested Commission review but Commission has not decided whether to review the case	35
30-day time period for decision to become final has not expired	7
Commission granted request for review and review is in process	3
Stayed, but Commission has not decided whether it will review the case	8
Total pending	53
Final decisions	38
Total decisions	91

Reviews and final decisions by the Commission could aid the reparations program by providing precedent on important unresolved legal and policy issues and possibly reducing the number of complaints. Some issues which might be resolved by affirmative Commission review of initial decisions include:

--Whether or not it is a violation of the act's antifraud provisions for a registrant to induce someone to trade commodity futures if that person is unsuitable to do so in light of his financial condition and needs.

--The validity of some of the judges' decisions interpreting the reparations procedures and authority therefore; for example, whether there is authority to award attorney's fees and the limits of the authority to determine where a hearing will be held.

--The types of activities forbidden by the act, and thus subject to redress by the award of reparations, have not been clearly defined. What constitutes fraud or cheating in commodity transactions remains to be defined.

--The role of the reparations procedure in aiding the work of the Enforcement Division in assuring compliance with the act. No formal guidelines exist explaining when reparations matters should be referred to the Enforcement Division for further investigation.

Need to simplify regulations

CFTC's Chairman has called for the reparations procedure to be "unique and simple." The procedures followed, however, are anything but simple and easy to understand. Examples of the regulations show that they are complex and frustrating. Even the Commission publication explaining the reparations procedure to the public warns:

> "If there is no settlement and formal proceedings are instituted, it is generally wise for the party complaining to seek professional legal advice because the matter becomes complex with filing deadlines to be met, court-like proceedings, 'due process' requirements and rules of evidence. A person who proceeds without counsel should seek a copy of the Rules of Practice and the Reparations Rules of the CFTC."

We contacted 12 persons who submitted written complaints to CFTC concerning some aspect of their dealing in commodities. Only three, including one person who was an attorney, said they would file formal complaints. Eight persons told us they would not file complaints, commonly citing the complexity of the regulations and the excessive amount of time required as the reasons. One person did not indicate whether he would file.

The regulations relating to reparations cover over 20 pages of the Code of Federal Regulations. Many of the regulations are technical in nature, including

--how to compute time limits for filing documents;

--the size, grade, and type of paper used to submit documents to the Commission;

--procedures allowing parties to mutually agree to the authenticity of matters relevant to the pending proceeding; and

--the specific form of motions and other filings.

Making the regulations simpler to follow would undoubtedly make the program more attractive and popular with

the trading public. However, it should also allow cases to be processed and adjudicated faster, thus allowing the judges to hear and decide on more cases. We believe increasing the coverage of the reparations program would boost the image of the Commission to protect the trading public and at the same time enhance the public's confidence in the futures markets.

During our review we noted that CFTC has taken some steps to simplify and speed up procedures, such as using telephone conferences to resolve differences among parties before hearings; however, we believe more can be done. A study should be performed by the Commission, with outside assistance, aimed at simplifying the regulations without endangering the due process rights of the parties involved.

Oral depositions

CFTC regulations make no specific provision for opposing parties to interview each other and record the interviews before the hearing in order to discover the opposing sides of the controversy. This procedure, known as taking depositions, is used frequently in civil courts to avoid surprises at trials and speed hearings. Generally the procedure consists of a witness under oath answering questions about the case posed by the adverse party (or his attorney). Cross-examination is generally allowed. A written transcript of the entire proceeding is kept and under certain circumstances may be used at the actual hearing or trial.

The advantages of this procedure are that it requires immediate, unrehearsed responses to oral questions and allows the questioner the immediate opportunity to pose followup questions. A disadvantage is that it is more expensive than the present procedure of written questions presently used in reparations cases, especially if the parties live far apart, necessitating extensive travel. The present procedure only allows parties to pose written questions to the opposing side, and requires only written responses. This is called deposition upon written interrogatories, and generally it is difficult to obtain as much information from this procedure as from the oral deposition because followup questions to incomplete or inadequate answers cannot be asked immediately. This is especially true if only one party uses an attorney.

Under certain circumstances oral depositions would save time at hearings and foster prehearing settlement of disputes by allowing the parties a more realistic assessment of the merits of their case. On balance, if this procedure were

allowed, but not required, time and expense could be saved on some occasions. We believe the Commission should change the reparations regulations to specifically allow this procedure to help speed up cases and encourage more prehearing settlements.

Abbreviated hearings procedure

Section 14 of the act does not give the parties an absolute right to an oral hearing in cases involving claims of $2,500 or less. These cases are determined on a written record unless the Commission allows an oral hearing. In cases involving more than $2,500, an oral hearing must be held unless waived by the parties. About 25 percent of all cases involve claims less than $2,500, and about 30 percent involve claims between $2,500 and $5,000. Thus, if the limit for the abbreviated procedure was raised to $5,000 over half of all cases, about 55 percent, could be disposed of without an oral hearing.

Considerable time and effort could be saved by eliminating oral hearings in such a large number of cases. But the administrative law judge would lose the opportunity to hear the differing views of the parties and thus test the credibility of their testimony. The parties would lose the opportunity to confront their opponents in person. In balancing these conflicting viewpoints, some agencies have adopted modified procedures where oral hearings are held only on the basic and novel issues of a case. In this way the divergent viewpoints can be reconciled and time and resources are conserved. We believe that the Congress should consider establishing an abbreviated hearing procedure for all cases below $5,000, allowing oral hearings on only the most significant issues, with written evidence allowed to supplement the oral hearing. In this way all participants can confront their opponents in person but in a quicker and more informed procedure. This would benefit the entire system.

CONCLUSIONS

For the reparations program to be most effective it should be a relatively swift, simple, and inexpensive means of adjudicating claims stemming from violations of the act. Achieving these objectives would make the reparations procedure work better and allow more of the trading public to make use of it. However, the program's effectiveness is being seriously jeopardized by a growing backlog problem.

If the Commission is to alleviate the problem it needs to assign more staff to review, process, and hear the cases. Better screening of cases would also help reduce backlogs. Screening could be improved if written guidelines were established to assist CFTC reviewers and if controls were instituted to assure that the guidelines are being used.

To assure that the program is run efficiently, to monitor its progress, and to improve its performance over time, the Commission should establish reasonable time standards for the processing and adjudicating of cases. On a regular basis actual performance should be compared to the standards and the reasons for variations should be determined. Periodically the standards should be reevaluated and updated.

Without the sincere commitment from the highest levels in the agency, improvements in the program are unlikely to occur. The Commission needs to place a higher priority on reviewing initial decisions. The Commission's track record of reviewing initial decisions is less than admirable.

Commission review of initial decisions will also establish precedents on important legal and policy issues. This would provide additional guidance for staff review of cases and provide the basis for parties to settle prior to formal hearings. Also, it should assist the judges in reaching quicker decisions.

Making the reparations regulations simpler would allow cases to be adjudicated faster. In addition, it would encourage more of the trading public to make use of the program. We believe the Commission, with outside assistance, should study the present regulations with a view toward simplifying them but at the same time protecting the due process rights of the parties involved.

Allowing the opposing parties to take oral depositions would save time at hearings and foster prehearing settlement of disputes. Similarly, amending the act to establish an abbreviated hearing procedure for all cases involving damages of $5,000 or less should simplify and speed up the program. The new procedure would limit oral hearings to the basic or novel issues of a case. This way the judges could concentrate on the essential issues and on the more material cases.

RECOMMENDATIONS TO THE CHAIRMAN, CFTC

To reduce backlogs and make the reparations program more responsive to the needs of the trading public, we recommend that the Chairman:

--Assign more staff to review, process, and hear cases.

--Establish written guidelines for screening of reparations cases.

--Establish reasonable time standards for processing and adjudicating cases, evaluate the reasons for variations from the standards, and periodically update the standards.

--Assure that the Commission gives a higher priority to reviewing the initial decisons of the judges.

--With outside help, perform a study of program regulations, with a view toward simplifying the regulations and protecting the rights of the participants.

--Allow opposing parties to take oral depositions.

RECOMMENDATION TO THE CONGRESS

To streamline the program, the Congress should amend section 14 of the Commodity Exchange Act so that in cases involving claims of $5,000 or less, oral hearings will be limited to the basic or novel issues of the case.

CHAPTER 10

ECONOMICAL PROCUREMENT POLICIES AND PROCEDURES SHOULD BE FOLLOWED

The Commodity Futures Trading Commission has not followed many of the procurement policies and procedures which have been established for the efficient and economical procurement and management of property and services by Government agencies. Overall, the Commission relied extensively on sole source procurements, with competition rarely being obtained. In negotiating leases the Commission entered into long-term leases which are prohibited by law and did not obtain appraisals of fair market value of the leased property. Such appraisals are necessary to assure that legal rent limitations are not exceeded. The Commission spent amounts on improvements to leased property in excess of legal limitations and also procured much of its property directly from commercial sources rather than satisfying its needs from other Government sources, as most agencies are required to do.

Although the Commission is not a major procuring agency, it made many sizable purchases in its first 2-1/2 years. Through fiscal year 1977, the Commission awarded contracts and purchase orders totaling over $6.2 million of which $4.7 million, or about 76 percent, were noncompetitively negotiated with commercial sources. The largest group of purchases were for multiple-year leases of office space in Washington and the regional offices, amounting to over $1 million a year. The largest single nonrecurring-type purchase was a $950,000 contract to design and furnish the Washington office. Other purchases were made for administrative, management or technical services, furniture and equipment, office machines, news services, and similar items.

Many of the Commission's procurement actions were undertaken in an atmosphere of urgency during the early formative period when the staff and organization were not fully developed. The Commission lacked procurement expertise, and problems resulted because key agency officials, who made important procurement decisions, lacked understanding and appreciation for the economical procurement policies and procedures that should have been followed. Many of the Commission's procurement problems could have been alleviated, we believe, if the Commission had sought the advice and assistance of the General Services Administration (GSA),

the Government's specialist in procurement matters. The Commission, however, deliberately avoided this approach and did its own procuring.

By its procurement approach, the Commission obtained office space, furniture, equipment, and supplies which are of a better quality than that normally obtainable by Government agencies. However, there is little assurance that the Commission's procurements were made to the best advantage of the Government, price and other factors considered.

COMMISSION PROCUREMENT APPROACH

Section 12(b) of the Commodity Exchange Act provides the following in regard to contracts:

> "* * * The Commission shall also have authority to make and enter into contracts with respect to all matters which in the judgment of the Commission are necessary and appropriate to effectuate the purposes and provisions of this Act, including, but not limited to, the rental of necessary space at the seat of Government and elsewhere."

On the basis of this provision and specific language in its appropriations acts authorizing expenditures for office space in the District of Columbia and elsewhere, the Commission determined that it had independent authority to procure its own leases of real property without going through GSA but, in all other respects, that it was bound by Federal procurement and property management regulations.

There is no legislative history explaining the meaning or purpose behind the enactment of section 12(b). We agree with the Commission's view that the authority in section 12(b) to rent space is inconsistent with, and therefore in effect supersedes, the requirement for Government agencies to lease through GSA. We cannot, however, see any valid reason for this separate authority as there do not seem to be any unique requirements of the Commission's mission that would have been impaired if its space had been obtained through GSA.

We also note that section 12(b) merely gives the Commission the right to lease space; it does not specify the procedures to be followed. We believe the Commission should have followed GSA's general standards in leasing space, but it has not always done so--as discussed later.

For purposes of comparison, we have included in appropriate sections of this chapter a discussion of the policies and procedures that GSA and other Government agencies are required to follow.

FEDERAL PROCUREMENT AND PROPERTY MANAGEMENT LAW AND REGULATIONS

The Federal Property and Administrative Services Act of 1949 (40 U.S.C. 471 *et seq.*) established GSA as the Federal Government's central supply organization for other than military supplies. GSA is to provide an economical and efficient system for Government agencies to obtain a wide variety of procurement and property management services. The Administrator of GSA, in carrying out his responsibilities under this act, has issued uniform Federal procurement regulations and Federal property management regulations which generally apply to all Federal civilian agencies.

Federal procurement regulations

The Federal procurement regulations require Government agencies to obtain supplies and services from Government sources and from contracts of other Government agencies, including excess and surplus stocks, GSA's Federal Supply Schedule contracts and stores stocks, and similar sources. These sources provide a wide range of property and services, including office furniture and equipment, office supplies, etc.

The Federal property management regulations also specify the methods by which agencies may procure their needs, discuss the desirability for full and free competition, indicate the extent of competition to be obtained, and set forth explicit provisions relating to formal advertising and negotiating contracts.

Formal advertising and negotiation are the basic methods by which the Government procures supplies and services. The law provides that purchases by Government agencies be made by formal advertising for bids whenever feasible and practicable. Contractors are invited to submit firm bid prices for specified supplies or services, and a contract is awarded to the lowest responsive and responsible bidder.

When a procurement cannot be awarded by formal advertising, agencies are expected to make maximum practicable use of competition in negotiating contracts. Contractors are given requests for proposals which state the

Government's requirements and criteria for evaluating offers. After interested firms are allowed sufficient time to prepare and submit offers, negotiation with those in the competitive range follows or the award may be made to the lowest offeror without discussion. The firm with the offer most advantageous to the Government, price and other factors considered, is awarded the contract. Thus, negotiated procurement, as opposed to formal advertising, allows the Government to question and discuss with the firm the conditions and features of an offer.

Only when competition is determined to be infeasible may contracts be noncompetitively negotiated.

Federal property management regulations

The Federal property management regulations specify, among other things, the policies and procedures for acquisition of real property, the assignment and use of space, and procurement sources and programs.

It is the basic policy of the Government that GSA will lease space in privately owned buildings when needs cannot be satisfactorily met in Government-controlled space. GSA's leasing authority extends to all Federal civilian executive agencies, with certain minor exceptions primarily where the space is situated outside an urban area.

GSA has established space standards and criteria and guidelines to promote the economic and prudent use of space. GSA is also responsible for the initial layout of space. Its regulations forbid any covered Federal agency, without written approval, to obtain interior office design or space layout services from any non-Federal firm or individual. When such services are needed, GSA will enter into the contract and supervise the contractor's performance.

The GSA Government-wide supply system provides procurement support to executive agencies. Approximately $3 billion worth of furniture, supplies, materials, and services are purchased each year. Approximately 30,000 commonly used items are held in inventory, and self-service retail stores provide a readily available source of standard office supplies for the convenience of Federal agencies.

COMMISSION LEASES AND IMPROVEMENTS TO REAL PROPERTY

When the Commission was established as a separate agency in April 1975, it was occupying office space in Government-owned buildings and in private buildings leased by GSA in various cities around the country. Since that time, the Commission has moved to its own leased and improved office space in some of the newest and most prestigious buildings in Washington, D.C., Chicago, and New York, the sites of its largest offices. Following are the locations and the annual rental costs.

Location	Annual rental cost
2033 K Street, NW. Washington, D.C.	a/ b/ $ 505,153
Sears Tower Chicago, Illinois	371,334
One World Trade Center New York, New York	238,261

a/ Lease is subject to annual escalation.

b/ Amount does not include about $40,000 for 65 employee parking spaces in the building which are paid for by CFTC.

In the process of leasing its office space, the Commission followed practices which limited competition, entered into long-term leases which are prohibited by law, failed to determine compliance with legal limitations as to rental costs, violated legal limitations as to improvement costs, and did little to evaluate proposed costs of modifications. These matters are discussed in the following paragraphs.

Competition and negotiation of leases for office space was limited

The practices followed by the Commission to obtain its leases limited competition and opportunities to negotiate lower prices. Essentially, the Commission established a restricted geographic area within which it desired to locate in a city, considered some of the locations available within that area which suited its needs, and then negotiated with

only a single selected offeror. While price was considered, it was not a major factor.

Washington lease

The Commission obtained its Washington lease through a real estate agent who supplied a list of available buildings in Washington and vicinity. The Commission decided in late May 1975 to locate in downtown Washington within the boundaries of Wisconsin Avenue, 16th Street, Pennsylvania Avenue and R Street "* * * because of the proposed regional Metro system and easy access from either Virginia or Maryland by private auto. It was also more accessible to the National Airport for people who had business dealings with the CFTC."

Other criteria established at that time for selecting office space in Washington included (1) the price per square foot should be competitive with current private sector rates and not to exceed $9.50 per square foot, (2) first preference to a building where CFTC would represent a minimum presence of 65 percent of the total occupants, (3) in-building parking for a minimum of 50 spaces with adequate parking available nearby and with good public transportation, and (4) erection of a sign outside of the building identifying it as the CFTC location. Interior design and construction were to be completed and the space occupied by November 1, 1975.

Within a week after establishing the criteria, the building committee met, surveyed available building data, visited five building sites, and narrowed its search to two prime locations. Both companies submitted initial and revised proposals to the real estate agent. These proposals were analyzed by the building committee and "* * * it was in their best and unanimous judgment that they recommended that 2033 K Street best fit the qualification criteria."

A letter of intent to lease office space at 2033 K Street was issued as of June 30, 1975, and a lease was negotiated the following month. Building construction and alterations delayed the Commission's occupancy until April 1976, 5 months later than desired.

Other leases

The procedures followed to obtain leases in New York and Chicago were very similar. Formal solicitations for the lease of office space in restricted areas of each city were

sent to selected rental firms. Few responses were received and negotiations were conducted with only one selected offeror.

In New York, for example, 12 firms listed in the Real Estate Directory of Manhattan were solicited on July 15, 1975, for the leasing of office space in the lower Manhattan area bounded by Vesey Street, Liberty Street, West Street, and Broadway. About a week later a justification was prepared for locating near the World Trade Center complex where four of the five commodity exchanges were to be relocated.

Of the firms who were solicited, only three responded with a proposal. The significantly high priced offer was not further considered after it was explained how the price was computed. The lowest price offered was for space on the 19th floor of the World Trade Center, but was considered nonresponsive because only two rather than three 5-year renewal options were offered and construction would take 4 to 6 months, thus going beyond the requested 90 days to occupancy. About 1 year later, on July 30, 1976, a lease for space on the 47th floor of the World Trade Center was awarded to the second low bidder, but occupancy did not take effect until October 1976.

The Commission justified its selection of the New York location on the basis that it should be part of the commodity and financial community in the area, various needs existed for continual daily two-way contact between the Commission and the exchanges, savings of about 4,000 manhours (about 2 staff years) of professional staff time by moving to the World Trade Center building, and for prestige and image purposes.

We understand the Commission's desire for locating near the exchanges and recognize that such locations are advantageous. However, in all three cities, we believe that the Commission should also have weighed the cost of space to be leased against the cost and expense of less convenient space within a broader area of the cities before the final decisions were made.

GSA normally affords agencies full opportunity to designate the general area in which they desire their space to be located, but delineation of the boundary lines to be used--sufficiently large to assure full and free participation by potential offerors--is the full responsibility of GSA.

Long-term leases prohibited by law

The Commission negotiated numerous long-term leases which obligated it for amounts in advance of available appropriations, actions prohibited by law. The lease for office space in Washington commenced on March 8, 1976, and continues for 5 years until March 7, 1981, at which time a lease provision for an additional 5-year period may be negotiated. The lease also provides that rental payments are "* * * specifically conditioned upon and subject to Congressional appropriations * * *" for each fiscal year. Leases with similar terms and conditions were also negotiated for office space in Kansas City, New York City, and Chicago. In the latter two leases, the additional rental periods are for three 5-year renewal terms.

The Adequacy of Appropriations Act (41 U.S.C. 11) and the Anti-Deficiency Act (31 U.S.C. 665) preclude, unless otherwise authorized by law contractual agreements requiring direct obligations in advance of appropriations and any other obligation or liability that may require expenditure of funds (42 Comp. Gen. 272 (1962)).

The Supreme Court has held that extended term contracts violate these acts even though they are made contingent upon the availability of future appropriations, as in the case of the Commission's leases.

We believe that the only contractual arrangement which would satisfy the requirements of these statutes would be leases for the first year's needs with an option for renewal for succeeding years, following a determination that such action would be in the Government's interest and on giving of notice to the contractor. This affirmative action would require, in effect, making a new contract.

Legal limitations on rental and improvement costs not considered

The Commission negotiated numerous leases and improved the leased property without knowing whether it was exceeding legal limitations. It is not possible, at present, to determine whether the maximum rent limitation has been exceeded because the fair market value of the leased properties are not known. Improvements and alterations to the leased office space in Washington, however, have gone far beyond the limits established by law.

Section 322 of the Economy Act (40 U.S.C. 278(a)) applies to all Federal agencies in regard to the following maximum rental and improvement limitations:

> "* * * no appropriation shall be obligated or expended for the rent of any building or part of a building to be occupied for Government purposes at a rental in excess of the per annum rate of 15 per centum of the fair market value of the rented premises at date of the lease under which the premises are to be occupied by the Government nor for alterations, improvements, and repairs of the rented premises in excess of 25 per centum of the amount of the rent for the first year of the rental term * * *."

Rental of office space

The Commission negotiated leases in Washington, New York, and Chicago without determining the fair market value of the rented premises. In New York and Chicago the Commission did, however, obtain appraisals of fair market "rent" which was an estimate of the amount of money the property would command if it were vacant and available for rent on the open market.

The appraisals obtained by the Commission did not provide information with which to determine compliance with the law because they dealt with "rental value" rather than "market value." Without appraisals of fair market value, it is not possible to determine whether CFTC complied with the legal rental limitations. In this regard, GSA obtains an appraisal of the fair market value of each property it intends to lease and determines its rent limitation before a lease agreement is signed.

Improvements and alterations

The Commission had extensive improvements and alterations made to its leased office space in Washington. These improvements and alterations included built-in cabinets, wood paneling in corridors, wall-to-wall carpeting throughout, vinyl wall covering, special lighting and electrical outlets, extra partitioning and doors, and similar work. Costs for this work exceeded the maximum limitation of the law. Following is a schedule comparing the legal limitation with the costs of improvements and the resulting amount in excess of the limitation.

Annual rental		$505,153
Deduct: Landlord-furnished utilities and services (estimated)(note a)		-114,142
Net annual rental		$391,011
Economy Act limitation--25 percent		97,753
Extra improvements directed by the Commission:		
Landlord improvements	b/ $212,000	
Improvements made by other contractors	137,750	349,750
Estimated amount of improvements in excess of legal limitation		$251,997

a/ These items are not subject to Economy Act limitations, but the costs were not determined by the Commission during exact lease negotiations. We have estimated this amount using a rate of $1.75 per square foot, based on cost data provided us by the building owner. Our discussion with a GSA official indicated that this rate is a reasonable basis for the estimate.

b/ Several items on the landlord contract may not be considered improvements according to GSA's interpretation of the Economy Act, but they are relatively few. Available information did not permit us to make a precise determination.

Cost of improvements to Washington office not evaluated

The Commission did not obtain sufficient data to evaluate the costs of improvements and determine that the proposed prices were reasonable, as discussed below.

On June 30, 1975, the same day the letter of lease intent on the Commission's Washington office space was issued, the Commission awarded a negotiated, noncompetitive contract to the landlord for improvements to the leased office space in an amount not to exceed $159,400. The exact total amount of the improvements were to be determined later when the plans, specifications, and final working drawings were prepared by the landlord and approved by the Commission. Between

late November 1975 and February 1976, the landlord submitted five separate cost proposals to make various improvements and alterations in accordance with the working drawings which the Commission had approved from time to time. The proposals were approved, the work performed by subcontractors, and invoices paid in the amount of $159,200.

In addition to the foregoing, other improvements and alterations were also being proposed by the landlord, approved by the Commission, and the work performed. In some instances the work had been authorized orally by Commission personnel and performed by the subcontractor before the landlord submitted the proposal. Purchase orders totaling $52,900 were awarded by the Commission to cover this work. Thus, total improvements and alterations by the landlord--which we could identify--totaled $212,100.

Essentially, the landlord's proposals identified the location of the work, described the improvement, and estimated the quantity and cost of the improvements, such as:

720 linear feet of type 2 partitioning	$11,542
1-1/4 inch conduit differential for 106 phones	6,932
Furnish and install 90 incandescent lights in Commissioners' offices	4,712
127 type 3 doors with hardware	2,219
Plumbing and fixtures	1,991

In addition, the proposal included subcontractor overhead (5 percent of direct costs) and fee (10 percent of direct costs) and landlord overhead (5 percent of subcontractor direct cost) and fee (10 percent of total subcontract costs).

Details in support of the foregoing estimates, such as labor hours and rates and materials prices, were not submitted, and we were unable to locate any Commission records on the matter or personnel who could recall evaluating costs and prices.

The Federal procurement regulations require a prospective contractor to submit accurate, complete, and current cost or pricing data (i.e., historical accounting data, vendor quotations, bases for estimated hours, labor rates, and similar factual data) to the contracting officer or his representative prior to the award of any negotiated, noncompetitive contract expected to exceed $100,000. If submission of the data is impracticable, the contractor must identify, in writing, the specific data not submitted.

When cost or pricing data is required, the contractor must also sign a certificate of current cost or pricing data in which he certifies that, to the best of his knowledge and belief, the cost or pricing data submitted or specifically identified in writing is accurate, complete, and current.

Obtaining and analyzing the foregoing information is necessary so that Government agencies can have an adequate negotiating position and insure that they have obtained adequate safeguards against inflated cost estimates. With the data, both the Government and the prospective contractor can start from a common base in establishing the costs of contract performance.

PURCHASES OF PERSONAL PROPERTY AND SERVICES

From its very inception, the Commission obtained large amounts of furniture, supplies, and various services on a negotiated, noncompetitive basis. Some items have been obtained, as required, from GSA supply sources, but many more could have been obtained through GSA and eliminated the need for separate contracting.

Furniture purchased without competition

The Commission purchased most of its furniture from commercial sources on a noncompetitive basis rather than using GSA supply sources. According to Commission officials, the purchases of furniture were justified on the basis of urgency in establishing and expanding the agency. These purchases of desks, chairs, sofas, credenzas, and similar items were made primarily through numerous, large purchase orders and a major contract for furnishing and improving the Washington office.

On August 5, 1975, the interior design firm hired by the landlord submitted a proposal to CFTC for interior design work and a separate unsolicited offer to negotiate all purchases of CFTC's furniture and furnishings for a fee of 7 percent over manufacturer's invoice cost.

In the ensuing months much discussion and debate took place in the Commission over the question of whether it could purchase its furniture and equipment through the interior design firm or whether it must go to GSA for such items. The Commission's General Counsel argued against the

outside purchase because he believed it would be in violation of applicable Government regulations. The interior design firm presented information to the Commission to support its contention that it could provide many of the items at prices lower than could be obtained on competitively awarded GSA contracts. The Commission generally accepted this view even though one Commission comparison of the interior design firm's estimated costs with the costs of certain existing furniture acquired on a GSA contract revealed that GSA's prices were one-third lower. In spite of the internal controversy surrounding this procurement, the urging of some in the Commission to go to GSA, and the ultimate urgency which developed for this purchase, Commission officials informed us that GSA was never consulted.

In our opinion, a comparison of proposed contractor prices with GSA contract prices was not appropriate because they were not comparable. GSA recognizes that prices on large volume purchases may not be comparable with the prices in its schedule contracts. GSA, therefore, requires that large purchases be made competitively on the open market, either by GSA or the agency itself, if GSA grants it a waiver. Also, when the public exigency is involved, GSA regulations allow agencies to procure items on the open market without a waiver from GSA.

On December 5, 1975, the Commission Chairman invoked the public exigency provisions of the GSA regulations and authorized the negotiation of a noncompetitive contract with the interior design firm because (1) the Commission and the Government would suffer financial and other injuries unless a negotiated contract was immediately executed for the required services, furnishings, and equipment, (2) the Commission was unable to immediately and adequately describe all of the required services, furnishings, and equipment, and (3) the required nonpersonal and professional services, furnishings, and equipment could be obtained by and through the interior design firm, thereby affording the Commission the most efficient, economical, and timely acquisition of the total requirement.

Negotiations took place and a sole source contract not to exceed $950,000 was awarded to the interior design firm on February 5, 1976.

Commercial purchases of office supplies

The Commission also purchases numerous office supplies on the open market directly from commercial sources rather than using GSA supply sources, as required. Commonly used office supplies, such as legal pads and felt-tip pens, are routinely bought from office furniture and supply stores in Washington, D.C. In fiscal year 1977 these purchases totaled more than $20,000.

A Commission official said these supply sources are only used when the items are not available from GSA sources at the time they are needed or when better quality items are desired. With adequate advanced planning, such reasoning could rarely justify the nonuse of GSA supply sources for office supplies. Regulations specify that all agencies must requisition from GSA their requirements of stock items available from GSA supply distribution facilities. Other sources may only be used in cases of public exigency or unforseen circumstances. Agencies must use the GSA items when they will adequately serve the required functional end-use purpose; otherwise, a GSA waiver must be obtained. Personal preference and subjective evaluation are not accepted by GSA as sufficient justification for a waiver.

Noncompetitive awards for administrative, management, and technical services

Our analysis of 25 contracts awarded for administrative, management, and technical services between April 1975 and April 1977 disclosed that the Commission obtained competition for only three contracts, each of which was for an amount above $30,000. For the remaining 22 noncompetitive procurements, the Commission accepted the proposals and prices offered, usually without discussion or evaluation. A breakdown of these contracts follows:

Range of value	Numbers	Amounts
$ 2,500 - $ 4,999	2	$ 7,250
5,000 - 9,999	14	100,450
10,000 - 29,999	4	81,980
30,000 - 99,500	5	285,277
Total	25	$474,957

Only one of these contracts was still open as of January 31, 1978.

CONCLUSIONS

The Commission's procurement procedures and practices need improvement. Most of the Commission's purchases have been made on a noncompetitive basis, or with limited competition, and with little evaluation of proposed costs and prices. Competition is the Government's most effective method for obtaining reasonable prices, but, in its absence, skillful evaluation and negotiation of prices should take place.

While some use is being made of Government sources of supply, the Commission routinely buys furniture and office supplies from commercial sources when they should be obtained through GSA.

The Commission interpreted its enabling legislation as allowing it to negotiate its own leases of real property without going through GSA. While we cannot disagree with this interpretation, we can see no valid reason for this separate authority. There do not seem to be any unique requirements of the Commission's mission that would be impaired if it were required to obtain its space through GSA.

In negotiating its own leases, the Commission did not always follow standard procurement practices and applicable laws. The Commission entered into long-term leases which obligated it for amounts in advance of appropriated funds, an action which is prohibited by law. Competition and negotiation of leases were limited and leases and improvements to real property were made without regard to the Economy Act of 1933 which establishes maximum limits for rent and improvements.

The Commission should negotiate leases for only 1-year periods, with an option for year-to-year renewal. The Commission should obtain appraisals of the fair market value of its leased property in order to determine whether it has complied with the Economy Act. Also, the Commission should seek recovery of the costs of improvements in excess of Economy Act limitations. In view of the foregoing, we believe the Commission's leasing authority and functions should be placed in the hands of GSA.

RECOMMENDATIONS TO THE CHAIRMAN, CFTC

We recommend that the Commission more closely follow the procurement and property management regulations promulgated

by GSA for executive agencies. This should include (1) seeking of maximum practicable competition in all future procurements, (2) obtaining enough data to effectively evaluate proposals and negotiate reasonable prices, and (3) maximizing the use of existing Government procurement sources without regard to personal preference.

With regard to its long-term leases, we recommend that the Commission comply with the administrative and reporting requirements of the Anti-Deficiency Act (31 U.S.C. 665(i)) and take any other actions required by law. We further recommend that the Commission negotiate leases which comply with the Adequacy of Appropriations Act and the Anti-Deficiency Act.

We also recommend that the Commission obtain appraisals of the fair market value of its leased property and determine whether it has complied with the maximum rental limitations of the Economy Act. Any rental costs in excess of the limitations should be recovered from the landlords. We further recommend that the Commission recover the cost of all improvements to its Washington office in excess of the Economy Act improvement limitation.

RECOMMENDATION TO THE CONGRESS

We recommend that the Congress amend section 12(b) of the enabling legislation by deleting the phrase "including but not limited to the rental of necessary space at the seat of Government and elsewhere." This would have the effect of placing the leasing authority and functions of the Commission in the hands of GSA.

CHAPTER 11

CFTC'S FINANCIAL DISCLOSURE SYSTEM NEEDS TO BE STRENGTHENED

Our review of CFTC's code of conduct regulations was primarily concerned with whether

--all required financial disclosure statements were promptly and properly filed and adequately reviewed,

--employees not required to file financial disclosure statements should be required to file them, and

--an excessive number of employees were being hired from the commodity industry and returning to this industry after Government employment.

The functions and purposes of CFTC include strengthening the regulation of futures trading, preventing price manipulation and dissemination of misleading commodity information, and protecting commodity market users. To properly fulfill these responsibilities and maintain public confidence in its operations, CFTC must insure that employees adhere to the highest standards of ethical conduct.

Our examination of various aspects of CFTC's code of conduct regulations revealed that, on the basis of prior reviews, the Commission has taken steps to strengthen and improve its financial disclosure system. As a result of this action, the system is now detecting, and procedures have been established to avoid, potentially conflicting situations. However, on the basis of our review, we believe that some employees (who now do not file statements) should be required to file an annual disclosure statement and some should certify annually that they have no financial interests or outside employment which would violate agency regulations. Currently, there is no effective system to assure CFTC management that these employees are not misusing inside information for their own benefit or violating CFTC regulations.

FINANCIAL DISCLOSURE SYSTEM

Executive Order 11222 of May 8, 1965, prescribed standards of ethical conduct for Government officers and employees and directed the Civil Service Commission to establish regulations implementing the order. Subsequently, in November 1965, Civil Service issued instructions requiring each agency to prepare standards of employee conduct and establish a system for reviewing employee financial disclosure statements. Civil Service must approve regulations established by each agency.

Agency regulations

CFTC's code of employee conduct (17 CFR part 140) was adopted July 2, 1976, following an examination by a program study group of other commissions' conduct regulations and an examination of its own need to protect against various types of conflict-of-interest situations. The code of conduct established ethical standards for the five commissioners and employees. Besides implementing the executive order and Civil Service's instructions, the code set forth very specific regulations concerning business and financial transactions, outside employment, acceptance of gifts, disclosure of non-public information, postemployment practices, and financial disclosure.

CFTC's regulations are very specific with respect to business and financial interests and adequately detail those transactions and interests which are prohibited. One of the regulations (17 CFR 140.735-4(b)) states that:

"No Commission member or employee shall:

> (1) Participate, directly or indirectly, in any transaction (i) involving a contract of sale of any commodity for future delivery; (ii) involving any commodity that is of the character of, or is commonly known to the trade as, an option, privilege, indemnity, bid, offer, put, call, advance guaranty or decline guaranty; or (iii) for the delivery of silver bullion, gold bullion, bulk silver coins or bulk gold coins that is or is to be executed pursuant to a standardized contract commonly known to the trade as a margin account, margin contract, leverage account or leverage contract or similar contracts when subject to regulation by the Commission;
>
> (2) Participate, directly or indirectly, in any investment transaction in an actual commodity, except as permitted in section 9(d) of the [Commodity Exchange] Act;
>
> (3) Have a beneficial interest, through ownership of securities or otherwise, in any person regulated by the Commission, such as a contract market or clearinghouse or member thereof, a registered futures commission merchant, any person associated with a futures commission merchant or with any agent of a futures commission merchant, floor broker, commodity trading

advisor or commodity pool operator, or any other person required to be registered in a fashion similar to any of the above under the Commodity Exchange Act or pursuant to any rule or regulation promulgated by the Commission;

(4) Have a significant beneficial interest, through ownership of securities or otherwise, in any other person required to file reports under the Commodity Exchange Act or pursuant to any rule or regulation promulgated by the Commission; or

(5) Purchase or sell any securities of a company which, to his knowledge, is involved in any (i) pending investigation by the Commission; (ii) proceeding before the Commission or to which the Commission is a party; or (iii) other matter under consideration by the Commission that could significantly affect the company."

The regulation further provides that a member or employee is considered to have sufficient interest in the transactions

" * * * of the spouse or minor child of the member or employee, or other relatives who are residents of the immediate household of the member or employee, so that such transactions must be reported and, absent compelling countervailing reasons, are subject to all the terms of this section."

CFTC's General Counsel is the ethics counselor. He is responsible for providing advice and interpretative rulings on employee conduct matters as needed by the Director of Personnel, Regional Deputy Counselors, and employees. The Director of Personnel is responsible for collecting and reviewing employees' financial disclosure statements. He usually delegates this responsibility to a senior staff member in his office. The General Counsel resolves conflict-of-interest matters that appear on the disclosure statement which cannot be resolved by the Director of Personnel or his designee.

CFTC's regulations require annual financial disclosure statements from:

--Executive schedule employees (except Presidential appointees required to file financial disclosure statements with the Civil Service Commission).

--All employees in positions of grade GS-13 and above.

--Employees occupying positions as attorneys, auditors, or investigators in grades GS-11 and GS-12.

--Consultants and experts.

Individuals file a financial disclosure statement prior to occupying these positions. This requirement is noted in the position descriptions for the positions.

Review of financial disclosure statements and CFTC's improved procedures

In September 1977, the Surveys and Investigations staff, House Committee on Appropriations, reviewed CFTC's financial disclosure system. During this review, certain system weaknesses were disclosed which prompted CFTC to take corrective action, including

--assigning responsibility for statement review to an individual in the Office of Personnel who is experienced in the commodity industry,

--developing more effective procedures for processing and reviewing financial disclosure statements,

--developing a new financial disclosure form for the 1978 filing period containing pertinent detailed questions relating to possible conflict-of-interest situations,

--performing a second review of the financial disclosure statements filed in July 1977, and

--developing more specific criteria as to the types of interests that would create conflict-of-interest situations.

During 1977, 199 CFTC employees (including experts and consultants) were required to file financial disclosure statements. In October 1977, when we initiated our review of its system, eight employees had not filed their statements. Seven of the eight employees have since left CFTC, and the other employee subsequently filed his statement.

CFTC's first review of the financial disclosure statements filed in July 1977 revealed no interests which appeared to violate Commission regulations. Its second review of the statements began in November 1977 and was completed in

January 1978 by the new reviewing official in the Office of Personnel. This official has experience in the commodity industry. In coordination with our review, he questioned 49 financial interests held by 24 employees, under the new agency review criteria.

The Office of Personnel and the Office of General Counsel have determined that financial interests in companies classified in the following categories could represent potential conflicts in light of CFTC's regulations:

--Agriculture businesses.

--Food companies.

--Companies whose primary business involves producing or processing of raw commodities (up to the retail level) which have future contract counterparts to include precious metals and copper.

The 49 financial interests, identified as questionable, were analyzed by the reviewing official to determine whether any of the interests represented a possible conflict of interest--i.e., a company that is involved with CFTC (1) in litigation or reparation proceedings, (2) in a reporting status, or (3) in some direct manner. The reviewing official identified 26 of the 49 interests held by 18 employees that represent possible conflicts. The 26 interests were referred to the Office of General Counsel for legal review.

In addition to the financial interests identified above, the reviewing official also asked the Office of General Counsel to rule on

--nine property interests including farms and ranches, held by six employees;

--three employees' outside employment; and

--two employees' loans.

Most of the cases were referred to the Office of General Counsel in January 1978. The General Counsel has discussed some of the referrals with personnel officials, and as of February 3, 1978, he had responded to one case in writing. The General Counsel decided that no conflict of interest existed in that case.

Our review of the five CFTC Commissioners' statements filed in 1977 with the Civil Service Commission disclosed three financial interests in securities held by one

Commissioner, and one property interest held by another Commissioner that appears questionable under the new review criteria established by CFTC. We notified Civil Service in February 1978 of these financial interests and asked that it review the disclosure statements to determine whether any potential conflicts of interest exist. Civil Service's ethics counselor agreed that he would contact CFTC's Office of General Counsel regarding this matter.

We believe that CFTC's recent action to strengthen its financial disclosure system is effective for detecting questionable financial interests held by reporting employees.

PROCEDURES NEEDED TO GUARD AGAINST MISUSE OF CONFIDENTIAL INFORMATION

As mentioned earlier, CFTC required 199 of its 481 employees to file annual financial disclosure statements. To determine the adequacy of CFTC's criteria for identifying positions which should file statements, we reviewed position descriptions of incumbents who currently do not file statements. We concluded that there are other employees who should be required either to file an annual disclosure statement or certify annually that they have no financial interests or outside employment which would violate agency regulations.

CFTC's regulation (17 CFR 140.735-9) states that:

"A Commission employee shall not divulge, or cause or allow to be divulged, confidential or non-public commercial, economic or official information to any unauthorized person, or release such information in advance of authorization for its release."

In addition, section 9(e) of the act provides criminal penalties for the misuse of nonpublic data by any CFTC Commissioner or employee.

Our review of the position descriptions for auditors, investigators, attorneys, and economists in grade levels that were not required to file a disclosure statement disclosed that these individuals have access to sensitive nonpublic data in the performance of their duties. Many of them perform duties similar to those in higher levels but receive more supervision and have less decisionmaking authority. They do, however, have an impact on the decisionmaking process through the collection, development, and analysis of data. Because of their access to sensitive data, their potential for influencing the decisionmaking process,

and CFTC's regulatory responsibilities and statutory restrictions, we believe the incumbents of these positions should be required to file annual financial disclosure statements.

Incumbents in a number of other positions also have access to sensitive nonpublic information in the course of fulfilling their duties. Yet there is no monitoring or enforcement system in effect to insure that the employees are not (1) using information for their own benefit, (2) involved in possible conflict-of-interest situations, or (3) violating agency standard of conduct regulations which apply to all employees. Administrative assistants to the Commissioners, paralegal specialists, computer specialists, certain secretarial personnel, trading reports clerks, documents clerks, and statisticians are among the positions with access to the nonpublic information.

We believe CFTC should establish a certification system for employees not required to file financial disclosure statements. One method would be to require these employees to certify annually that they, their spouses, minor children and other relatives who are residents of the immediate household do not own any interests or have any outside employment which violates CFTC's regulations. We believe such a statement, coupled with specific advice to the employees concerning what constitutes a conflict of interest, would cause greater employee ethical awareness and provide a measure of assurance to management that employees are not involved in conflict-of-interest situations. We also believe such a certification in lieu of a financial disclosure statement would adequately protect the privacy of lower level employees.

POSTEMPLOYMENT SYSTEM

CFTC does not maintain records designed to determine where employees were formerly employed. Likewise, it does not request information to determine where former employees are working. Therefore, it was not possible for us to determine whether or not a revolving door pattern exists between CFTC and the commodity industry.

At our request, CFTC determined from available information that 62 employees may have been employed in the commodity industry prior to their Federal employment. The CFTC information disclosed that 7 employees were previously employed by commodity exchanges, 27 were employed by companies in the commodity or securities industry, and 28 were employed by law firms which may have represented clients in the commodity industry.

Since April 1975, 156 professional employees in grades GS-7 and above (including 30 experts and consultants) have separated from CFTC. Of these, 10 went to work for commodity exchanges, 12 joined commodity related firms, and 11 accepted positions in law firms, some of which represent clients in the commodity industry.

Postemployment regulations

CFTC's code of conduct regulations (17 CFR 140.735-10) cover postemployment restrictions and state that:

--"No person shall ever appear in a representative capacity before the Commission in a particular matter if such person, or one participating with him in the particular matter, personally considered it or gained nonpublic knowledge of the facts thereof while he was a member or employee of the Commission.

--"No person who has been a member or an employee shall, within one year after his employment has ceased, appear in a representative capacity before the Commission in any matter which was under his official responsibility as a member or employee of the Commission at any time within a period of one year prior to the termination of such responsibility * * * ."

The lifetime ban is more strict than 18 U.S.C. 207(a) 1/ in that it goes beyond personal involvement and includes the gaining of nonpublic knowledge of a particular matter whether the former employee was personally involved or not. In its regulations, CFTC has defined "appearance before the Commission" to mean personal appearances before or personal communications with the Commission or any member or employee regarding matters arising under the statutory provisions administered by the Commission. "Representative capacity" has been defined to include not only the usual type of representation by an attorney,

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1/ Basically, 18 U.S.C. 207(a) prohibits a former Government employee from acting as an agent or attorney in any matter in which he participated personally and substantially as such officer or employee and in which the United States is a party or has a direct and substantial interest.

but also representation of a corporation in the capacity of an officer, director, or controlling stockholder thereof.

To enforce these regulations, CFTC established a reporting requirement for former members and employees contemplating appearances before the Commission. This requirement states that:

> "Any former member or employee of the Commission who, within two years after ceasing to be such, is employed or retained as the representative of any person outside the government in any matter in which it is contemplated that he will appear before the Commission shall, within ten days of such retainer of employment, or of the time when appearance before the Commission is first contemplated, file with the General Counsel of the Commission a statement as to the nature thereof together with any desired explanation as to why it is deemed consistent with this section * * *."

Reporting procedures

Being a relatively new agency, CFTC has not had much experience with postemployment matters. Employees are made aware of postemployment regulations when they are hired. Letters concerning postemployment matters are received and handled by the General Counsel.

When the reporting system was first established in July 1976, the former employees' notification letters were reviewed and, if necessary, investigated to determine whether the appearance would be in compliance with CFTC's regulations. The General Counsel would subsequently respond with a letter setting forth the postemployment regulations and usually approving the request of the former employee to appear before CFTC.

The General Counsel later decided that too much time was being spent in responding to notification letters. Under current procedures, CFTC only acknowledges receipt of a notification letter and makes an investigation if the contents of the letter indicate that the appearance might violate agency regulations. From July 1976 through November 1977, CFTC received 17 letters from 6 former employees notifying it of contemplated appearances.

CONCLUSIONS

As a result of various reviews of its financial disclosure system, CFTC has strengthened its system. Its system is now

detecting, and action is being taken to avoid, potential conflict-of-interest situations. However, we believe there are other employees who should be filing statements.

CFTC, through its regulations and the act, prohibits the misuse of confidential or nonpublic agency information. However, with the exception of the annual financial disclosure statement filed by designated higher level employees, there is no requirement to help insure that lower level employees are not misusing nonpublic information for their own benefit or violating regulations prohibiting the ownership of certain interests. Because of the sensitivity of the information available to employees, we believe the agency should develop a certification system to insure that conflicts of interest are avoided.

We believe that if properly implemented, CFTC's post-employment system, whereby employees notify the agency of any proposed appearances before the agency, can be an effective enforcement mechanism.

RECOMMENDATIONS TO THE CHAIRMAN, CFTC

We recommend that the Chairman:

--Require lower level employees in the positions of auditors, investigators, economists, and attorneys to file financial disclosure statements annually.

--Establish a certification system for employees not required to file financial statements to insure that they and members of their immediate households do not own any interests or have outside employment which violates CFTC's regulations.

CHAPTER 12

CFTC ATTEMPTS TO REGULATE THE SALE OF COMMODITY OPTIONS HAVE NOT BEEN EFFECTIVE

The 1974 Commodity Futures Trading Commission Act, which revised the Commodity Exchange Act of 1936 to provide comprehensive regulation of all commodities, goods, and services traded in the futures markets, continued the ban on the trading on or off domestic exchanges of commodity options on those commodities regulated before 1974. 1/ It did not, however, ban the trading of options, including foreign commodity and dealer options, on commodities not previously regulated. Instead, the 1974 act granted the Commodity Futures Trading Commission exclusive jurisdiction over options--effectively preempting the States' and the Securities and Exchange Commission's regulatory activities in this area--and authorized it to determine whether, and so in what fashion, option trading in these previously unregulated commodities should be permitted.

CFTC considered but took no action to ban the trading of foreign commodity and dealer options, which had been legally available in this country throughout the period since 1936, although various fraudulent schemes involving the sale of options, particularly options on commodities traded on the London commodity exchanges (London options), had received considerable publicity in the early 1970s.

Instead, following the recommendations of an advisory group, many of whose members had ties to exchanges or firms that proposed eventually to trade options, CFTC developed a two-part or two-stage strategy for the regulation of options. Under part A, the interim or first stage of its overall options regulatory strategy, CFTC tried to regulate the sale of foreign and dealer options by issuing regulations covering, among other things, registration of all persons offering options to the public, segregation of customer funds, keeping of books and records for CFTC inspection, and minimum dealer capital requirements. Part B, the

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1/ These "previously regulated commodities," basically important domestic agricultural commodities, are specifically enumerated in section 2(a)(1) of the amended act.

comprehensive second stage of CFTC's two-part options regulatory strategy, envisioned a pilot test of options trading which, in addition to foreign options and dealer options, would feature domestic exchange trading of options on the previously unregulated commodities. Part B has not been implemented by CFTC to date. Trade options--transactions between commercial principals involving the physical commodities--were not included in the scope of CFTC regulations.

CFTC, however, has been unable to effectively enforce its option regulations, and option trading has attracted substantial customer interest as well as the participation of allegedly fraudulent operators who saw the potential for quick profits through high-pressure, boilerroom-type operations. At the same time, CFTC's attempts to develop and enforce its option regulations and to prevent fraudulent and illegal activity in the sale of options caused a heavy drain on its resources and seriously interfered with its ability to deal with its more basic responsibility for regulating commodity futures.

Because it was understaffed and unprepared to compel strict compliance with its option rules, CFTC has not been able to make of these rules the meaningful customer protections they might otherwise have been. A number of option firms, among them some of the largest, have operated in open defiance of CFTC rules. CFTC only recently, in the face of continued revelations of alleged fraud and customer abuse, as well as intense criticism from State officials who claim that CFTC is not adequately protecting their citizens, has concluded that it is necessary to suspend the sale of foreign and dealer options after all.

CFTC still intends, however, to go ahead with a pilot program to test trading of options on domestic exchanges. It has requested a supplemental appropriation for this purpose for fiscal year 1978 as well as a budget increase for fiscal year 1979. Although such a pilot test may in time be appropriate, we believe that implementation at this time is inadvisable. Instead of options, CFTC should devote all its resources, including any supplemental appropriations, to improving its regulation of futures trading. As this report points out, many areas basic to the effectiveness of futures regulation are greatly in need of improvement.

COMMODITY OPTIONS

A commodity option, in contrast to a commodity futures contract, represents a right, but not an obligation, to buy

or sell a commodity (or a commodity futures contract) at an agreed-on price within a specified time. As a trading tool, commodity options may have many of the same uses as commodity futures contracts, although as a practical matter their commercial utility and attractiveness, in this country at least, largely remain to be demonstrated. Commodity users and hedgers may use options to establish a price today which they will pay for a product 6 or 9 months from now. Options might also protect against a possible decline in the market value of owned commodity products.

The speculative side of option trading, however, has attracted greatest notice in this country. In trading commodity futures, speculators, even when correct in assessing price trends, may be whipsawed out of the market by adverse short-term fluctuations or by their failure or inability to meet successive margin calls. By using options, speculators can initiate and maintain positions in high-profit-potential commodity markets with the assurance that their risks have a fixed limit (the option premium plus brokerage fees) and confidence that they can maintain their position for the specified time without the risk of margin calls, stop-loss closeouts, and whipsaw moves.

The history of option trading in this country extends to the 1860s when options (then called "privileges") for grain were traded on several midwestern exchanges. Such trading, however, was subject to widespread criticism from its earliest days, primarily because options, which have been known by various names over the years, were considered mere gambling contracts with no actual intent to obtain the commodity. Bans or restrictions on option trading have been imposed by the Federal Government and others from time to time since 1874 when Illinois outlawed trading in privileges. (See app. VI for a more detailed discussion of the history of option trading and regulation in the United States.)

Although some bills which were considered during deliberations leading to the 1974 act would have banned all option trading, the act as finally passed banned option trading only in the commodities previously regulated under the 1936 act. The 1974 act, however, granted CFTC exclusive jurisdiction over all commodity options and authorized CFTC, after notice and opportunity for hearing, to issue rules, regulations, or orders either to prohibit option transactions

in the previously unregulated commodities or to allow such transactions under such terms or conditions that it was to prescribe within 1 year (or later if it notified the Senate and House agriculture committees) after the act's effective date. The act also authorized CFTC to set different terms and conditions for different markets.

SIGNIFICANT CFTC ACTIONS ON COMMODITY OPTIONS

One of the first questions which CFTC found itself obliged to consider after it officially came into existence on April 21, 1975, was how to deal with the growing problem of fraud in the sale of off-exchange options in the previously unregulated commodities. Fraudulent schemes involving the sale of options had received considerable publicity in various parts of the country and had also been the subject of testimony in congressional hearings on the legislation creating CFTC.

On June 24, 1975, against a background of increasing concern about the growing fraud problem, CFTC issued an antifraud rule (17 CFR §30.01, 1976) which made it unlawful, among other things, for any person directly or indirectly to (or attempt to) cheat, defraud, or deceive any other person in connection with any commodity option transaction. Early in October 1975 CFTC first exercised its injunctive authority under the 1974 act when it sought injunctions against two option firms which it alleged were in violation of its antifraud rule.

In July 1975 CFTC asked the U.S. District Court at Oklahoma City for permission to participate as amicus curiae--a friend of the court--in an SEC case involving the offer and sale of commodity options. CFTC intended this action, in part, to apprise the courts and various State and Federal agencies of the exclusive jurisdiction over commodity-related matters conferred on it by the 1974 act.

Also in late 1975, CFTC announced formation of a 17-member advisory committee on the definition and regulation of market instruments. The advisory committee, chaired by CFTC's Vice Chairman, was charged with responsibility for considering all aspects of commodity options, leverage contracts, and related market instruments and making recommendations to CFTC for appropriate regulatory action. CFTC also requested the public's views on the regulatory approach to

be adopted for options. Specifically, it asked for comments on five proposed regulatory plans:

1. Prohibit all option transactions.

2. Restrict option transactions to boards of trade designated as contract markets by CFTC.

3. Adopt a rule forbidding option transactions except in accordance with a CFTC-approved business plan.

4. Prohibit "naked options" irrespective of actions which might be taken on other types of options. (A naked option represents nothing more than the option grantor's unsupported promise to perform. The option grantor does not necessarily own commodity futures contracts or the physical commodity to meet his obligation nor is performance of the obligation guaranteed by a recognized exchange or clearinghouse.)

5. Permit option trading only by persons registered with CFTC as futures commission merchants.

To facilitate its work, the advisory committee assigned subcommittees to consider particular subject areas. The seven-member subcommittee on options held several meetings from late November 1975 through April 1976. In mid-May 1976 the subcommittee presented its recommendations to the full advisory committee, which adopted the recommendations (with a few exceptions and modifications) and on July 6, 1976, transmitted its report to the Commissioners. The advisory committee's major recommendations on options were that option trading in general should not be prohibited but that

--domestic trading in options on contract markets (exchange options) and in foreign options and domestic dealer options off contract markets (off-exchange options) should be permitted only if there was a showing satisfactory to CFTC that protections substantially equivalent to those afforded futures customers on contract markets were available;

--trading in assignable options (options that can be conveyed to a third party off the contract market) on domestic futures contracts should be prohibited;

--in general, option trading should be regulated in a fashion similar to that of futures contracts;

--in general, option trading on futures contracts should be limited to the contract markets on which the underlying futures contracts were traded; and

--option trading on domestic futures contracts off contract markets should be prohibited.

The advisory committee felt strongly that it was not necessary to demonstrate an improvement or betterment of the public interest in order to permit option trading, any more than it was necessary to affirmatively justify engaging in any other form of economic activity. It concluded that commodity options had been and were being legitimately used by commercial and other interests in ways that were not contrary to the public interest and that a sufficient case had not been made for banning option trading in general.

However, one public member of the advisory committee observed in a dissent from the advisory committee report that

> "the Commission is going to have a difficult time with its limited staff in policing these transactions where they occur away from a regulated exchange."

On September 13, 1976, the Commissioners, after rejecting by a 4-to-1 vote a proposal that would have temporarily suspended all option trading in the United States, approved a resolution proposing a two-part plan for regulating options. Under part A of the plan, the CFTC staff was to draft interim regulations aimed at off-exchange options, particularly at the fraud and customer protection problems created by the growing domestic trade in London options. Under part B, regulations were to be drafted later aimed at developing a comprehensive regulatory plan covering both off-exchange options and domestic-exchange-traded options.

It was envisioned that part B would include a limited, rigidly controlled 3-year or less pilot test program of trading on domestic exchanges of options on selected commodities to develop an experience translatable to other commodities and designed to determine (1) the nature and extent of the effect of option trading on the underlying futures and cash markets, (2) the economic contribution made by option trading, and (3) the capability of designated contract markets to conduct market surveillance and assure orderly markets.

In introducing the resolution that was approved, CFTC's Vice Chairman, who had chaired the options advisory committee, referred to the widespread fraud problems in the sale of options:

> "We know that people are getting ripped off right and left on options in this country. * * * I think that the way that options are being offered in this country is contrary to the public interest. Nothing could be more clear to me than that. * * * Customers are bilked. They are charged outrageous premiums in many cases. They are enticed into the options business as part of a pyramid operation. In many cases, what is sold to them as a London option has * * * never been to London."

Despite these problems, the Vice Chairman and three of the other four Commissioners apparently believed that the part A regulations, which were being proposed for quick implementation, would in a short time largely eliminate the fraud problems and pave the way for part B, which would clean up the industry once and for all. The Vice Chairman said:

> "Part A has the objective of immediately cleaning up the options business * * *. It doesn't clean it up as thoroughly as banning it. * * * It doesn't clean it up as thoroughly as we want to in the long run * * * [but] it is something I am led to believe by the staff can be done quickly and I think that is probably our goal. * * * [It] is designed to be a holding action * * *."

On the specific regulations proposed for part A--funds segregation, minimum capital, disclosure, and other requirements--the Vice Chairman said:

> "I think this will be a substantial blow to the way options are sold in the U.S. * * * We feel that by doing this probably 90-95 %--my rough estimate--of the incentive for people to continue to engage in the options business is probably going to go down the line."

The one Commissioner who was in favor of imposing a temporary ban on option trading said, in referring to the proposed two-part plan:

> "It comes down to the basic area that I think we're all concerned with and this is the protection

of the public. We are proposing to let the so-called London options continue in their present form for, we say, at the very best, 50 days, probably for God knows what; and our response to all the complaints we have had arising from abuses in London options--which are more than everything else--is to permit them to go now for another 50 or 60 days, or whatever, and say, 'okay, we are going to clean you up.' So we are telling the U.S. public, that we are supposed to be protecting, that we will protect them in 50 days, 60 days or so but, in the meantime, it is business as usual. And the only reason I can find for this is that we might discommode those that are doing the business."

Elaborating on his own proposal to temporarily suspend option sales, the Commissioner noted that most of the major wire houses did little or no retail option business and, therefore, would not be adversely affected by the suspension. He added that those that would be adversely affected

"* * * will be the same ones that are giving the industry a black eye, and the ones most favorably affected will be the responsible FCMs and salesmen and, most important of all, the public, I think. And in light of all the publicity that options excesses have generated * * * I don't know how we can responsibly permit the continuation of that situation for even one more day; and the day that we do that we have capitulated to the worst element of those that we are charged with regulating. I believe that we have to put first things first and protect the U.S. investment public, regardless of who might be inconvenienced."

PART A REGULATIONS DID NOT PROVIDE THE SHORT-TERM SOLUTION ENVISIONED BY CFTC

Despite the Commission majority's optimism that the two-part plan would quickly succeed in curbing abuses in the sale of options, CFTC was unable to adhere to the projected schedule for implementing the part A option rules or to move as quickly as anticipated to adopt the comprehensive regulatory plan of part B. Also:

--The part A rules failed to provide effective regulatory control over the option industry in

part because a number of option firms, including some of the largest, operated in open defiance of the rules and because CFTC lacked the means and resources to adequately maintain and enforce compliance with its requirements.

--The part A segregation rules were delayed several months by court challenges after the other rules had gone into effect.

--CFTC lacked a "reporting system" for options comparable to its market surveillance program for futures trading and, as a result, was largely in the dark concerning the day-to-day, month-to-month realities of options trading (e.g., magnitude of options trading, identity of options market participants, profitability of options transactions, commercial utilization of options, etc.).

--CFTC did not fully consider the effect on customer protection of its assertion and defense of its exclusive jurisdiction over options.

--CFTC's attempts to develop and enforce its option regulations and to prevent fraudulent and illegal activity in the sale of options caused a heavy drain on its resources.

Wide agreement now exists among CFTC's Commissioners and staff that early CFTC action in 1975 or 1976 to temporarily ban the retail sale of foreign and dealer options would have had very few adverse consequences, because it is believed that relatively few firms were then in the business of selling options. The dramatic growth in options activity seems to have occurred only after CFTC signaled its intention to develop a regulatory scheme for options rather than banning them or placing a temporary moratorium on their sale.

Problems in finalizing part A regulations

CTFC's proposed part A (interim) regulations were approved on September 29, 1976, and published for comment in the Federal Register on October 8, 1976. They provided for:

1. Registration of all dealers offering options to the public as FCMs and their sales employees as associated persons.

2. Segregation (from the dealer's assets) in the United States of all funds and property received from an option customer and treatment of those funds as belonging to the customer.

3. Certain books and records to be maintained by dealers and to be made available for CFTC inspection.

4. An FCM engaged in option transactions to have an adjusted working capital of at least $50,000.

5. Persons soliciting or accepting orders for options to make a summary disclosure to an option customer 24 hours before entry of the transaction of all fees, charges, premiums, markups on premiums, and sales commissions.

The regulations were originally expected to take effect on or about November 18, 1976, and remain in effect for about 2-1/2 or 3 months until the part B regulations could be implemented.

The proposed regulations were received with strong objections in some quarters, notably among firms selling London options in this country. A number of such firms organized in October 1976 to form the National Association of Commodity Option Dealers (NASCOD).

One of the main concerns of the London option dealers was the regulation dealing with segregation of customer funds, which CFTC viewed as the main pillar of its customer protection effort in options. The dealers' concern, of which CFTC was fully cognizant, was that British Government regulations required payments for London options to be remitted to Britain. CFTC's proposed rules, however, would have required that, until the option was exercised or had expired, all the customer's funds be set apart in this country. Therefore, the firm would have had to remit payment to the foreign option seller out of its own funds. Many smaller option firms complained that their limited capital would not permit them to do business this way and charged that CFTC was deliberately attempting to drive them out of business, leaving the London option field to the larger, established FCMs.

In the face of increasingly critical comment from option dealers and threatened court challenges to the segregation rules, the Commissioners voted on November 18,

1976, to revise the segregation and disclosure rules and to delay the dates of implementation.

The revised regulations, which were published in the Federal Register of November 24, 1976, reduced the segregation requirement from 100 percent to 90 percent of the customer's funds. CFTC also expressed its willingness to consider proposals for equivalent alternatives to its segregation requirement. The disclosure rule was relaxed to require a dealer to give the customer a summary disclosure of the option price, premium, and commission at the time of sale and provide a detailed confirmation statement within 24 hours of the entry into the option transaction. No significant changes were made in the proposed registration and minimum capital requirement rules.

The revised regulations, except for the segregation rules, took effect on December 9, 1976. 1/ This was accompanied by considerable CFTC-generated publicity about the seriousness of the option fraud problem and by the inauguration of a CFTC option "hot line" designed to answer questions about options and to warn prospective option purchasers of the importance of asking option salesmen certain basic questions and of "shopping around" before buying.

Registration rules have not been fully effective in protecting the public from unscrupulous, unfit, and unqualified dealers

Viewed as the key to gaining regulatory leverage over the option industry, the part A rules on registration of option dealers as FCMs and their sales personnel as associated persons have largely failed to provide the effective regulatory controls sought by CFTC or the customer protection needed by the public. The reasons for these failures include the following interrelated factors:

--Deficiencies in the registration process at CFTC which, combined with limited staff, have made it difficult to ensure that minimal fitness, financial stability, and other prerequisites of registration are met.

1/The segregation rules were scheduled to go into effect December 27, 1976, but were not enforced by CFTC at that time because of court challenges.

--A lack of resources with which CFTC could monitor, continued compliance with registration requirements and take effective action against those who fail to comply.

--A disposition on the part of many firms and persons selling options to operate in open defiance of the registration rules, coupled with CFTC's inability to take prompt and decisive enforcement action against them.

--A lack of qualification standards which would ensure, at a minimum, that offerors and sellers of options would have a basic understanding of the nature and workings of the futures industry and possess the necessary experience to deal competently and professionally with the public.

Problems with the registration process

CFTC set a deadline of January 17, 1977, for all commodity option dealers and all persons selling options to the public to be registered. As the deadline approached, CFTC was deluged with late applications (7 from FCMs and about 500 from associated persons) as well as about 50 earlier submitted applications that had not yet been processed. For the latter group, CFTC announced that it would take a conditional "no action" stance, ending February 21, 1977, on enforcing the law against these individuals should they choose to sell options. For the former group, CFTC said that it would process applications in the order received but that, from January 17, 1977, until formal notification of approval for registration the applicants would be legally barred from selling options. This bar was not totally effective.

Because of the lack of specific dealer fitness criteria a limited investigative capability, and deficiencies in reregistration procedures, which were discussed in chapter 6, combined with the volume of applications and pressure to process them expeditiously, CFTC's investigations and evaluations of the applicants were less thorough than the nature of the option fraud problem warranted. Available evidence indicates that, as a result, CFTC registered a number of FCMs who were seriously undercapitalized and otherwise of doubtful financial stability. The evidence also shows that CFTC registered some individuals whose records, if thoroughly investigated and evaluated, would have amply justified denial of registration.

Lack of resources for monitoring continued eligibility for registration

In addition to initially registering unfit FCMs and associated persons, CFTC was unable, because of a lack of staff resources, to monitor continued eligibility and to take prompt and effective action against already registered individuals who did not conform to the conditions of continued registration. According to a July 27, 1977, statement by CFTC's Chairman, for example, CFTC had deferred or dropped a large number of customer fraud, fictitious trading, and potential manipulation investigations because it had only 26 professional investigators nationwide.

In the case of associated persons, CFTC does not reinvestigate renewal applications nor does it have a reliable or systematic method for monitoring continued fitness.

CFTC's inability to adequately monitor and compel continued compliance with registration conditions meant that those firms and individuals who violated the regulations continued in the trade under grant of "license" from CFTC and continued to benefit from the legitimacy and respectability which the word "regulated" suggests.

Open violation of registration rules

Another problem was the defiance of CFTC's registration rules by a number of option dealers and their associated sales personnel. Many firms selling London options had been registered with CFTC as commodity trading advisors before the part A regulations became final. The part A regulations required these firms to reregister with CFTC as FCMs and their salespeople as associated persons.

In several cases in which firms and individuals submitted their registration applications near the deadline, CFTC denied registration outright. In several other cases, it declined to make prompt determinations on the applications but advised applicants that, until registered in the appropriate capacity, they could not legally sell options. However, many individuals continued to sell options in open violation of CFTC registration rules, and several of the Nation's largest option dealers were able to continue their operations despite CFTC's efforts to put them out of business or to force them to submit to CFTC scrutiny and regulatory control.

In a number of cases, court actions and administrative proceedings ensued, with CFTC only recently prevailing against some of the most persistent challengers of its option regulations. According to CFTC records, it has obtained injunctions against about 60 firms and individuals in the commodity option area and put about 14 companies out of business. Also, as of February 17, 1978, it had 32 London option firms either under investigation or in the initial phases of litigation.

Lack of dealer qualification standards

As discussed in chapter 6, CFTC is empowered to establish qualification standards on such things as education, training, and experience for various categories of registrants, but it has not yet done so. One consequence of this is that option selling in this country, according to CFTC documents and statements, continues to be characterized by a high degree of glib talk and high-pressure salesmanship and a low degree of expert knowledge and professional experience.

Sales personnel are often recruited with promises of very high earnings potential. Any training which they may receive appears to relate much more to developing a persuasive sales pitch than to developing knowledge of the commodity markets and their operations. Under these circumstances, it is not surprising to find, as numerous commentators--including CFTC officials--have noted, a large number of nonprofessionals.

No meaningful customer protection without segregation of funds

Of all of CFTC's option rules, unquestionably the most important, from the point of view of customer protection, are those relating to segregation of customer funds. CFTC viewed these rules as the linchpin of its interim regulatory plan--that they would make it most difficult for marginal, undercapitalized, and disreputable firms to continue in business. Because an option dealer would have to simultaneously segregate 90 percent of a customer's funds in this country and remit full payment for the option to London (called double segregation by some), it was generally accepted that most firms would need to borrow substantial sums of money to continue to operate. CFTC anticipated that many firms would be unable to do so and would, therefore, have to leave the business. According to one Commissioner,

"The idea behind Part A * * *. is not necessarily to make it particularly easy to offer commodity options in this country * * *.

"In some cases it is going to be true * * * that the people we are probably trying to get, the undercapitalized individuals, are not going to be able to get the money at all to continue, because they simply do not have * * * the background, the necessary integrity in order to justify their being financed by a bank."

In the case of those firms able to continue in business, CFTC anticipated that the segregation rules would provide the previously lacking protection for customers against complete loss in the event of an option dealer's insolvency or bankruptcy. CFTC experience with the financial collapse of several option firms had indicated that this was an urgent need.

CFTC's segregation rules were strongly criticized by the industry from the moment they were first published for comment. As noted earlier, CFTC partially yielded to this criticism by reducing the segregation requirement from 100 percent to 90 percent of the funds received from customers. However, industry critics were essentially unsatisfied by this change and some chose to challenge the segregation rules in the courts.

On December 21, 1976, a Federal judge preliminarily enjoined CFTC from implementing this portion of its regulations. The judge explained his action by stating that CFTC's segregation rules would create an economic hardship for U.S. option firms.

Because of this injunction, CFTC announced on December 22, 1976, that it did not intend to take action to enforce the segregation rules against any option dealers selling London options in the United States. This continued to be CFTC policy until April 25, 1977, when, as a result of an April 4, 1977, U.S. Court of Appeals decision upholding the validity of all the option regulations, CFTC announced its intention to require full compliance with all the regulations, including those governing segregation of customer funds.

This was nearly 5 months after the rest of the interim option rules went into effect and meant, in effect, that for a period much longer than part A had originally been intended

to remain in place, the public was without benefit of these key customer protection provisions. The problem did not end there, however. Because of additional court challenges, several of the Nation's largest commodity option dealers continued to avoid compliance with the segregation rules. On August 8, 1977, a U.S. Supreme Court Justice rejected a CFTC motion to compel these firms to comply with the segregation rules pending an appeal for a Supreme Court review. The Justice stated:

> "* * * [I]t does appear that the regulation would fundamentally alter the ground rules for doing business in a substantial industry, with potentially fatal consequences for a number of the firms currently in the trade * * *."

In November 1977, however, the Supreme Court declined to hear the appeal, the effect of which was to uphold CFTC's segregation rules.

<u>CFTC's exclusive jurisdiction over commodity matters has contributed to customer protection problems</u>

The 1974 act, in giving CFTC exclusive jurisdiction over commodity matters, effectively preempted the States and SEC from the field of commodity regulation, including the prosecution of fraudulent activity. Because of understaffing and limited experience, CFTC was not able to fill the regulatory gap which this created and which has been exploited by fraudulent option dealers. This has resulted in State officials' claims that CFTC is not adequately protecting their citizens from fraudulent option operations.

In February and March 1978 congressional hearings on CFTC, several State officials recommended that CFTC's exclusive jurisdiction be abolished or at least modified to the extent that the States be granted concurrent jurisdiction over fraudulent and deceptive practices. CFTC officials in their testimony acknowledged the problems created by preemption as well as the desirability of State assistance in protecting the public. At the same time, however, they were reluctant to accept any erosion of CFTC's exclusive jurisdiction by permitting State securities officials to apply the antifraud provisions of their securities laws in cases involving the fraudulent and deceptive marketing of commodity futures instruments.

In the wake of the commodity option scandals of the early 1970s, a number of States took measures to protect their citizens against this form of investor fraud. Since CFTC's creation, however, attempts by these and other States and by SEC to take legal action against alleged option frauds have been challenged in court both by the defendants, who claimed that only CFTC had jurisdiction over them, and by CFTC, which filed friend-of-the-court briefs asserting its exclusive jurisdiction.

The State securities commissioners we contacted, including those of several of the most populous States, said that the courts' general acceptance of CFTC's claims of exclusive jurisdiction over options has meant, in practical terms, that the States are powerless to protect their citizens from the kinds of customer abuses which have characterized London option sales. They said that, in terms of experience, size of investigative and enforcement staffs, and ability to respond quickly, the States would be far more able than CFTC to prosecute fraud and provide essential customer protection. CFTC has a total staff of about 450, while the combined SEC and State regulatory strength for the entire securities field is about 3,500 to 3,800 persons.

The State officials told us that, in view of CFTC's numerous friend-of-the-court filings, they concluded that it was wasteful of their time and effort to even attempt to prosecute fraudulent option dealers operating in their States. They said that, even if CFTC did not act in every case, potential respondents were likely to invoke CFTC's exclusive regulatory authority in the confident belief that they were more likely to escape effective enforcement action from CFTC than from the States.

According to CFTC, however, the States were not totally excluded from the option area nor barred from taking legal actions under their general fraud statutes or in support of the 1974 act under the doctrine of parens patriae 1/. The State officials said, however, that both courses were administratively cumbersome and impractical. They said that under specific State securities fraud laws (called "blue sky" laws), State securities authorities could bring legal action directly. Under the two courses suggested by CFTC, however,

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1/In this context, the parens patriae doctrine would allow a State to act as the protector of its citizens and sue as the guardian of their interests.

such actions would typically have to be brought by the State attorneys general who are not as experienced in these types of fraudulent activities and who have numerous other responsibilities which could preclude their taking effective action against fraudulent option operations.

Some State officials also expressed doubt about the *parens patriae* doctrine in general, stating that it had been little used or tested in the courts in securities and commodity related matters. They observed that CFTC's suggestion of this approach comes at a time when CFTC is belatedly recognizing its inability to cope with the enforcement problems created by the sale of London options. A senior level CFTC enforcement official also advised us that it is very difficult for States to use *parens patriae* to successfully weed out fraudulent commodity option firms.

In a February 7, 1978, memorandum to the Comptroller General on the question of whether SEC should assume CFTC's functions, SEC said that it believed that CFTC had focused on expanding its area of exclusive jurisdiction and narrowing the authority of State agencies and of SEC without regard for the need to assure adequate protection of the public. It also said that the amount of time CFTC devoted to preserving and expanding its exclusive jurisdiction may well have been a misallocation of resources affecting CFTC's overall ability to carry out its statutory responsibilities. (See next section for a further discussion of this matter.)

SEC said that, in contrast, it had developed a strong and effective working partnership with State securities administrators, who bring competence, integrity, and needed resources to the fight against securities law violation. CFTC had established an advisory committee on State relations in 1976 but, through December 1977, only three meetings had been held--the first two in June and August 1976 and the third in December 1977.

In discussing these matters, we are not challenging CFTC's interpretation of its exclusive jurisdiction over options or questioning its authority to act as it has in asserting that jurisdiction. We believe, however, that in its early deliberations concerning whether to attempt to regulate options or to place a moratorium on their trading, CFTC should have given more consideration to the factor of exclusive jurisdiction and to its implications for effective enforcement of option regulations. We believe, also, that in view of the mounting evidence that its interim regulatory program was not providing the essential customer

protections that had been promised, CFTC should have been more mindful of and responsive to the views of State and Federal regulatory officials who had been effectively preempted from the field of commodity options but who were, perhaps, better equipped and better staffed than CFTC to control the problem.

CFTC has taken some recent actions which seem to recognize its inability to fill the regulatory gap created by its assertion of exclusive jurisdiction. In January 1978, it filed a friend-of-the-court brief with a Massachusetts court expressing the position that the injunctive relief sought by Massachusetts under its consumer protection act did not conflict with the exclusive jurisdiction provision of CFTC's act. Also, in congressional testimony in February and March 1978, CFTC proposed an amendment to the act which would formalize the parens patriae doctrine to permit State enforcement of the act and allow States to take cases to Federal courts. However, because this approach precludes the involvement of State securities officials and the benefits of their manpower, experience, and expertise, it has generally been rejected as an inadequate and unworkable solution by the States.

Regulation of options has caused a heavy drain on CFTC resources

CFTC records show that CFTC has devoted a substantial portion of its resources to developing and attempting to enforce its interim option regulations. According to CFTC statements, however, this investment has not only failed to bring option sales under control, but has impaired CFTC's ability to properly carry out its primary duty of regulating the futures markets.

An October 20, 1977, report by CFTC's Office of Executive Director showed that, in fiscal year 1977, all aspects of option regulation consumed about 50.5 staff years, or 10.5 percent of CFTC's total recorded staff time. This represented expenditures of $1,216,700, or 9.3 percent of CFTC's total expenditures. For the Enforcement Division, 32.9 percent of its staff hours and 33.2 percent of its expenditures were devoted to option-related activities in fiscal year 1977.

In almost all areas of the Commission's operations--registration, audits, enforcement, hearings and appeals, etc. --the report indicated substantial increases in workload and work-related problems attributable to options. It also noted that in the fourth quarter of fiscal year 1977 approximately

75 percent of all complaints received by the CFTC's reparations unit involved disputes over options.

In November 1976, even before the interim regulations had been put into effect, CFTC's then General Counsel said:

> "* * * the Commission * * * virtually from its inception has spent enormous amounts of time and resources on the subject of commodity options regulation."

In a July 27, 1977, statement relating to a proposed budget increase for fiscal year 1978, CFTC's Chairman said:

> "It is no longer possible for this Commission to perform its statutory mandate to oversee the $820 billion futures trading industry, and at the same time try to structure and regulate * * * commodity options sales * * *.
>
> "We are, for example, almost one year behind in auditing brokers. We are months behind in exchange contract review and exchange rule review. We are weeks behind in processing salesperson registration. And we can barely keep up with the daily surveillance of the trading in half a hundred commodities on the ten domestic exchanges.
>
> "Additionally, we have deferred or dropped a large number of customer fraud, fictitious trading, and potential manipulation investigations, because we have only 26 professional investigators nationwide."

Also, an August 15, 1977, document prepared by CFTC's Office of General Counsel (a draft announcement of a proposed ban on options trading, which was not published) said:

> "The Commission's experience with option trading to date indicates that, notwithstanding a substantial investment of its resources to the task of developing and attempting to enforce its interim option regulations, the unsound business practices and fraudulent activity that led to the scandals of the early 1970's, have not been brought under control.

* * * * *

"At the time of the adoption of the Commission's interim regulations, it was noted that a very substantial portion of the Commission's resources had been devoted to monitoring the activities of option dealers, to investigating those activities, and to bringing enforcement actions. Even then, however, the Commission did not remotely anticipate the extent to which its attempts to monitor and enforce compliance with the Act and regulations have seriously drained its resources and threaten significantly to impair the Commission's ability to fulfill its more basic statutory responsibilities. * * * It has become increasingly apparent that the amount of time, personnel, and money being devoted by the Commission to its attempts to regulate rather than prohibit option trading has been increasing rather than decreasing, and is already substantially out of proportion to any benefit that option trading may be said to afford the public--particularly in light of the extent to which fraudulent and other unsound practices continue to exist.

"During the current fiscal year the Commission will have devoted more than 10% of its budget to option-related activity, and the staff divisions directly responsible for option-related activity are now devoting 20% of their resources to the task. All indications are that a substantially greater amount of time would have to be spent in the future if the Commission should deal with the presently existing and developing problems through further attempts at regulation and enforcement.

"A significant proportion of all the enforcement actions and proceedings instituted by the Commission in district courts and administratively have been against commodity option firms based upon violations of the Act and of the interim commodity option regulations. In July 1977, approximately 28% of the pending enforcement actions involved option-related violations. To this extent the Commission's enforcement personnel have been unable to direct their attention to more basic Commission concerns under the Commodity Exchange Act.

* * * * *

"Considerable resources have also been diverted to a defense of the interim regulations the Commission has adopted. Similarly, substantial expense may likely be anticipated to defend any further regulatory action the Commission may choose to take, since some litigious persons are sure to consider themselves adversely affected."

The draft proposal added that the record before the Congress concerning fraudulent commodity option activities in the 1960s and early 1970s, and the facts brought to CFTC's attention as part of the early rulemaking proceedings would easily have justified a CFTC decision to have banned the sale of options long before now. CFTC's most recent actions with respect to suspending the offer and sale of options are discussed later in this chapter.

PART B PLAN COULD CONTINUE TO DRAIN RESOURCES AND DISTRACT CFTC FROM ITS PRIMARY DUTIES

Just as developing and attempting to enforce its part A interim option regulations claimed a significant proportion of its staff time and resources, CFTC's proposed implementation of its part B rules providing for a comprehensive plan of option regulation, including a pilot program to test option trading on domestic exchanges, can be expected to continue the drain on its resources. The extent and effect of this drain will depend on a number of interrelated factors, among them

--the size and scope of the pilot program;

--the additional budgetary resources which the Congress may make available;

--the effect which the part B rules and the new element of competition from exchange-traded options would have on the problems of fraud and customer protection in the sale of off-exchange options (assuming that sales of such options would be permitted in the context of a pilot test); and

--the arrangements which may be worked out between CFTC and the industry to share the cost and effort of monitoring, policing, and evaluating the pilot test and the economic purpose served by the various types of options which are traded.

Part B plan

On March 24, 1977, the CFTC Commissioners voted to proceed with part B of the two-part program. They approved the publication for comment in the Federal Register of regulations intended to amend the part A regulations governing off-exchange options and to provide for a limited, 3-year or less, pilot program to determine the economic feasibility of allowing domestic-exchange-traded options. The proposed regulations were published in the Federal Register on April 5, 1977.

In the Federal Register announcement, CFTC indicated that its experience to that time in regulating the offer and sale of off-exchange options had not provided an adequate basis for making the congressionally mandated determination of whether or not to prohibit options or, if allowed, how to regulate them. As a result, it had concluded that the best way to resolve the uncertainty would be through the limited, rigidly controlled pilot program it was proposing. For the pilot program, CFTC proposed to limit the types of option instruments and the number of commodities in which it would allow trading. It proposed to:

--Limit trading to call options on futures contracts. (CFTC said it had not decided finally whether to reject or approve put options on futures contracts or options on physical commodities.) 1/

--Restrict trading to the exchanges on which the underlying futures contracts are traded and require that options not be traded otherwise than according to the exchanges' rules.

--Prohibit the offer and sale of dealer options on physical commodities for the duration of the pilot program. (CFTC believed that the absence of a clearing or equivalent mechanism on the dealer markets, as well as the difficulties in supervising and controlling trade practices in a dealer market, would make dealer options unsuitable for the test program.)

1/A "call option" is an option to buy a commodity or a commodity futures contract at a predetermined price within a specified period. A put option is an option to sell.

--Prohibit the margining of premiums on domestic exchanges. (CFTC was concerned that the comparatively low purchase cost of a margined option might reduce the liquidity of domestic futures markets by drawing trading activity away from these markets.) 1/

--Require, as a condition of option trading approval, that the underlying futures contract have a sufficiently high volume to preclude option trading from having a disruptive effect on trading in the futures contract. (CFTC proposed to permit option trading only if the futures contract averaged at least 1,000 trades a week for the previous 12 months.)

--Require, as a means of avoiding other possible adverse effects on the underlying futures contracts and to enable CFTC to conduct market surveillance, that the commodities underlying the futures contracts on which options would be allowed have (1) a readily available deliverable supply and accurate statistics thereon, (2) an efficiently functioning delivery system, and (3) a reliable mechanism available to the public for determining cash market prices.

To achieve parity in customer protection between domestic-exchange-traded options and off-exchange (foreign) options, CFTC proposed to require that any foreign board of trade that wished to participate in the pilot program be "recognized" by CFTC as a foreign commodity option exchange and provide for

--the segregation of option customers' funds (or a a CFTC-approved equivalent),

--a mechanism for clearing trades (or a CFTC-approved equivalent),

--registration of option transactions in the names of options customers in the United States, and

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1/ A margined option would offer an option purchaser greater financial leverage in that he would be able to enjoy the right represented by the option without making an initial investment equal to the full cost of the option premium. There are recent indications that CFTC may be willing to permit some form of margining of option premiums under a pilot program.

--the quotation and dissemination of option, and underlying futures or commodity, price information in the United States on a timely basis.

CFTC added that, as an alternative to requiring foreign boards of trade to be recognized as foreign commodity option exchanges (an approach which the London exchanges were known to be reluctant to accept), it was considering placing formal obligations solely on the persons in the United States offering and selling the foreign options.

During public hearings held in Washington on May 25, 26, and 27, 1977, CFTC heard testimony from representatives of various sectors of the industry directly interested in the proposed regulations. There were no witnesses representing nonindustry groups, such as consumer or public interest groups, nor, in general, was there any significant questioning of the need for or desirability of a program authorizing option trading.

Among the witnesses' major comments and suggestions, in terms of differing in important respects from CFTC's proposals, were that:

--Put options, options on physical commodities, and dealer options (traded off exchanges) should be permitted during the pilot test.

--CFTC should not require an economic justification for option trading as a precondition to approving such trading. (Many witnesses testified that there was too little evidence at present to satisfy such a test, adding that it should be one of the functions of the pilot program to do this. Others went further, maintaining that it should not be necessary at all to demonstrate extensive commercial hedging use of options. They argued that a number of useful economic purposes would be served by largely speculative use of the option market, among them a contribution to liquidity in the underlying futures market.)

--CFTC should not require foreign boards of trade to seek CFTC "recognition" as a condition of participation in the pilot program. (Several London option trade spokesmen maintained that, because the problems with London options were not in London but in the way

they were marketed in this country, it was essentially up to CFTC to regulate the domestic sellers of such options.)

--Margining of option premiums should be permitted, at least for trade customers.

Several witnesses, especially representatives of FCMs and established U.S. boards of trade, substantially agreed with CFTC's proposals to restrict option trading to the organized commodity futures exchanges, to ban over-the-counter (off-exchange) options, and to limit exchanges to offering options only in commodities in which they have futures contracts.

On October 17, 1977, CFTC published in the Federal Register proposed revisions to its part B regulations, stating that it would accept comments until December 1, 1977, but that it had not yet determined an effective date for implementing the program. Commenting on the revisions, CFTC said that it had found merit in many of the comments received during the 60-day comment period and in the 3 days of public hearings. The proposed changes, it said, were based substantially on these comments as well as on considerations of customer protection and of economy and efficiency in administering the pilot program.

The major differences between the revised regulations and those proposed on April 5, 1977, were:

1. Trading on domestic exchanges--Put options on futures contracts and options on physical commodities would be permitted in addition to call options on futures contracts.

CFTC said that it had been impressed by the arguments that the presumed economic justification for put options and for options on physical commodities was just as strong as, if not stronger than, that for call options on futures contracts. CFTC concluded, therefore, that it would be appropriate to permit several different option instruments within the structure of the pilot program, thereby obtaining a broader data base to evaluate which, if any, options served an economic purpose. It noted, however, that, at least in the early stages of the pilot program, it did not intend to license a given exchange to trade both put and call options in the same commodity.

2. Off-exchange options--Dealer option trading would be permitted to continue during the pilot program.

In reversing itself on the subject of dealer options, CFTC largely accepted the claims that prohibiting dealer options would be

--unfair, because dealer options had not been the source of any major regulatory problems for CFTC;

--unnecessary, because dealer options would be easier to regulate than foreign options and because dealer options could satisfy the primary criteria which CFTC had adopted for option trading on domestic exchanges; and

--contrary to the public interest and inconsistent with the goals of the pilot program, because the dealer market would provide healthy competition to exchange-traded options, provide useful comparative data, provide narrower quotes and better execution in some instances, and allow a "less anticompetitive" means of achieving the objectives of the act 1/ than would the proposed prohibition.

CFTC said that its willingness to permit dealer option trading would be conditioned on a showing that appropriate safeguards could be instituted to substitute for those safeguards provided by a clearinghouse in the case of exchange trading. It specifically solicited comments on the forms such alternative safeguards might take as well as on criteria which it might employ in selecting dealer option contracts to be included in the pilot program.

1/ Section 15 of act, states:

"The Commission shall take into consideration the public interest to be protected by the antitrust laws and endeavor to take the least anticompetitive means of achieving the objectives of this Act, as well as the policies and purposes of this Act, in issuing any order or adopting any Commission rule or regulation, or in requiring or approving any bylaw, rule, or regulation of a contract market or registered futures association established pursuant to section 17 of this Act."

3. Off-exchange options--Foreign commodity option exchanges would not be required to apply for "recognition" by CFTC.

Particularly because of the London exchanges' expressed unwillingness to submit to CFTC jurisdiction, CFTC proposed that instead of requiring CFTC recognition of foreign boards of trade, it would place formal obligations solely on the persons and firms in the United States offering and selling foreign options. It added, however, that only foreign exchanges which "voluntarily meet certain specific criteria * * * previously proposed as requirements" for recognition would be eligible to participate in the pilot program.

Conceding that none of the numerous problems of fraud and customer protection experienced in the sale of London options in this country had been attributable to any act or omission of the London exchanges, CFTC expressed continued confidence in the integrity of these exchanges and in their ability to police their members and to ensure the financial integrity of options transactions in which their members engaged. CFTC also expressed hope that its proposals for continued sale of London options in this country would

> "* * * afford option customers direct access to members of the foreign commodity option exchanges in order to satisfy any claims that may arise in connection with their option transactions and will eliminate many of the abuses that have arisen as a result of option customers' dealings with unscrupulous and financially unstable firms."

In a letter to the Chairman of the Senate Committee on Agriculture, Nutrition, and Forestry on February 17, 1978, CFTC's Chairman said that the Commissioners had before them a staff draft of a resolution containing the major elements to be included in the final regulations for the pilot program. He said that the Commissioners had that day determined to delay temporarily consideration of the resolution and that it was uncertain when the final regulations would be published.

The Chairman said that among the factors CFTC would consider in adopting and implementing the pilot program would be the availability of additional funds and staff positions and CFTC's ability to monitor and supervise adequately exchange option markets. He said that options traded on domestic exchanges and use of exchange clearing mechanisms should provide an inherent guarantee of performance, allow control

and supervision of trading, and facilitate the gathering and dissemination of market data. He added that current surveillance and monitoring functions could be adapted to the pilot program, but that no program would be approved which was not deemed to be in the public interest.

Estimated costs of part B pilot program

On July 20, 1977, after several months of preparation, CFTC's Office of Executive Director submitted to the Commissioners an estimate of resources needed for future activity in options, including implementation and evaluation of the part B pilot test program. The Executive Director's memorandum noted that, in preparing the estimates, certain alternative sets of assumptions were made about the types of options that would be traded (for example, call options only, both call and put options, options on futures contracts only, and options on both futures contracts and physical commodities); the projected volume of option trading; anticipated activity in foreign options; and other matters, such as CFTC staff planning to begin regulation of domestic-exchange option trading. The memorandum also noted that

> "* * * the staff has also considered the regulatory scheme necessary for regulating options trading. During the pilot program, extensive data collection and economic analysis of that data will be required. This will be accomplished by placing the responsibility for the data collection on the exchanges that wish to be designated as part of the pilot program. Further, it is assumed that the Division of Enforcement will continue to bring complaints for fraud and deceit against option dealers. Increases in resources are shown in some of the Trading and Markets areas such as registration, since limited experience indicates that the average person associated with options trading seems to be 'less fit' than the average person associated with the futures business. The staff has also assumed the continuation of close monitoring of new futures commission merchants for compliance with minimum capital requirements and in the establishment of proper procedures for segregating funds, etc."

The resource estimates, which we did not independently evaluate, were considered by CFTC staff to be minimal because, in their final form, they covered only trading in puts and

calls on the proposed COMEX (Commodity Exchange, Inc.) silver futures contract, puts and calls on the proposed AMEX (American Stock Exchange, Inc.) silver actuals, and continuation of foreign option sales as conducted under part A. It was recognized that, if CFTC were to approve a greater number and variety of options, corresponding adjustments would have to be made in the estimates.

Finally, the memorandum pointed out that

> "The resource estimates for regulation of options under the pilot program are not readily comparable to resources being expended in regulating futures trading. Managers are making estimates to effectively regulate and evaluate the options trading; if they were asked for similar estimates for regulating futures, the estimates would be expected to be considerably in excess of existing staff. However, this office has tried to ensure that option resource estimates do not include increased resources for non-option related activities."

Based on these restrictive assumptions, the Executive Director concluded that, for fiscal year 1979 (the first full year in which part B rules were expected to be in effect), resource requirements for options would amount to nearly 154 staff years and a total cost of a little over $4.6 million. These figures compare with 50.5 staff years and costs of $1,216,700 for all aspects of option regulation in fiscal year 1977. For fiscal year 1977 CFTC's total actual staff years amounted to 480 and its total expenditures to a little over $13 million.

The estimates received a mixed reception from the Commissioners. One Commissioner, noting that the estimates were based on the assumption that only two exchange options would be traded, concluded that approval of only four more options out of the many that had been proposed could result in CFTC spending as much as 75 percent of its resources on options alone. Another Commissioner was skeptical about the magnitude of the estimates, observing that the estimates included additional personnel who may not be necessary and that they assumed that the volume of option trading would equal the volume of futures transactions.

He said he believed that CFTC could devise ways to reduce the cost of regulating options in phase two, including requiring exchanges to shoulder a greater portion of the costs of monitoring and evaluating the pilot program, making

the program self-funding through imposition of a tax or transaction fee on each option transaction, 1/ and restricting the number and types of options which would be permitted.

In view of CFTC's experience with options to date, we believe that a conservative and cautious estimate of resource needs is preferable to one which is highly optimistic and based on "best case" assumptions about the effects of competition and the industry's willingness, determination, and ability to regulate itself. We recognize that the costs of regulation will depend in great part on the type of pilot program which ultimately emerges.

At the time we completed our review, CFTC was continuing its discussions with domestic exchanges which have proposed options and with foreign exchanges in an effort to devise mutually acceptable arrangements for protecting the public, protecting the markets, and balancing the interests of the industry and the Government. It had not, however, set forth clearly and in detail the criteria by which it proposed to evaluate the pilot program, particularly the criteria for determining what constitutes a valid economic justification for option trading.

INDUSTRY INFLUENCE IN THE FORMULATION OF OPTION POLICIES

Although the use of advisory committees is widespread throughout the Government as a means of drawing upon the reservoir of specialized knowledge and experience which often exists in the private sector and elsewhere and which may be of great value in formulating public policy, there is always the risk that a particular viewpoint (or set of viewpoints) may be more forcefully and articulately presented than others and may result in unduly and excessively influencing the outcome of policymaking deliberations. The members of the CFTC advisory group which dealt with the subject of options regulation were sincere, qualified, dedicated, and hardworking--indeed, by all accounts, this was one of the most diligent and hardworking of all the CFTC advisory panels. We are concerned, however, that in both the composition of the advisory group's membership and the nature of its recommendations, there is a suggestion of overrepresentation of the industry viewpoint.

1/ There are currently no Federal transactions fees levied on futures trading.

Of the seven members of the option subcommittee, six were clearly identifiable as being part of or having close ties to the commodity-trading industry, particularly to that part of the industry in the forefront of advocating commodity option trading and eager to see exchange trading of options begun at the earliest possible date. Five of the seven subcommittee members had ties to exchanges or firms that proposed to trade commodity options when CFTC implements its part B regulations and the option pilot program.

We are not alone in expressing this concern. One member of the full advisory committee told us that he was greatly disturbed by the number of people on the option subcommittee who had a vested interest in seeing options approved by CFTC. He said that, because of their alleged personal and professional stake in the outcome of CFTC's option policymaking, these persons should have disqualified themselves from the start.

Another member of the full advisory committee, who was quite critical of the thrust of the committee's recommendations on options, said that, in view of the composition of both the option subcommittee and the full advisory committee, it was inevitable that the group would come up with the recommendations that it did. He said that the advisory committee "became, as almost all advisory committees do, the vehicle to make the decision. It gave the Commission the opportunity to say later: 'We were only implementing the recommendations of our expert advisory panel.'"

CFTC's Vice Chairman, who chaired the advisory committee, also acknowledged certain misgivings about the composition of the advisory group in his preface to the advisory committee's report. He stated:

> "There are certain * * * issues raised by the use of Advisory Committees in government, particularly with respect to its regulatory function. One is the broad question of the public's perception of the Committee's membership; another is the Commission's use of the report. Although the Committee was constructed in such a way as to provide maximum expertise and balance, the fact remains that to obtain that expertise, there were more people from 'industry' than those purporting to be from the 'public', although the vast preponderance of members were not from the option industry _per se_.

There is, therefore, a delicate question of 'industry' influence in the Advisory Committee process that has to be acknowledged. Once acknowledged, however, this report provides sound information and policy recommendations upon which the Commission's independent assessments can be made."

Notwithstanding the Vice Chairman's caution that the Commissioners acknowledge the possibility of an excessive degree of industry influence, we are somewhat concerned about the close correlation which exists between the advisory committee's recommendations and the Commissioners' actions and decisions on options, especially on the pilot program. We are also troubled by the lack of evidence that the Commissioners have, since publication of the advisory committee report and its recommendations, made a concerted effort to garner the views of those who might feel differently about options or that it has seriously considered the expressed opinions of organizations, such as the National Planning Association, 1/ or individuals, such as the Attorney General of the State of New York, who have come forward on their own and advocated the banning of options.

As noted earlier in the 3 days of hearings on the proposed part B regulations in May 1977, not one non-industry group was represented. None of the witnesses expressed opposition to the trading of options generally or to the idea of a pilot program. In fact, the criticism that was expressed related to alleged restrictions and omissions in the proposed rules and resulted, eventually, in the Commissioners broadening those rules to include during the pilot program forms of options that they had originally been inclined to disallow.

Although we cannot say that CFTC's option policies would have turned out differently if other interests and viewpoints had been more fully represented, we believe that

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1/ The National Planning Association is an independent, nonprofit organization that conducts research and policy studies relating to the use of the productive resources of the United States. In a March 21, 1977, release, the Association recommended against option trading in futures markets, stating that it would amount to "another layer of speculation."

it is essential that a Federal agency, such as CFTC, which uses advisory committees to assist in formulating public policy, actively seek the broadest possible representation of interests and viewpoints and, having done so, that it consider thoroughly the sources of and possible motivation for the views which are offered. Such evaluation and weighing of advice is absolutely necessary if the responsible Federal officials are to avoid being unduly influenced by vested interests and limited viewpoints.

CFTC DECISION TO BAN THE SALE OF LONDON AND DEALER OPTIONS

On January 25, 1978, the CFTC Commissioners, acknowledging the growing and apparently insurmountable problems of fraud and enforcement in connection with the offer and sale of options, voted unanimously to suspend all trading in London and dealer options and instructed the staff to prepare a Federal Register Notice announcing and soliciting comment on this proposed suspension. The notice was published on February 6, 1978, (43 Fed. Reg. 4869) and provided for a comment period ending March 8, 1978. As part of the rulemaking procedure, CFTC also held a public hearing on the proposed suspension on February 28, 1978.

After a number of delays in taking a final vote on the proposal, the Commission voted unanimously on April 5, 1978, to publish a final Federal Register Notice implementing the suspension. This notice was published on April 17, 1978, (43 Fed. Reg. 16513). The notice provides that the suspension will become effective on June 1, 1978.

In commenting on and recommending the suspension at CFTC's February 28, 1978, public hearing, the Director of CFTC's Division of Enforcement observed:

> "It is apparent from the Division's experience that the vast majority of firms selling commodity options are engaging in fraudulent and unsound practices and are not complying with the interim regulations relating to the segregation of customer funds, minimum capital requirements and disclosures.
>
> "The Division's * * * investigations and litigation to date evidence that most firms selling commodity options have engaged or are presently engaged in organized boiler room-type sales campaigns * * *.

"Typically, inexperienced, untrained and frequently unregistered salespersons, using commercial mailing lists, long distance WATS telephone facilities, and canned sales pitches, contact as many as 100 prospects a day. The sales pitches, designed to appeal to greed and to convey a sense of urgency, vary little from firm to firm, and the same pitch is used for pitching any number of different commodities, simply by transposing key paragraphs. These pitches are bound with unsubstantiated and inherently fraudulent profit predictions and statements relating to exchange guarantees.

* * * * *

"Despite vigorous enforcement and the institution of numerous enforcement actions, it is apparent that violations of the regulations are pervasive and that they continue unabated.

* * * * *

"I think the experience that we are having with London commodity option firms * * * shows that the fraud, the misstatements, the misrepresentations are so pervasive that there is really no way at this time that enforcement action can adequately handle all of these firms.

* * * * *

"I think that we've seen, through the practices of the firms involved in the sale of London options to this date, an attitude of noncompliance; we have found an industry that is completely inundated with fraudulent sales techniques and activities. And I think that the public interest at this time cries out for someone to take hold of this and put a stop to it. I think that the only proper way that we can put a stop to it at this point in time is through [a] suspension."

New York's Assistant Attorney General in Charge of the Bureau of Securities, testifying on behalf of that State's Attorney General, said that his office had been in favor of banning the trading of London and dealer options 2 years ago and was now even more in favor of such action.

He said that:

> "In the many cases that we have dealt with in this field, we are unaware of any customers who made significant money in commodity options transactions. They always ended up with losses, with the rare exception in one case where preference was given to friends and relatives of certain principals and salespersons to withdraw credit balances before the inevitable bankruptcy."

He also urged that CFTC not proceed with its proposed pilot program or that it do so only with extreme caution. He said that his office believed that, aside from problems that might be created by inadequate surveillance by the exchanges, "the unscrupulous will somehow inevitably turn this field into another disaster for investors."

An official representing Nebraska's Bureau of Securities said his agency had received numerous complaints about the sale of options to State residents and that he believed that such sales to the public had no legitimate purposes.

An attorney representing the National Association of Commodity Option Dealers maintained that the London option market was important to U.S. investors because it provided a broader base for investment opportunity. He said that even a temporary suspension of London option trading would punish the ethical option firms for the deeds of a few. Other industry witnesses also opposed the proposed suspension saying, among other things, that

- --the ban would be the height of Government overregulation and hurt the chances of a successful domestic option program;
- --CFTC should not ban options because of its own inability to regulate them;
- --tools are available to CFTC to properly regulate the industry; all that is needed is capable, sensible people to use the tools;
- --the ban would not affect the unscrupulous operators because they had moved on to other schemes; and
- --the problem was not with London options but with the U.S. retailers of them.

Some of the industry witnesses said that CFTC and the industry should cooperate in developing a regulatory framework to fully develop the potential of options while protecting the public, instead of banning option sales and putting the industry out of business. An attorney for one of the London exchanges said that the exchange, although disappointed by the proposal, was sympathetic to CFTC's dilemma and that he hoped CFTC would periodically review the suspension while the proposed domestic option pilot program was put into effect.

CONCLUSIONS

Under part A of its option regulation plan, which has lasted far longer than originally envisioned, CFTC has been unable to effectively regulate option sales. At the same time, its attempts to develop and enforce option regulations and to prevent fraudulent and illegal activity in option sales have constituted a heavy drain on CFTC resources and have seriously interfered with its ability to deal with its more basic responsibility for regulating commodity futures.

Because the 1974 act granted CFTC exclusive jurisdiction over options--effectively preempting the States' and SEC's regulatory activities in this area--CFTC should have carefully assessed whether it had the necessary resources to properly regulate options. It should also have more carefully assessed the economic purpose and public interest to be served by permitting the sale of options. Such assessments, in our view, would have pointed up the need for a cautious go-slow attitude toward options.

CFTC, which acted to assert its exclusive jurisdiction over options even before it issued its part A regulations late in 1976, was in no position to match the customer protection and enforcement capability of SEC and the States' securities authorities. Moreover, CFTC had been warned of this in July 1976 by a public member of its advisory committee which had considered the question of regulating options.

Another factor which, in our opinion, called for delay in implementing option regulations was the relative lack of experience of the new agency as well as the very considerable amount of unfinished work which remained to be done in meeting the requirements of the act and in fulfilling its considerably expanded mandate for regulating futures markets.

Because it was seriously understaffed and unprepared to compel strict compliance with any of its option rules, CFTC was never able to make of its part A registration, segregation, recordkeeping, disclosure, and antifraud rules the meaningful customer protections they might otherwise have been. A number of option firms, among them some of the largest, operated in open defiance of CFTC rules, including those requiring registration of principals and representatives of FCMs, segregation of customer funds, and maintenance of minimum levels of capital.

Wide agreement now exists among CFTC's Commissioners and staff that early action to temporarily ban the retail sale of options would have had few adverse consequences because it is believed that relatively few firms were in the business of selling options at the time CFTC began promulgating option rules. CFTC's decision to regulate rather than ban options attracted customer interest as well as the participation of allegedly fraudulent operators who saw a regulatory gap offering the potential for quick profits through high-pressure, boilerroom-type operations.

Having decided to regulate options and having implemented interim option rules in late 1976 and early 1977, CFTC nevertheless did not have to adhere to this course. Once it found itself unable to enforce its regulations, it could have reversed its position and placed a moratorium on option sales.

Only recently, however, in the face of continuing revelations of alleged fraud and customer abuse as well as intense criticism from State officials who claim that it is not adequately protecting their citizens, has CFTC concluded that it will have to ban the sale of foreign and dealer options after all and published regulations to that effect. The agency still intends, nonetheless, to go ahead with plans for implementing the part B pilot program to permit trading of options on domestic exchanges. It has requested a supplemental appropriation for this purpose for fiscal year 1978 as well as a budget increase for fiscal year 1979.

Although an option pilot test may in time be appropriate, we believe that implementation of such a program is inadvisable at this time. Our review has convinced us that CFTC and the futures industry both have some distance to go before the quality of regulation envisioned by the Congress--both industry self-regulation and direct regulation by CFTC--becomes a reality. Until greater progress is made toward this goal, introduction of option trading on domestic exchanges seems to us to be unwarranted and premature. Instead of options, CFTC should devote all of its resources, including

any supplemental appropriations, to improving the regulation of futures trading.

RECOMMENDATIONS TO THE CHAIRMAN, CFTC

Because many areas basic to the effectiveness of futures regulation are greatly in need of improvement and any CFTC attempts to regulate options can be expected to continue to drain its resources and distract it from its primary duties, we recommend that:

--The regulations to suspend the sale in the United States of foreign and dealer options be implemented according to plan and remain in effect until CFTC has demonstrated to the appropriate congressional committees that it has improved its effectiveness in regulating the futures industry and that it has, or can be expected to have available, the means and resources needed both to maintain effective regulation of the futures industry and to undertake effective regulation of option sales.

--Implementation of a pilot program to permit trading of options on domestic exchanges be deferred also until the above demonstrations can be made.

As conditions for reinstatement of options trading at some future time, we recommend that CFTC:

--After consultation with industry and other interested parties, establish qualification standards to be met by firms and individuals applying for registration (or reregistration) as option dealers and associated persons. Such standards might include a requirement that any individual seeking registration pass an appropriate written test demonstrating knowledge of the commodity markets and their operations.

--Register (or reregister) as option dealers and associated persons only those individual firms and salespersons that, on a case-by-case basis, satisfy CFTC that they have in place such control and customer protection mechanisms as CFTC may require.

--Develop an options reporting system designed to provide the agency with essential data on volume of option trading, nature and number of market participants, commercial utilization of options, exercise of options, markups, profitability, and such other information as CFTC may require to adequately monitor option trading, enforce its rules and make necessary

determinations relating to the public interest and economic purpose aspects of option trading. In this regard, it may be desirable to impose as a requirement for registration as an options FCM the signing of a waiver authorizing CFTC to obtain from foreign exchanges any information on options transactions which these exchanges may possess and which CFTC may need for effective regulation. As a corollary, CFTC might allow U.S. option dealers to purchase options only from those foreign exchanges and exchange members which agree, in writing, to honor such waivers and cooperate fully in providing the information CFTC requires.

We recommend also that, before any pilot test of option trading on domestic exchanges is initiated, CFTC:

--Clearly set forth its test hypothesis(es) and specify and define the criteria it will use as well as the data it will need to evaluate the results of the pilot program (i.e., appraise its success or failure). Such evaluation and appraisal would include determination of whether or not option trading satisfies a valid economic purpose and is in the public interest.

--Carefully evaluate the rules, rule enforcement, and self-regulatory performance of exchanges that propose to trade options and condition approval of option trading by such exchanges on sustained high levels of compliance with CFTC standards and requirements.

--Undertake to perform cost/benefit analysis of the option pilot program and study ways of shifting the cost of regulating and evaluating the program to those who stand to benefit most directly. This might be accomplished through the use of transaction fees or some similar mechanism.

--Clearly and unequivocally state, so as to minimize the possibilities for misunderstanding or for subsequent legal challenge, that the pilot program is only a test program, a program of limited scope and limited duration, designed to obtain answers to specific questions concerning the trading of options. Exchanges, commission houses and others who choose to invest in option trading must do so in full recognition of the experimental, exploratory nature of the pilot program and must not be led to believe that such a program necessarily represents the advent of a new era of option trading in this country.

--Consider how the occasion of an option pilot test might also be utilized to provide answers to a number of unanswered questions and unaddressed issues in the broad area of futures regulation, including the need for and desirability of dual trading, the feasibility of full timing of transactions, and the computerization of trading activity. In view of the fact that the pilot program involves the creation of an activity de novo (with all that this implies in terms of freedom to innovate and experiment) CFTC is in a favorable position to structure the pilot program in such a way as to greatly advance its regulatory objectives, while at the same time obtaining answers to the basic questions for which the program is designed.

RECOMMENDATIONS TO THE CONGRESS

In order to provide enhanced customer protection in connection with the sale and trading of options (particulaly off-exchange options) and to take advantage of the enforcement experience and capability already in existence at the State level, we recommend that the Congress amend the Commodity Exchange Act to permit any State securities commission or other State authority to investigate and prosecute options fraud and other forms of commodity-related fraud under State blue sky or other antifraud statutes insofar as such State agency or authority does not take action which conflicts with the Commodity Exchange Act or the rules and regulations thereunder.

In order to support the Commission's recent actions to put a halt to illegal and abusive practices in the sale of options and to forestall legal challenges which might mean protracted delays in implementing the Commission's proposed suspension of option trading, we recommend that the Congress enact legislation to suspend the sale of options until such time as it can be shown, with reasonable certainty, that such trading can be conducted in a satisfactorily regulated manner with necessary customer protections and safeguards. Such legislation would usefully include conditions and criteria for later resumption of option trading, including a requirement that the Commission demonstrate to the appropriate congressional committees that it has made specific improvements in its planning, management, and regulation of the futures industry; that it has the necessary staff resources and expertise to undertake regulation of option trading; and that both industry self-regulatory procedures and Commission monitoring, surveillance, and enforcement capabilities are such as to ensure the necessary customer and market protections and foster public confidence in the integrity of option trading.

CHAPTER 13

ADDITIONAL EMPHASIS ON PLANNING NEEDED TO IMPROVE EFFECTIVENESS AND EFFICIENCY OF CFTC OPERATIONS

The Commodity Futures Trading Commission has been slow to recognize the need for planning and slow to implement a formalized planning process as a basic management function and decision tool. The result of this failure to give early and sufficient emphasis to planning is that CFTC has been less than optimally effective and efficient in the use of its resources and in the fulfillment of its regulatory responsibilities under the act as described in the preceding chapters of this report. In the absence of a strong commitment to planning, including adequate control mechanisms to ensure conformity between established goals, objectives, and priorities and actual resource expenditures, the agency's efforts have often lacked focus and direction. CFTC's regulatory posture has been overly _ad hoc_ and reactive as opposed to anticipatory and preventative.

CFTC PLANNING EFFORTS

During calendar year 1975, the year of its creation, CFTC performed little forward planning. For the most part, its efforts were directed to hiring staff, obtaining office space, and performing all the other administrative functions attendant to establishing a new agency.

CFTC first turned its attention to planning early in calendar year 1976. The bulk of "planning" activity during 1976 consisted of staff efforts, particularly on the part of the staff of the Office of Policy and Planning, to win Commission acceptance of the need for planning and to involve the Commissioners in thinking about the mission of CFTC, deciding what they wanted CFTC to be, and agreeing on what the agency should try to achieve through its regulatory actions. A first, tentative statement of Commission goals is found in a June 2, 1976, memorandum to the Commission from the head of the Office of Policy and Planning.

This memorandum and others make clear, however, that the goals were rather hastily prepared and represented more a staff effort to piece together and interpret the views of individual Commissioners than a carefully considered statement of Commission goals. We were told by Commission staff that this statement of goals had been prepared more because the Commissioners were unable to effectively answer certain questions posed in the course of congressional hearings in December 1975 and March 1976 than because of support for

planning at the Commission level. The four goals set forth in the June 2, 1976, memorandum, which continued to be the stated goals of the Commission throughout 1976 and most of 1977 despite the "rather de facto fashion" in which they had been developed, were to:

--Ensure the integrity of futures markets.

--Further the economic utility of futures markets.

--Encourage the improved efficiency of futures market operations.

--Assist in expanding the level of public knowledge and appreciation of futures markets.

In addition to these goals, the June 2, 1976, memorandum contained a number of questions to the Commission which we find quite significant, coming as they do, more than a year after the creation of CFTC, for example:

--"What is the Commission's view regarding proper balance between exchange and Commission responsibilities?

--"In what areas is self-regulation appropriate?

--"Where should we reduce regulatory burden?

--"Where is expansion of public knowledge or research most needed?"

On June 24, 1976, the Commission held a fiscal year 1977 planning meeting at which goals, philosophy, objectives, and priorities for fiscal year 1977, as well as specific program issues, were discussed. A July 8, 1976, memorandum from the Office of Policy and Planning summarized the June 24 meeting and set forth the priorities agreed on.

Our review of the major points of the June 24, 1976, planning discussion as well as other fiscal year 1977 planning documents prepared by the staff indicated that a number of areas identified as priority objectives for fiscal year 1977 in fact witnessed little or no progress during that period. Examples of these include the following:

--Dual trading, where the basic questions remain unanswered. (See ch. 5.)

--Training, experience, and testing requirements for futures professionals. (See ch. 6.)

--Development of a CFTC research agenda and program. (See pp. 221.)

--Improvement of CFTC and exchange audit function. (See ch. 7.)

--Development of a commodity specialist capability. (See pp. 225.)

Throughout most of fiscal year 1977 CFTC conducted planning on a month-to-month basis. Late in the year, however, a yearly Commission calendar was established. As a result, CFTC's planning focus changed from a month-to-month posture to an annual one. Although this still represents relatively short-term planning, it is an improvement over prior planning efforts.

Despite the improvements made, CFTC still has a long way to go before it will have a planning process in which agreed on short- and long-range goals are articulated, objectives established and prioritized, and accomplishments measured against that which was intended. Progress has been made toward establishment of goals, objectives, and priorities; however, little has been done to establish an accountability system whereby CFTC can assure adherence to its goals, objectives, and priorities. Although such a system was designed and approved by the Chairman in September 1977, we have since been informed that the Chairman has announced that the system will not be implemented. We can only regard this news as an indication of continued insensitivity on the part of the Commission to the need to better plan, direct, and monitor staff effort to ensure that CFTC resources expenditures truly serve the goals and objectives established by the Commission and that they do so in the most efficient and effective manner possible.

CFTC's planning efforts are discussed in greater detail in appendix VII.

REASONS FOR POOR PLANNING BY CFTC

In our discussions with Commissioners and with CFTC staff the following factors were most frequently cited to explain why CFTC at an early date did not commit itself to a meaningful planning process:

--There was little active support for and interest in planning on the part of the Commissioners.

--Statutory mandates and deadlines contributed toward formation of an ad hoc, crisis management orientation which became ingrained.

--Lack of staff expertise in certain areas as well as lack of certain basic information required for decisionmaking led to some recognizedly important tasks being postponed in favor of more easily accomplished work. Also, in the absence of top down priority setting by the Commission, staff was often in the position of establishing de facto priorities for CFTC.

--There was insufficient qualified staff to adequately perform formal planning.

--Certain Commissioners had projects and interests which they pursued and promoted without regard to other competing demands on Commission attention and resources and without consideration of the relevance of these projects to the Commission's overall mission.

--A reluctance on the part of the Commission to face difficult, potentially devisive questions and to fully air certain important issues on which there may be disagreement among the Commissioners.

Little support for and interest in planning by the Commissioners

This was a frequently cited reason for inadequate planning, one given both by high-ranking Commission staff members and by two of the Commissioners themselves. One Commissioner with whom we spoke said that the Commission had been "very negligent" about doing basic planning, setting objectives, scheduling work, and generally being attentive to what the staff was doing. He said that he had argued very early on that the Commission needed to do better work in planning and setting priorities, but his suggestion was not accepted. He said that beginning in the spring of 1977 the Commission began to make assessments of its ongoing and scheduled activities as part of an effort to improve the overall budgetary process. Short-term priority setting evolved into monthly and quarterly scheduling of Commission agendas. In his opinion, this was a needed improvement and one that the Commission should have been doing much earlier. Another Commissioner was even more critical in his assessment of the Commission's planning performance. He stated that the Commission does virtually no planning, that there is a significant void in this area. He agreed that planning

is an important management function and felt that the Commission should have planning meetings, something which, he said, it did not have at the time he made his statement to us in June 1977.

According to a high-ranking staff member well acquainted with the Commission's operations, policy setting and planning are clearly Commission functions, and the Commission needs to assume its responsibilities in this area. Another staff member familiar with the Commission's decisionmaking processes observed that planning was something the Commission was never able to face up to in the first 2 years of its existence. In this person's view, it was difficult to shift from a crisis management orientation to a planned, deliberate setting of goals, objectives, and priorities because there was not much support for planning, particularly for long-range planning, from the Commission's Chairman. To get a planning function going, we were told, it takes support from the top and such support was not forthcoming.

Statutory mandates contributed to an ad hoc, crisis management orientation on the part of the Commission and staff

The Commission has not had a formal, operational planning function during much of its organizational life. The absence of such an activity is generally conceded by Commissioners and staff alike. Where people seem to disagree is with regard to the reasons for this lack of planning and also with regard to the need for planning in a situation where a large number of congressionally directed activities have been laid out in the legislation which created the agency.

Several of the Commissioners and Commission staff members with whom we spoke attributed the Commission's inadequate planning to the need to first perform the many legislatively mandated tasks contained in the CFTC Act and to "write the book on regulation," i.e., develop a basic, comprehensive set of rules governing the conduct and responsibilities of industry participants.

Typical of this viewpoint are the comments of one Commissioner who told us that he had performed his own inventory and analysis of the congressionally mandated responsibilities of the Commission and of the resources that had been required to meet these responsibilities and concluded that they had taken up fully 90 to 95 percent of the Commission's resources. This 90 to 95 percent was, in his view, beyond the Commission's ability to plan.

A former member of the Commission staff told us that because the Commissioners felt under [illegible]ssure to make a lot of important decisions within a man[illegible] time period, a crisis atmosphere was created which [illegible] it very difficult to move from an ad hoc, reactive stance into a planned operation. This staffer felt that the Congress had done CFTC a great disservice by mandating deadlines for the accomplishment of certain tasks. Acknowledging that a great deal of flexibility still remained for the Commission in deciding how to go about performing the mandated tasks and even in obtaining extensions of the congressionally imposed deadlines, if it felt this was necessary or prudent, this person explained that the Commission was reluctant to go to the Congress and ask for more time because it did not want to admit that it could not do everything.

This person cited the Commission's handling of the commodity options question as an example of how the Commission moved too fast in one of its mandated decision areas. Maintaining that it is clear from a reading of the act that the Commission's primary responsibility is to the futures markets, this staff person expressed the view that the Commission should not have gotten involved in options until it had a better handle on understanding and regulating the futures markets. It was not required to accord options the high priority it has or to make the decisions it has.

Another Commission staff member well acquainted with the Commission's decisionmaking and work scheduling processes stated that Commission policy is established entirely on an unplanned, ad hoc basis. He said that the effect of this lack of planning is that the Commission has spent over 2 years accomplishing work that had been dictated by legislation and by circumstances. He added that he could not look ahead and predict what the Commission will be doing in the future.

De facto priorities set by staff

One high-level Commission staff member told us that in the absence of Commission guidance to the staff, in the form of long-range planning and clearly formulated objectives and priorities, the staff was itself setting priorities and determining what was important to work on. Often the Commission did not even have a clear idea of what the staff was working on until proposed regulations were sent up for the Commission's consideration. The agenda for the Commission was, in effect, determined by what the staff had ready for Commission consideration and discussion. For a long time one operating division head saw the writing of regulations

as the principal activity of the Commission and, as a result, "writing the rule book on regulation" came to be one of the Commission's top de facto priorities.

Another reported consequence of the Commission's failure to plan, to establish and prioritize objectives, and to provide direction from the top down was that a shortage of staff expertise as well as a lack of certain basic information needed for decisionmaking purposes often led to recognizedly important tasks being postponed or glossed over in favor of more easily accomplished work.

Insufficient qualified planning staff

The former head of CFTC's Office of Planning and Policy Review, who had been with CFTC from its inception until April 1977, informed us that the principal reason her office did not do more long-range planning was that it had only three professionals and they were almost totally absorbed in the office's primary function of policy analysis. She said that her staff tried to get objectives established so that it might be possible to assess outcomes and cost effectiveness of program activities. To accomplish this, objectives needed to be established by organizational units. This, in turn, necessitated working closely with those organizational units, since most staff members seemed to have little idea of how to go about planning.

She agreed that what was done by her office in the way of planning was limited, citing specifically some memoranda to the Commission on priority setting and scheduling, and some short term planning via the budgetary process. She felt, however, that her office did initiate the beginning of a long term planning cycle that the Office of Executive Director was to take over after her departure in April 1977.

We questioned the former Executive Director about CFTC planning shortly after the planning function had been formally transferred from the Office of Policy and Planning to his office in May 1977. He told us that his intention was to formalize and considerably strengthen planning at the agency by hiring two full-time professional planners who would be placed in the Office of Management and Finance under his overall authority.

He stated that two planning position openings, a GS-14 Senior Planning Officer and a GS-12/13 Planning Officer, had been announced in mid-May 1977. Our subsequent inquiries revealed, however, that although two positions had in fact been advertised and had elicited a number of internal and

external applications, the positions were never filled. Instead, 6 months later in late November 1977, CFTC decided to provisionally assign to the planning function an employee who had previously worked in the audit area in CFTC's Trading and Markets Division. We were told that the individual in question, a former Commodity Exchange Authority employee, would be able to bring some program knowledge and experience to the Office of Management and Finance which was felt to be lacking in that office.

Projects of particular interest to certain Commissioners

Frequently cited by staff and Commissioners alike as an obstacle to adoption of a planned and disciplined approach to resource use at CFTC was the practice of certain Commissioners of calling on the staff to undertake work related to their own particular interests and concerns without clearing the requests with appropriate officials. In some instances, such requests would have no particular relevance to more important work the Commission had previously agreed to emphasize; in other instances the requests might lead to duplication of work already underway elsewhere in the agency.

In many cases, we were told, such requests would entail the interruption and delay of other inherently more important work, often without the knowledge of the Executive Director, the operating division heads, or the other Commissioners. Commodity options-related work requested of the staff by one Commissioner was a frequently cited example of work that had been requested and undertaken without approval of the full Commission. Other examples included requests by a Commissioner for development of information to be used in speeches, a duplicative market surveillance program maintained by one Commissioner who wanted to learn more about this activity, and assorted special requests for information which developed into significant staff undertakings, perhaps contrary to the expectation and intention of the particular Commissioners who had made what they thought were simple requests.

Most of those with whom we discussed this subject said that the situation had improved somewhat in recent months as the individual Commissioners have become aware of some of the potentially disruptive consequences of their requests for special staff work and have been more careful in making and framing such requests and in clearing them through appropriate channels to ensure that work is not undertaken without the knowledge of managers and that it does not duplicate or interfere with other work being done by the staff.

Reluctance to adequately confront difficult and important decisions

In our discussions with Commissioners and staff, another criticism which was frequently expressed in one form or another was that the Commissioners have failed to confront squarely, and to discuss fully and completely, important issues on which there are significant differences of opinion among them. This has resulted, we were told, in a lack of explicit and well-considered policy, in vague and ambiguous guidance to the staff, and in the ability of some determined and persistent parties to gain approval of initiatives for which there was little solid support but for which the opposition was disorganized. It seems also to have resulted in the Commission not focusing early and in a serious manner on the nature of its basic mission and responsibilities and on the fixing of goals, objectives, and priorities which would have guided and structured its endeavors in the formative years of CFTC's existence.

One Commissioner told us that in terms of setting priorities there was a real reluctance on the part of the Commission to come to grips with issues, because it would have required tradeoffs and, being more explicit, definite, and up front, it would have required making much more overt the different points of view of the Commissioners. There is a natural tendency, he observed, to avoid that kind of thing.

Another Commissioner noted that the Commission has taken very few formal votes on the matters which have come before it for consideration. Normally, he said, the Chairman takes the approach of declaring that the matter is "passed without objection." Attorneys in CFTC's Office of General Counsel confirmed that votes are seldom taken.

One result of the Commission's failure to openly debate and fully explore, discuss, and resolve issues relating to its regulatory mission and actions is that the direction and guidance given to staff is often unclear or ambiguous. The Commission's "marching orders" are vague said one senior CFTC attorney; "We often do not know what the Commission consensus is and what our specific instructions are."

NEGLECTED PRIORITIES: IMPORTANT AREAS WHICH HAVE SUFFERED BECAUSE OF POOR PLANNING

Given CFTC's limited staff and budget, the relative inexperience of much of its personnel, and the fact that the new agency was charged with extending Federal regulation over large segments of the commodity futures industry which

had never been adequately regulated before, it should be apparent that a carefully planned regulatory strategy was needed to aid in the identification and ranking of regulatory objectives and to ensure optimum effectiveness and efficiency in the utilization of scarce resources in pursuit of these objectives.

With this in mind, as well as the generally accepted view that CFTC's responsibility is first and foremost to improve the understanding, operation, and regulation of futures markets, we have identified a number of areas which, in our view as well as the views of various CFTC Commissioners and staff members, have received inadequate or improper emphasis by the Commission. Some of these subjects and activities are specifically mentioned and "mandated" in the CFTC Act. Others are implicit in the broad legislative requirements that CFTC, among other things, monitor and enforce exchange self-regulation, designate contract markets, and prevent price manipulation. All are vital, in our opinion, to proper execution of the agency's regulatory responsibilities.

Several of the subjects or activities are discussed in separate chapters in this report and not repeated here. These are:

--Exchange rule enforcement reviews. (See ch. 4.)

--Dual trading and trade practice investigations. (See ch. 5.)

--Contract market designation. (See ch. 3.)

--Market surveillance (See ch. 8.)

The remaining neglected subjects or activities which are discussed in this chapter include:

--Development of a research program.

--Education--internal and external.

--Development of a commodity specialist capability.

Research

Despite the long history of commodity futures trading, there remain many basic unanswered questions concerning the use of futures markets by various categories of market participants, the specific economic contributions of futures trading, the effects of futures trading on the variability

and general level of commodity prices, the competitive structure of futures markets, and a host of other important topics. Equally significant, in terms of public policy and Government regulation of futures markets, is the general lack of information needed to resolve certain basic regulatory questions, such as whether or not dual trading by brokers should be permitted, the economic and public policy implications of tax trading (i.e., use of futures trading for purposes of tax avoidance and tax deferral), the incidence of wash trading and fictitious trades and the means of detecting and preventing these abuses, development of criteria for assessing degree of market concentration and control, and in general, development of better analytical tools and measures with which to monitor the state of the markets and assess the need for regulatory action or intervention.

CFTC is directed by section 18 of the act to establish a research program as part of its ongoing operations. In addition, in our 1975 report we recommended that the Chairman establish a formal research program. Furthermore, in staff documents prepared by the Office of Chief Economist, as well as in statements made to us by Commissioners and senior staff members, emphasis has been placed on the importance of developing a long term, basic research function within CFTC. We have been told that research should be an ongoing activity insulated from the day-to-day pressures and concerns of the agency and free to focus on questions of fundamental importance to the understanding, use, and regulation of futures markets, questions which necessarily have a longer term payoff than do the ad hoc problems which arise in the daily course of Commission operations. However, notwithstanding these expressions of support for research, the fact of the matter is that the research function at CFTC has generally lacked resources and has been almost entirely ad hoc, i.e., directed toward analysis of problems currently confronting the Commission. The Commission's chief economist acknowledged this in a paper presented in June 1976 to a Chicago Board of Trade-sponsored seminar on "Researchable Issues in Commodity Futures Trading," in which he said:

> "Because of the deadlines associated with a number of issues identified in the CFTC Act of 1974, most of the research conducted so far has been of a short term nature and addressed to such issues as: (a) contract terms and conditions; (b) speculative limits; (c) delivery points; (d) commodity options; (e) dual trading; and (f) price manipulation cases."

Discussions held with Commissioners and senior staff during the course of our review as well as examination of documents provided by the Office of Chief Economist indicate that nearly 2 years after the chief economist's comments were made, CFTC's research efforts continue to exhibit an *ad hoc* orientation.

External education

As in the case of research, the Commission is directed by section 18 of the act to develop educational programs to further the general purposes of the act. The Commission has, however, devoted relatively little attention or resources to this area. Even more important, the Commission has not developed a strategy and a guiding plan to ensure that those resource investments which have been made contribute in a clear, coherent, and effective manner toward the realization of specific, agreed-on goals, objectives and priorities. Such limited and tentative initiatives as have been taken in the education area have been taken in a planning vacuum. The approach to education has, as a result, been piecemeal and haphazard.

Our review showed that as early as October 1975 the chief economist was urging the Commission to develop a consensus view of what it wanted and expected of a CFTC educational program. More than a year later, in March 1977, the Commission's Executive Director was still calling on the Commission to provide basic policy guidance and direction for CFTC's educational and training efforts. In a March 2, 1977, memorandum to the Commission, the Executive Director said that the purpose of a Commission meeting scheduled for March 8, 1977, was to determine Commission education policy. In the memorandum the Executive Director posed a number of questions to the Commission. He stated that the Commission's responses would provide the guidelines needed to develop a specific education program for Commission approval.

The questions posed were rather basic, and it is somewhat surprising to observe that more than 1 year after the Executive Director's March 2, 1977, memorandum the Commission has still to provide answers to most of the questions. With the departure of the Commission's Executive Director in August 1977, CFTC's external educational efforts appear to have been relegated to a semipermanent organizational limbo. CFTC's Director of Education told us in December 1977 that his office had received no guidance on an external education program. He did not know what, if any, educational planning and program development efforts might be underway elsewhere in CFTC. A Commissioner with whom we discussed CFTC's educational activities agreed that with respect to education

there had been a lack of priority and policy guidance on the part of the Commission. He felt that the main problem was a lack of agreement within the Commission as to what education really means and the role which CFTC should play in education.

Internal education

With regard to internal education activities, i.e., the training of CFTC staff in general commodity futures-related topics and in specialized areas relating to their specific work responsibilities, the progress registered by CFTC has been somewhat better than that noted in external education. Even here, however, development of a comprehensive and coherent approach has come about very slowly and belatedly. Moreover, much remains to be done in order to provide for the diverse training needs of the various elements of CFTC staff in the regions and in headquarters.

Although the need for internal education was discussed in staff memoranda to the Commission in October and December 1975, even minimal efforts in this area were not begun until late 1976 and early 1977. As a result of the Executive Director's March 2, 1977, memorandum to the Commission stressing the need for policy guidance regarding development of an education program, the Executive Director was able to secure from the Commission a measure of agreement and support for priority attention to internal education needs.

During the spring and summer of 1977 the Office of Executive Director undertook a number of steps designed to make an internal education program operational. In March 1977 the internal education function was formally assigned to the Office of Personnel, and one of two employees in the Office of Education was reassigned to Personnel to assist the training officer in developing a staff training program. A task force of eight CFTC employees was also designated to serve as advisors in this effort. Work was immediately begun on development of two general training courses.

This first phase of course development was completed in mid-1977 and the two training courses were offered for the first time in July 1977. As of December 31, 1977, a total of 41 employees had participated in one course and 36 in the other. All of the training was confined to "recent or new hires," the group which had been identified as the highest priority candidates for training. The other groups ultimately targeted for such training included "other professionals" and "support staff."

Although a welcome sign of progress, this is only a very tentative beginning toward fulfillment of the staff training needs of CFTC. It does not begin to address the need for indepth training concerning specific aspects of commodity futures trading, nor does it provide specialized training in the particular functional skills needed by various categories of CFTC professional employees. Such training is, however, planned for later in 1978.

Development of a commodity specialist capability

Virtually everyone we spoke to at CFTC on the subject of a commodity specialist capability agreed that it is of vital importance for the agency to acquire such expertise in order to understand what is happening with respect to the various commodities under its jurisdiction and to be able to act in a timely manner when market conditions call for a regulatory response or initiative. According to an operations plan prepared by the previous Executive Director, a commodity specialist program is needed to ensure specific and general market expertise, not only for CFTC's surveillance and analysis functions but also for the agency's public education program.

One Commissioner told us that to really understand commodity trading and do effective market surveillance one needs to thoroughly understand the cash market. He admitted that CFTC does not presently have commodity specialist knowledge and that it is a serious problem.

In view of the many statements made by Commissioners and staff stressing the importance of a commodity specialist capability, we are somewhat puzzled by the apparent lack of attention which has been devoted to developing or acquiring such expertise. In conversations with representatives of the Office of Chief Economist, Office of Executive Director, and Office of Personnel, we were told that CFTC does not presently possess the sort of expert commodity knowledge which is generally understood by the term "commodity specialist capability" and that it is doing little to bring such a capability into existence. Representatives of the Office of Personnel told us that, to the best of their knowledge, no one in that office has ever even been asked to prepare a position description for a commodity specialist classification or to attempt to assess what the market for such expert knowledge might require in terms of grade and compensation.

A number of those with whom we spoke on the subject of commodity specialists expressed the view that the

biggest obstacles to acquiring and maintaining such expertise in CFTC are the civil service grade and wage scales that could be provided to attract and retain talent for which CFTC would be in direct competition with the higher paying private sector. It may well be that position classifications and related grade and wage scales for CFTC commodity specialists would not be competitive with private industry, but we have seen no evidence that CFTC has done any analysis which would support this conclusion. Indeed, as already noted, we have been told that it has not performed any such evaluation.

One representative of the Office of Personnel commented that in his own experience at CFTC the subject of commodity specialists has not typically been discussed in terms of grade and salary levels. It has been discussed, rather, in terms of whether CFTC has or would want to have in Washington headquarters a staff large enough to include commodity expertise. He felt that it would require some degree of commitment on the part of the Commission to set aside enough slots for these positions, and he added that there is no evidence that such a commitment has been made.

CONCLUSIONS

The effectiveness of CFTC in the first 3 years of its existence has been less than what might reasonably have been hoped for and expected of the agency created by the Congress to improve the quality and comprehensiveness of Federal regulation of the futures industry. The shortcomings and weaknesses of CFTC are traceable in large degree to the failure of the Commission to provide effective planning, direction, and control of the agency's staff and to the failure to respond in an appropriate manner to the agency's internal organizational needs as well as to the external challenges posed by the agency's regulatory environment.

The most serious failure of the Commission--and one which has had far-reaching repercussions--has undoubtedly been its failure to undertake an early and sufficient commitment to a strong planning process as the foundation for all its regulatory initiatives and resource expenditures. The Commission has been reluctant to debate the hard issues which potentially divide it but which must be addressed and resolved if the agency is to have a guiding mission and coherent regulatory philosophy. The Commissioners have been slow to accept the need to establish goals and objectives and to order and continually reevaluate priorities to ensure the optimal utilization of limited resources. Having established goals and objectives and having set priorities, the Commissioners have not been guided by them and have not

established procedures which would ensure that the staff would follow them.

The chief result of the Commission's failure to commit itself to a meaningful planning process is that CFTC's regulatory posture has been essentially reactive rather than purposive; the agency has spent a great deal of time and effort in responding to ad hoc situations and in crisis management. It has become embroiled in a costly and only partly successful effort to contain the problem of fraud in the sale of foreign commodity options--at the expense of needed regulation in areas of far greater intrinsic importance. The Commission's approach to regulation, in the absence of effective planning and policy development procedures, has been to a great extent unfocused, undirected, and inefficient. A number of very important functions, many of them fundamental to any effective scheme of futures regulation are seriously in need of improvement. Yet these functions have received insufficient attention as a result of the Commission's failure to assign to them the priority which they deserve. Some important areas which suffered neglect as a result of the Commission's failure to plan properly include:

--Development of a research program to perform needed long term research.

--Creation of a commodity specialist capability to enhance the Commission's ability to understand what is happening with respect to the various commodity markets under its jurisdiction and to improve its ability to act in a timely manner when market conditions call for a regulatory response.

--Development of an internal and external education program.

RECOMMENDATIONS TO THE CHAIRMAN, CFTC

To improve CFTC's planning posture the Chairman should assure that:

--The Commission gives its full support and commitment to establishment of planning as a basic and integral part of the management process at CFTC.

--The Commission is particularly attentive to the need for long-range strategic planning as a means of identifying, evaluating, and anticipating to the maximum extent possible the challenges which the future may

hold for CFTC and as a means of preparing itself to meet those challenges in the most effective manner.

--The Commission institutes accountability procedures designed to ensure adherence to its plans.

--The Commission takes measures to ensure that the following "neglected priorities" receive attention and support commensurate with their importance to the effectiveness of the Commission's overall regulatory effort.

--Research--The Commission should give high priority to the development of a basic, long-term research capability within CFTC.

--Commodity specialist capability--The Commission should undertake to improve the ability to monitor, understand, and evaluate the basic economic and commercial characteristics of commodities under its jurisdiction. It needs to develop among its staff a commodity specialist capability which would include a broad knowledge of cash and futures fundamentals for specific commodities, an understanding of the patterns of production, marketing, distribution, and use of these commodities (including actual or potential problems in any of these areas), and an ability to view and analyze these commodities in a historical context in order to better understand the significance and regulatory implications of particular trends or developments.

--Internal education and training--The Commission should continue and strengthen recently begun efforts to develop a staff education and training program.

--External education--The Commission should develop an overall strategy and plan to guide its external education efforts. It should do this after careful assessment of external education needs and after thoughtful consideration of the role which it should play _vis a vis_ the industry and others (such as academic institutions).

CHAPTER 14

WEAKNESSES IN ORGANIZATION AND MANAGEMENT

HAVE HAMPERED CFTC OPERATIONS

The Commodity Futures Trading Commission has been adversely affected by a number of specific organizational and management problems which have impaired its ability to make the most effective and efficient use of its resources. Some of the more serious problems which we have identified include the following frequently interrelated factors:

--Lack of strong management experience in top executive positions.

--Management weaknesses in the Executive Director's office due to organizational instability and jurisdictional disputes.

--High rate of staff turnover and loss of experienced personnel.

--Failure to develop professional cadres and managers from within the organization.

--Lack of broad representation of views on CFTC advisory committees.

LACK OF STRONG MANAGEMENT EXPERIENCE IN TOP EXECUTIVE POSITIONS

The form of organization provided for CFTC by the Congress is the so-called strong chairman type of Commission. Section 2(a)(6) of the act provides, *inter alia*, that:

"The executive and administrative functions of the Commission, including functions of the Commission with respect to the appointment and supervision of personnel employed under the Commission, the distribution of business among such personnel and among administrative units of the Commission, and the use and expenditure of funds, shall be exercised solely by the Chairman."

The role of the Commission Chairman as outlined in the act would seem to call for someone possessing strong management experience. The act makes provision, however, for an

Executive Director to whom the Chairman may delegate any of his functions as he deems appropriate. Section 2(a)(5) of the act provides that:

> "the Commission shall have an Executive Director who shall be appointed by the Commission, by and with the advice and consent of the Senate, and serve at the pleasure of the Commission. The Executive Director shall report directly to the Commission and perform such functions and duties as the Commission may prescribe."

Section 2(a)(6)(F) provides that:

> "The Chairman may from time to time make such provisions as he shall deem appropriate authorizing the performance by any officer, employee or administrative unit under his jurisdiction of any functions of the Chairman under this paragraph."

To assure the smooth day-to-day functioning of the agency, at least one of the individuals occupying the Chairman and Executive Director positions should possess strong management experience. This, however, has not been the case.

The current Chairman has frankly acknowledged his limited management experience. However, according to the Chairman this lack of prior management experience has not been a problem. His philosophy is that he should have overall management control of CFTC but that he should not have to be involved in the day-to-day administration of the agency. He prefers to leave the daily running of the agency to the Executive Director so that he might be free to spend more time as a leader.

We discussed the organizational arrangement of CFTC with the other four Commissioners and with senior staff members. They were in agreement that the strong chairman form of organization is desirable for CFTC and that under such an organizational setup the Chairman should possess strong management experience. They recognized, however, that an acceptable alternative would be to have an Executive Director with strong management experience.

Clearly, the recruitment of experienced managers for the position of Executive Director would enhance the management capability of CFTC. However, our examination of the prior work experience of the Commission's first two Executive Directors indicated that before joining the Commission neither individual had had extensive prior supervisory

or managerial experience or had previously held management positions comparable in scope and authority to the position of CFTC's Executive Director.

FACTORS CONTRIBUTING TO LIMITED EFFECTIVENESS OF EXECUTIVE DIRECTOR'S OFFICE

The potential organizational benefits of having an Executive Director have not been fully realized at CFTC. This is attributable, we believe, to several factors which are rather difficult to sort out and evaluate independently but which in their combined effect have constituted, in our view, a definite limitation on the effectiveness of the Executive Director's position.

The first limiting factor relates to the need for Senate confirmation of individuals appointed to the Executive Director's position. As previously stated, the act requires such confirmation. We noted, however, that none of the recent incumbents of the position were confirmed. As a result, they functioned in an "Acting Executive Director" capacity for the duration of their tenure. In our opinion, the lack of Senate confirmation undoubtedly impaired their ability to perform their job in the most effective manner, and thereby diminished the potentially valuable contribution the Executive Director could make to CFTC.

We have been told by congressional and CFTC staff members that the requirement for Senate confirmation was inadvertently included in the 1974 amendments to the act. An earlier version of the bill would have provided for a part-time rather than a full-time Commission. Under a part-time Commission, the position of Executive Director would obviously have greater intrinsic importance because the Executive Director would have greater control over the day-to-day activities of the agency. Therefore, Senate confirmation would make sense in terms of defining and placing accountability.

The second factor limiting the contribution of the Executive Director position is one which has plagued the entire CFTC operation, i.e., a lack of continuity occasioned by the departure of key personnel. In its 3-year history, CFTC has had three Acting Executive Directors. The first Executive Director remained with the Commission only about 7 months. The second incumbent took over the position in November 1975, and held it until his resignation 19 months later on August 1, 1977. The position remained vacant for 7 months, from August 1, 1977, to March 1, 1978. During that time as many of the functions of the Executive Director

as possible were shouldered by the Deputy Executive Director. The position of Deputy Executive Director is a new one, having been created only in June 1977, and its occupant had for some time, in addition to his responsibilities as Acting Executive Director, overall responsibility for supervision of CFTC's market surveillance system.

Any manager, no matter how capable and experienced, requires a certain amount of time to familiarize himself with his organizational environment, to diagnose the organization's problems and needs, to forge cooperative working relationships with his colleagues, to formulate a management strategy and operational plan, and to implement his program. The lack of continuity in the occupancy of the Executive Director position, we believe, is responsible in part for the agency's not doing a better job than it has of planning, goal setting, and ordering of priorities, and for its not making more effective and efficient use of its limited resources.

A third factor which we would cite as a limitation on the effectiveness of the Executive Director's Office was the jurisdictional disputes which took place between the Commission's second Acting Executive Director and the heads of CFTC offices and operating divisions. We were told by the Chairman, by the other Commissioners, and by senior staff that the individual in question was dissatisfied with the position and authority which he inherited from his predecessor in November 1975.

At that time the Office of Executive Director had authority only over the relatively low-graded contingent of employees inherited from the Commodity Exchange Authority. The "new", generally higher-graded employees hired to staff management and policy-level positions in Washington headquarters were not under the Executive Director's authority. Largely because of the Executive Director's discontent, in November 1976 the Commission agreed to restructure the Commission staff and give the Executive Director broad authority over the operating divisions.

This new arrangement was not implemented smoothly or harmoniously, however. One division head declined to submit to the authority of the Executive Director, and as a result, his division had to be restructured completely, leaving him with a largely consultative and advisory role. Other operating division heads continued their former pattern of reporting directly to the Chairman, thereby increasing the frustration of the Executive Director and further straining his relations with these individuals.

The result of all this infighting and jurisdictional squabbling was that a considerable amount of time and energy were spent simply on resolving disputes, defending one's "turf", and lobbying the Commissioners for support. For many months the Executive Director was unable to establish harmonious and cooperative relationships with his colleagues or to perform with full effectiveness in exercising the broad delegation of management authority which had been made to him. He announced his intention to resign in June 1977 and left the agency on August 1, 1977.

HIGH RATE OF TURNOVER AND LOSS OF EXPERIENCED PERSONNEL

Two related factors which appear to have complicated the organizational and operational problems of CFTC in its first years of existence are the agency's relatively high rate of personnel turnover and, probably more important, the continuing loss of a number of its most experienced, qualified, and high-ranking staff members. Although it is difficult to measure with any precision the specific effects of these factors, our conversations with Commissioners and staff revealed a widely held belief that they have negatively affected the agency's organizational effectiveness and efficiency and have hampered progress toward development of a reservoir of competence, experience, and expertise within the agency.

With respect to the rate of turnover of CFTC staff, Civil Service Commission statistics for fiscal year 1976 show that CFTC's rates for separations and quits were among the highest of all Goverment agencies surveyed. 1/ In fiscal year 1976, CFTC experienced a total of 118 separations; this was equivalent to a separation rate of 31.6 percent. 2/ For the same period CFTC experienced a total of 59 quits, representing a quit rate of 15.8 percent. Of the 33 agencies and departments listed by the Civil Service Commission

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1/ A separation is a personnel action (such as a dismissal or resignation) which results in the loss of an employee from the active work force of a department or agency. A quit is the voluntary termination of employment by an individual employee.

2/ The separation rate (and the quit rate) per 100 employees is found by dividing the total number of separations (or quits) by average employment for the period in question.

only 5 had fiscal year 1976 separation rates higher than CFTC and only 1 had a higher quit rate.

Civil Service Commission statistics for fiscal year 1977 show that for the same 33 agencies and departments, CFTC continued to have among the highest rates of separations and quits. The number of CFTC separations for that period was 163, equivalent to a separation rate of 35.8 percent. Only 4 of the 33 agencies had higher separation rates. CFTC's quit rate for the same period was 19.1 percent, the second highest of the 33 agencies listed by Civil Service. For purposes of comparison, the overall Federal Government quit rate was 7 percent in 1976. In 1977 it was 7.9 percent.

Probably even more serious than CFTC's relatively high rate of staff turnover is the nature of the staff it has lost. This includes a significant number of high-ranking staff members who joined the Commission in its earliest days, people who participated in the long and arduous processes of organizing the new agency and learning the ins and outs of the multifaceted industry CFTC was created to regulate. Retention of these individuals by CFTC, at least during the first several years of its existence, would have enabled the agency to steadily and systematically build on its achievements and experience and to institutionalize the expertise acquired by these staff members.

In calendar years 1975 through 1977, a total of 156 professional employees, defined as GS-7 and above, left the Commission's employment. Because of delays in filling some of the vacancies, as well as the substantial learning curve involved in much of the Commission's work, the loss of these people has created gaps and slowed progress in a number of areas.

The following examples illustrate the extent to which CFTC has seen its ranks of experienced managers and valued senior staff depleted.

Office of Personnel

During the period May 1975 to March 1976 there was virtually a complete change of staff in CFTC's Office of Personnel. We were told by a CFTC official familiar with the personnel operation that the personnel specialists who left had found CFTC a difficult place to work in.

Whatever their reasons for leaving, it seems likely that this lack of stability and continuity in CFTC's personnel operations contributed to the program deficiencies

noted by the Civil Service Commission in its August 1977 report on the Commission's personnel operation. Civil Service noted, for example, that CFTC's new personnel staff, hired in mid-1976, inherited very little in the way of a personnel management program at CFTC. Civil Service found, among other things, that the agency had no formal manpower planning system, that its merit promotion procedures were not in conformance with Federal promotion policy, that there was no coordinated system for attorney recruitings, nor any attorney rating system, that the agency had not established or documented career ladders, and that there were serious weaknesses in training and executive development traceable in large part to the haphazard manner in which these matters had been handled in the past.

Division of Trading and Markets

The Trading and Markets Division is one of the most important operating arms of CFTC and has responsibility for, among other things, review of exchange rules, monitoring of exchange programs (including exchange rule enforcement programs), registration of firms and individuals required to be registered with the Commission, and financial auditing of those registrants subject to minimum financial and segregation requirements. This division has had a greater degree of staff turnover at the upper levels than any office or division within the agency.

On October 29, 1976, the division lost its first Acting Assistant Director for Contract Markets. This individual was in charge of management and direction of a divisional subunit, the contract markets section, which has responsibility for assuring that contract markets are properly performing their self-regulatory functions. This includes:

--Assuring the adequacy of contract market rule enforcement procedures.

--Conducting trade practice investigations.

--Review of exchange disciplinary actions.

--Review of exchange applications for designation as contract markets.

--Performing special studies.

The Acting Assistant Director in question had been with CFTC for 16 months prior to his resignation, having joined the agency 2 months after its creation. He left CFTC to become an official of a newly regulated New York commodity exchange.

On April 1, 1977, the division lost its first Director who resigned to enter private law practice. This individual had served as Director for 22 months, having joined CFTC in June 1975 shortly after its inception. The position of Director remained vacant from April 1977 until August 1977--a period of nearly 5 months--when it was filled by an attorney who had previously served as counsel to the Commission's Vice Chairman.

On July 1, 1977, the division's contract market section lost its second Acting Assistant Director. This individual had been with CFTC since September 15, 1975, and resigned from the agency to help establish a commodity options trading program at the same New York commodity exchange to which her predecessor had earlier gone. The position was filled for the third time by an attorney who had joined the agency April 24, 1977, a little more than 2 months earlier, and who had no previous commodity experience.

On August 5, 1977, the division lost its Chief Counsel who resigned to enter private law practice. This individual had been with CFTC for 26 months, having joined the agency on June 1, 1975. The position which he left was still vacant as of April 1978.

Office of General Counsel

On January 19, 1977, CFTC's General Counsel resigned to enter private law practice. This individual had been the agency's General Counsel since May 20, 1975, barely a month after it came into existence. His departure after nearly 2 years with CFTC represented a considerable loss to the agency both in terms of professional ability and lost expertise. The position of General Counsel was provisionally filled by the Deputy General Counsel until a full-time replacement could be found. This occurred nearly 5 months later on June 24, 1977.

Office of Chief Economist

The Commission's chief economic adviser resigned effective December 2, 1977, to head up development of a commodities program for a New York brokerage firm. He had held the position of chief economist since August 1975. Like most of the office and division heads who have left the agency, this individual had been with CFTC from its earliest days and had acquired first hand knowledge, experience, and insights into the economic and regulatory issues confronting CFTC which will undoubtedly prove quite difficult and time consuming to duplicate in a successor.

As of April 1978, no replacement had been named for the position of chief economist.

Division of Enforcement

On July 23, 1977, the Deputy Director of the Division of Enforcement resigned after only 7 months in the job. The present Deputy Director of the division has been in that position since October 5, 1977. He joined CFTC as a trial attorney in July 1975 and served as CFTC's Regional Counsel in San Francisco from May 1976 until his selection for the post of Deputy Director.

Following closely the Deputy Director's departure in July 1977 was the October 31, 1977, resignation of the Director of the division, who left CFTC to enter private law practice. This individual, a former enforcement attorney with the Securities and Exchange Commission, had been with CFTC as head of the Enforcement Division for over 2 years. His successor, a former United States attorney, was named by the Commission on October 26, 1977.

Office of Policy Review

The Office of Policy Review was known until May 1977 as the Office of Policy and Planning. At that time the planning function was formally transferred to the Office of the Executive Director. On April 1, 1977, the person who had headed the office for nearly 2 years resigned from the agency. She had come to CFTC as a special assistant to the Chairman in April 1975 and worked as a member of the Chairman's personal staff until October 1975 when the Commission voted to create an Office of Policy and Planning, reporting to the entire Commission, and named her to head the new office.

The position of Director of the Office of Policy Review was filled from within the Commission on June 10, 1977, by naming to the position an individual who had served since February 1976 as a senior staff economist in that office and who from April 1977 to June 1977 had served as Acting Director of the office.

New York Regional Office

The Director and Deputy Director of the New York Regional Office retired in April 1976. Both of these individuals were former Commodity Exchange Authority employees and had been with CFTC's precedessor agency since July 1968. The Commission named as Acting Regional Office Director a senior staff economist in the New York office who was

required for over a year to divide his time and attention between the responsibilities of the top regional office administrative position and direction of the New York region's important market surveillance and analysis program. The position of Director of the New York Regional Office was finally permanently filled on July 1, 1977, by selection of an individual from outside CFTC, a former financial consultant and bank official.

FAILURE TO DEVELOP PROFESSIONAL CADRES AND MANAGERS FROM WITHIN THE ORGANIZATION

Until very recently a lack of attention has been given to the development of professional cadres and managers from within CFTC. This failure to initially identify, nurture, and promote professional and managerial talent already within CFTC means that the agency, with a few exceptions, has been ignoring a valuable internal resource.

Even more significant, in view of the rather high rate of personnel attrition experienced by CFTC and the loss of many of its most talented and experienced top- and mid-level managers, is the fact that this loss of personnel, in the absence of a strong backup capability, has left the agency with gaps and weaknesses in a number of important functional areas and has compelled the Commission, in most instances, to look outside for managers to replace those who have left. Regardless of the innate ability of a manager brought in from the outside, a significant learning curve is involved in making that individual a fully productive member of the organizational team.

In July and August 1977 we met with representatives of CFTC's Office of Personnel and were informed that an executive development program had been announced and was in the formative stages of development at the agency. We were also told that it was proving extremely difficult to put together a meaningful program with the limited resources available for that purpose and that it would take some time to make it a reality. The individuals with whom we met agreed that the loss of key experienced staff had created a vacuum and had hurt CFTC's regulatory effectiveness. This was particularly true, we were told, because the agency had no professional development or training programs designed to develop lower- and middle-level managers and allow them to broaden and sharpen their management skills so that they might effectively step into upper-level positions that have been vacated.

The objectives of the Commission's executive development program, as outlined in a May 6, 1977, Commission document are to:

--Provide for the continuing career development of incumbent managers and executives.

--Identify and develop other employees who possess the capabilities for successful performance in top management positions.

--Establish by division and office an inventory of the potential managerial talent employed in CFTC.

--Provide for management continuity within CFTC.

Since announcement of the program in mid-1977, CFTC has created an Executive Development Board composed of nine high-ranking staff members. Seventy-two candidates have been interviewed and evaluated, and 10 individuals have been lected to participate in the first round of executive development training which will include management training at a Civil Service Commission Executive Seminar Center and rotating assignments to various "developmental positions" throughout CFTC. The program is scheduled to begin in 1978.

In addition, the agency has announced that it will provide management training for headquarters employees at the managerial level (GS-14 and above) who have not received at least 40 hours of training since they were appointed. Also, the Commission will sponsor executive training at the Federal Executive Institute in Charlottesville, Virginia, for its Executive Director and the Director of its Division of Trading and Markets. We are encouraged by these developments and view them as important--if long overdue--steps toward overcoming a serious management deficiency at CFTC.

LACK OF BROAD REPRESENTATION OF VIEWS ON CFTC ADVISORY COMMITTEES

A number of the policy initiatives taken by CFTC since the latter part of 1976 have resulted from recommendations made by various advisory committees established by the Commission to consider what it had preliminarily identified as important regulatory questions and to provide guidance to the Commission as to how it should attempt to address itself to these and other basic regulatory issues. Commission actions with respect to such matters as commodity options, dual trading, large trader reporting, speculative limits, and bona fide hedging are examples of CFTC regulatory

initiatives which stem in large part from recommendations made by CFTC advisory committees.

CFTC announced its decision to establish four advisory committees on August 5, 1975. The actual formation of the advisory committees was announced in late October 1975. The advisory groups began the first of their meetings in November 1975 and continued meeting throughout the spring of 1976. The first advisory committee report was published on July 6, 1976, and the last report was issued on December 23, 1976.

Our examination of the composition of CFTC advisory committees indicated that representatives of the futures industry far outnumbered public representatives on all four of the advisory committees chartered by the Commission in late 1975. Of a total of 58 participants, only 11 could be considered disinterested public members. Of these 11, the majority were academic economists or economists engaged in pursuits unrelated to commodity futures.

Four of the Commissioners, each of whom headed an advisory committee, told us that they selected advisory committee participants from among people they knew or from names recommended to them by their staffs. When we discussed with them the reasons for the low nonindustry representation on their advisory groups and the efforts made by them to increase the diversity of representation, we received the following responses. The Commissioner who headed the Advisory Committee on Market Instruments, which contained 4 nonindustry members out of a total of 16 members, told us that he deliberately selected people who he knew would disagree and argue among themselves because he believed he would get a better report from such a group.

The Commissioner who headed the Advisory Committee on the Economic Role of Contract Markets, which contained 3 nonindustry members out of 13, told us that he had made a conscious effort to include representatives of the general public. The Commissioner who headed the Advisory Committee on Commodity Futures Trading Professionals, which contained 2 nonindustry affiliated members out of a total membership of 13, said that he tried to get a mix of people from various sectors of the futures industry in the belief that a producer would have a different perspective and different interests than a country grain elevator operator whose perspective and interests would, in turn, differ from those of a futures commission merchant.

Finally, the Commissioner who headed the Advisory Committee on the Regulation of Contract Markets and Self-Regulatory Associations, which had 3 "public" members out of a total of 16, told us that based on his experience he concluded that it is difficult to find people who don't have an involvement in the industry and who, at the same time, have an interest in serving on advisory committees and are able to understand the issues involved.

Although we do not fault the Commission's use of advisory committees, we believe a greater effort should have been made to assure more balanced representation in the composition of the advisory committees. This is particularly important since the Commission relied heavily on the advisory committee reports for management decisionmaking and policy formulation purposes.

CONCLUSIONS

CFTC's operations have been hampered by weaknesses in the agency's organization and management. Because of this CFTC has been unable to make the most effective and efficient use of its resources.

The leadership and direction of the Commission have been impaired by the lack of strong management experience in both the Chairman and Executive Director positions and by weaknesses in the Executive Director's office due to organizational instability, lack of continuity, and jurisdictional disputes. The Commission has, however, recently appointed an Executive Director whose background indicates strong management capability. Hopefully the problems of the past will be corrected as the Commission moves forward under new leadership.

In this connection we believe the lack of Senate confirmation of past Executive Directors, as required by the act, impaired their ability to perform their job in the most effective manner. The requirement for Senate confirmation of the Executive Director, is, in our opinion, unnecessary and undesirable. We, therefore, believe that the act should be revised to delete this requirement.

One of CFTC's major difficulties has been a high rate of staff attrition. This has included a steady loss of some of the agency's most experienced and high-ranking staff members. This loss appears to have affected forward progress and impeded the accumulation and institutionalization of needed regulatory expertise. If the agency is to stabilize itself and put itself in a position to progress, it must find a way to slow the rate of attrition.

CFTC's loss of experienced high-ranking staff members is even more significant in light of the long standing absence of a program to identify, develop, and promote professional cadres and managers from within the agency. The new executive development program now being implemented by CFTC should help to correct this problem, however.

In its use of advisory committees, CFTC did not obtain balanced representation in committee membership. The general public was underrepresented while the industry was overrepresented. To assure that the results of the work performed by future advisory committees is as free as possible from any particular bias, CFTC needs to assure that the composition of these committees is as broad and diverse as possible.

RECOMMENDATIONS TO THE CHAIRMAN, CFTC

To better assure the future operational effectiveness of CFTC, the Chairman should require that a program be designed and implemented to promote employee retention. Such a program should be preceded by an evaluation of the Commission's staff turnover experience and the reasons for the high rate of employee attrition which has been noted.

To assure that the interests of the general public are adequately represented in the consideration and formulation of policy, the Chairman should establish procedures to ensure that the composition of future advisory committees is as broad and diverse as possible, including adequate representation of the general public interest.

RECOMMENDATION TO THE CONGRESS

The Congress should amend section 2(a)(5) of the Commodity Exchange Act to delete the requirement for Senate confirmation of CFTC's Executive Director.

EXCHANGES AND VOLUME OF CONTRACTS TRADED FOR
CALENDAR YEARS 1970, 1976, AND 1977

Exchange	Commodity	Number of contracts traded--CY 1970	1976	1977
Chicago Board of Trade	wheat	559,514	2,973,733	1,820,790
	corn	2,140,044	4,609,262	5,021,827
	oats	91,816	126,885	109,970
	rye	3,957	-	-
	soybeans	2,031,272	5,474,179	7,996,139
	soybean oil	1,907,436	1,685,819	2,535,046
	soybean meal	868,333	1,523,711	2,373,453
	live choice steers	4,577	-	-
	iced broilers	95,280	117,641	64,938
	silver	191,006	2,011,041	2,257,059
	gold	-	10,940	13,758
	plywood	47,426	233,373	368,770
	stud lumber	-	4	-
	GNMA mortgages	-	128,568	422,421
	commercial paper	-	-	3,553
	T-bonds	-	-	32,101
		7,940,661	18,895,156	23,019,825

APPENDIX I

Exchange	Commodity	Number of contracts traded--CY 1970	1976	1977
Chicago Mercantile Exchange	fresh eggs	678,627	146,341	130,042
	frozen eggs	19	-	-
	butter	-	22	-
	copper	-	55	-
	Idaho potatoes	78,030	1,889	4,727
	turkeys	-	118	144
	live hogs	115,108	1,146,815	1,307,712
	frozen pork bellies	1,778,443	1,201,066	1,358,730
	live cattle M-W	578,525	2,647,700	2,639,517
	frozen skinned hams	216	-	-
	lumber	85,513	350,530	486,691
	frozen boneless beef	1,584	-	41
	stud lumber	-	-	687
	live feeder cattle	-	62,795	133,274
	grain sorghums	-	-	-
	British pound	-	33,465	78,701
	Canadian dollar	-	17,068	161,139
	Deutsche mark	-	44,887	134,368
	Japanese yen	-	1,449	82,261
	Mexican peso	-	51,439	17,029
	Swiss franc	-	37,246	106,968
	Dutch guilders	-	392	2,812
	French francs	-	5,968	3,150
	U.S. silver coins	-	257	371
	gold	-	304,921	908,180
	treasury bills	-	110,223	321,703
		3,316,065	6,164,646	7,878,247

APPENDIX I

Exchange	Commodity	Number of contracts traded--CY		
		1970	1976	1977
MidAmerica Commodity Exchange	gold	-	2,573	2,650
	wheat	14,196	514,048	151,433
	corn	11,338	418,715	280,268
	oats	1,224	2,904	1,172
	soybeans	25,555	700,466	1,104,763
	silver	4,267	447,513	366,585
	rye	80	-	-
	U.S. silver coins	-	-	-
	live hogs	-	145,647	159,324
		56,660	2,231,866	2,066,195
The Board of Trade of Kansas City, Missouri, Inc.	wheat	179,485	687,811	617,122
	corn	3	-	-
	grain sorghum	466	539	15
		179,954	688,350	617,137
Minneapolis Grain Exchange	wheat	49,732	228,084	191,098
	corn	8	-	-
	oats	4	-	-
	durum wheat	-	471	36
		49,744	228,555	191,134
New York Cocoa Exchange	cocoa	312,667	333,421	307,628
	rubber	-	611	53
		312,667	334,032	307,681

APPENDIX I

Exchange	Commodity	Number of contracts traded--CY 1970	1976	1977
	coffee "U"	2	-	-
New York Coffee and Sugar Exchange	coffee "B"	-	13	-
	coffee "C"	102	174,486	214,202
	molasses	53	-	-
	sugar-world #8	266,667	-	-
	sugar-domestic #10	11,179	-	-
	sugar #11	75,944	984,677	1,055,984
	sugar #12	-	14,052	15,676
		353,947	1,173,228	1,285,862
New York Cotton Exchange and Wool and Citrus Associates	cotton #2	33,657	938,543	826,395
	orange juice, frozen concentrate	73,347	69,587	377,921
	wool	3,741	532	3
	wool top	66	-	-
	propane	-	1,958	301
	petroleum	-	7,346	-
		110,811	1,017,966	1,204,620
Commodity Exchange, Inc.	copper	177,467	1,243,011	1,070,210
	silver	693,697	3,741,908	3,573,301
	gold	-	479,363	981,551
	hides	7	-	-
	lead	35	-	-
	mercury	466	-	-
	propane	674	-	-
	rubber	10	-	-
	tin	71	-	-
	zinc	3	-	-
		872,430	5,464,282	5,625,062

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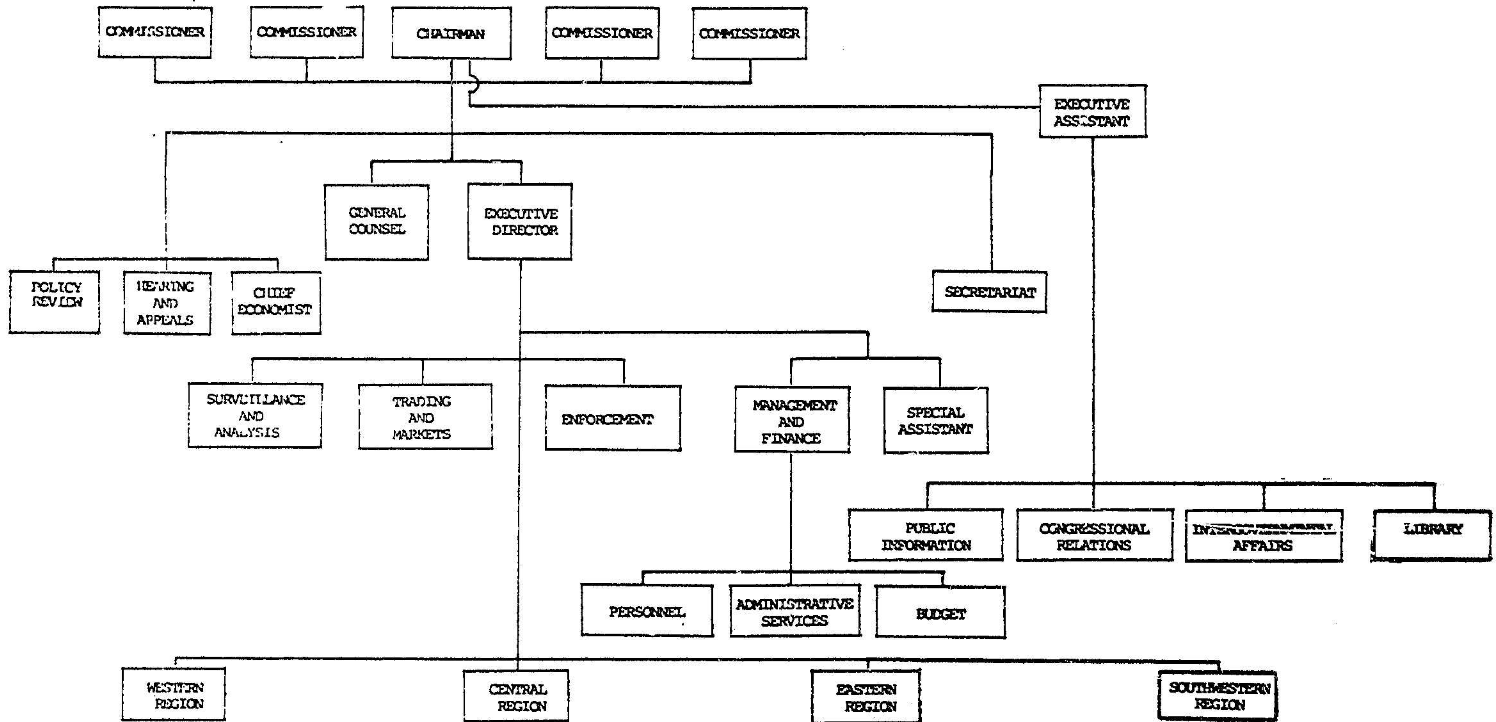
Exchange	Commodity	Number of contracts traded--CY 1970	1976	1977
New York Mercantile Exchange	aluminum	2	-	-
	apples	124	-	-
	palladium	757	6,811	19,971
	platinum	98,867	135,810	122,924
	plywood	792	-	-
	shell eggs	26	-	-
	U.S. silver coins	-	29,751	15,514
	gold (1 kilo)	-	2,351	1,017
	gold (400 ozs)	-	-	2,633
	Belgian francs	-	5,604	-
	Swiss francs	-	4	-
	potatoes Maine	316,691	413,021	41,248
	imported frozen boneless beef	-	3,114	2,690
	potatoes round white	-	43,649	478,558
	Idaho russets	119	-	-
	nickel	382	-	-
		417,760	640,115	684,555
TOTAL		13,610,699	36,838,196	42,880,318

Source: Futures Industry Association.

APPENDIX I

CFTC ORGANIZATION CHART



Source: CFTC

APPENDIX II

CONSULTANTS USED DURING REVIEW

Henry B. Arthur, Ph.D., Moffett Professor of Agriculture and Business, Emeritus, Graduate School of Business Administration, Harvard University

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

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

GAO'S PROPOSED AMENDMENTS TO THE COMMODITY EXCHANGE ACT DEALING WITH REGULATION OF FUTURES CONTRACTS ON FINANCIAL INSTRUMENTS

To improve the regulation of the commodity futures market and provide for consultation and coordination among the securities regulatory authorities.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

Short title

Section 1. This Act may be cited as the "Commodity Futures Trading Improvement Act of 1978"

Section 2

Section 2(a)(1) of the Commodity Exchange Act (7 U.S.C. §2), as amended, is further amended as follows:

(1) By inserting, after the phrase "interests in which contracts for future delivery are presently or in the future dealt in," the following: ", but shall not include any security subject to the registration provisions of the Securities Act of 1933, or any index composed of any such security or group of securities. An agreement shall include any contract for future delivery, and also shall include any transaction which is of the character of, or is commonly known to the trade as, an 'option,' 'privilege,' 'indemnity,' 'bid,' 'offer,' 'put,' 'call,' 'advance guaranty,' or 'decline guaranty.'"

(2) By deleting the language beginning with the phrase: "*Provided* that the Commission shall have exclusive jurisdiction" and ending with "other authorities from carrying out their duties and responsibilities in accordance with such laws.", and substituting the following provisions:

"(A) With respect to any agreement for future delivery of a commodity, except as provided in subparagraph (C) of this section, the Commodity Futures Trading Commission shall have exclusive jurisdiction to administer the provisions of this title: *Provided*, however, that nothing in this title shall affect the jurisdiction of any agency or authority of any state or territory to bring an action to enforce any state statute prohibiting or punishing fraudulent activities insofar as such agency or authority does not take action which conflicts with the provisions of this title or the rules and regulations thereunder.

"(B) Any agreement for future delivery of any security subject to the registration provisions of the Securities Act of 1933, or any agreement for future delivery of any

index composed of any such security or group of securities, shall not be regarded as a commodity but shall be deemed a security for purposes of registration and regulation by the Securities and Exchange Commission pursuant to the provisions of the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Company Act of 1940, and the Investment Advisers Act of 1940.

"(C) With respect to any agreement for future delivery of any security not subject to the registration and regulation provisions of the Securities Act of 1933, the Commodity Futures Trading Commission shall exercise its authority to administer the provisions of this title,

(1) Provided that the Securities and Exchange Commission may institute any enforcement action or proceeding under Sections 17(a), 20, and 22 of the Securities Act of 1933, with respect to any agreement for future delivery of any security not subject to the registration and regulation provisions of the Securities Act of 1933; and

(2) Provided further that, with respect to any enforcement action or proceeding brought under subparagraph (C)(1) of this section, the Securities and Exchange Commission shall inform the Commodity Futures Trading Commission immediately after the issuance of a formal order of investigation, and shall inform the Commodity Futures Trading Commission at least 10 business days before instituting an administrative proceeding or filing a complaint in any court. No action under subparagraph (C)(1) and (2) may be taken by the Securities and Exchange Commission if within such 10 day period the Commodity Futures Trading Commission institutes an administrative proceeding or files a complaint in any court regard ing the matters of which it was notified. The Commodity Futures Trading Commission may, in writing, waive this notification procedure."

The Commodity Exchange Act (7 U.S.C. §1 _et seq._), as amended, is further amended by adding to the end thereof the following new title.

Title V - Council on Regulation of Securities Futures

Purpose

Sec. 501. It is the purpose of this title to establish a Council on Regulation of Securities Futures which shall consider and recommend upon applications for designation of futures contracts written on securities instruments, advise on whether such designations should be continued, and make recommendations concerning the regulation of trading in such contracts, and ensure coordination and consultation among the securities regulatory agencies.

Definitions

Sec. 502. As used in this title--

(1) the term "securities regulatory agencies" means the Department of the Treasury, the Securities and Exchange Commission, the Commodity Futures Trading Commission and any other interested Federal agencies as shall be designated from time to time by the President.

(2) the term "Council" means the Council on Regulation of Securities Futures.

Establishment of the Council

Sec. 503. (a) There is established the Council on Regulation of Securities Futures which shall consist of--

(1) the Secretary of the Treasury,

(2) the Chairman of the Securities and Exchange Commission,

(3) the Chairman of the Commodity Futures Trading Commission, and

(4) such additional members as the President shall from time to time designate. The President shall specify the term of membership of such additional members.

(b) The Secretary of the Treasury shall be the first Chairman of the Council. The President shall, on a rotating basis, designate each succeeding Chairman of the Council.

(c) The terms of the Chairmen of the Council shall be 1 year.

(d) The members of the Council may from time-to-time designate other officers or employees of their respective agencies to carry out their duties as members of the Council.

(e) Each member of the Council shall serve without additional compensation but shall be entitled to reasonable expenses incurred in carrying out his official duties as such a member.

Sec. 504. Functions of the Council

Subject to section 505(b)--

(a) The Council shall consider and make recommendations upon those matters that come before it under subsection (b) and subsection (c) of this section. The Council may consider and make recommendations on actions including, but not limited to, modifications in contract terms and specifications, market surveillance, monitoring of trading, trade practice investigations, and regulatory market interventions, including the taking of emergency actions.

(b) The Commodity Futures Trading Commission and the Securities and Exchange Commission shall, immediately upon receipt of an application for initial designation of contract markets in futures contracts written on securities subject to section 2(a)(1)(A) and (B) of the Commodity Exchange Act (7 U.S.C. §2), and within a reasonable time before taking any action which the Council may consider pursuant to subsection (c) refer such application or action (including supporting documentation) to the Council for consideration and recommendation. Each member of the Council shall be notified in writing by the Commodity Futures Trading Commission and the Securities and Exchange Commission of any matter referred to the Council.

(c) The Council, upon petition of one of its members, shall also consider and make recommendations regarding the

advisability of any action taken or which could be taken by a member affecting the regulation of futures contracts on securities instruments.

Section 505. Recommendations and Response

(a) When a recommendation of the Council is found unacceptable by one or more of the applicable member Federal agencies, the agency or agencies shall within a reasonable time after the recommendation is transmitted to it (but not later than 45 days) submit to the Council a written statement of the reasons the recommendation is unacceptable.

(b) Nothing in this title shall preclude the Commodity Futures Trading Commission or the Securities and Exchange Commission from taking any action on a matter subject to section 504 when the applicable Commission determines that the action cannot await referral to the Council or receipt of the Council's recommendations.

Administration

Sec. 506. In carrying out the functions of the Council, the Chairman may utilize, with the consent of the Council and to the extent necessary, the personnel, services, and facilities of the member Federal agencies. The costs of operation of the Council shall be borne equally by the member agencies.

Access to Information by the Council

Sec. 507. For the purpose of carrying out this title, the Council upon majority vote of the members shall have access to all books, accounts, records, reports, files, memoranda, papers, things, and property belonging to or in use by member Federal securities regulatory agencies, including reports of investigations, economic analysis, together with workpapers and correspondence files related to such reports, whether or not a part of the report, and all without any deletions.

Sec. 508. The Council in any of its actions or deliberations shall not be subject to the Adminstrative Procedure Act (5 U.S.C. 551 et seq., 701 et seq.).

STATUS OF PROPOSALS BY CFTC'S CHIEF ECONOMIST FOR IMPROVING MARKET SURVEILLANCE DATA AS OF APRIL 1978

	Proposal	Status
I.	Drop the futures position reports filed by traders and change the reporting requirements for FCMs.	It was being tested on a step-by-step basis. CFTC was uncertain whether and when this would be implemented.
II.	Encourage FCMs to use CFTC's automated reports on futures positions.	It was being implemented. CFTC was considering the possibility of requiring FCMs to use the automated reports.
III.	Limit the present cash reports to grains and require a new detailed cash report from futures traders.	It has been modified. The present cash reports were still being used for all commodities which have Federal speculative limits rather than just for grains. The reporting levels were raised in November `976. The proposed new detailed cash report has been dropped.
IV.	Commodity supply data:	
	1. Require exchanges to furnish more detailed supply data on certain commodities.	The Commission decided to evaluate the requirement on an individual commodity basis. When it would be evaluated has not been decided.
	2. Further study on	
	a. potatoes	CFTC discussed potatoes with Agriculture but no resolution has yet been discerned.

	Proposal	Status
	b. lumber	CFTC completed a study on lumber and considered the supply data sufficient.
V.	Maintain up-to-date computer surveillance data.	It was being implemented.
VI.	Require long and short futures positions on omnibus accounts to be reported separately.	CFTC is evaluating comments received on a December 1977 Federal Register Notice on this proposal.
VII.	Require foreign accounts to be carried by FCMs on a fully disclosed basis.	Same as item VI.

HISTORY OF OPTION TRADING AND REGULATION

IN THE UNITED STATES 1/

The history of option trading in this country extends to the 1860s when "privileges" for grain were traded on several midwestern exchanges, including the Chicago Board of Trade. A privilege was a contract in which, as in the case of a modern option, a person acquired the right to sell to (put) or purchase from (call) another person a definite quantity of grain for a specified period of time (day, week, or month). A privilege could be obtained on either a physical commodity or on a futures contract. If the privilege was "good", the holder received the difference between the price stated in the privilege and the closing price of the underlying commodity.

Trading in privileges was subject to widespread criticism from its earliest days. The primary criticism was that privileges were mere gambling contracts; that is, there was no actual intent to obtain the commodity. In 1874 Illinois outlawed trading in privileges and, as a result, the Chicago Board of Trade prohibited trading of puts and calls on the exchange floor. In 1885 the Illinois Supreme Court upheld the 1874 law prohibiting privileges when it refused to enforce a privilege contract. The court said, in part, that

> "It was not in the contemplation of the parties any actual purchases of grain or other commodities should be made for the plaintiff, or on his behalf. Indeed, it is expressly agreed none should be made. * * * 'Optional contracts,' in this sense, are usually settled by adjusting market values, as the party having the 'option' may elect. It is simply a mode adopted for speculating in difference in market values of grain or other commodities."

1/ This appendix is based on information from a number of sources, including:

1) The CFTC Report of the Advisory Committee on the Definition and Regulation of Market Instruments (July 6, 1976).

2) The Report of the Interministerial Committee on Commodity Futures Trading (Canadian Ministry of Consumer and Commercial Relations, Ontario, February 1975.)

After the 1885 court decision, the Chicago Board of Trade tried to eliminate trading in privileges both on and off the exchange; however, its efforts were largely unavailing and it finally abandoned them because privilege trading was so widespread that punishing all the member violators would have disrupted the exchange. Only after a 1900 court decision upheld criminal prosecution for violators of the 1874 statute did the exchange members themselves agree to ban privilege trading.

Between 1900 and 1921 the continuing demand for a privilege-like instrument gave rise first to "indemnities" (so-called because they could be used to prevent a loss on open cash or futures commitments due to price changes--although they were often used when no such commitments existed) and then, in 1913, to a brief resurrection of privileges after the 1874 Illinois law was amended to provide that privileges would be prohibited only if, at the time the privilege was written, the parties intended only to make a price adjustment rather than to transfer the commodity underlying the privilege.

Because of speculative excesses on the grain exchanges after World War I, the House and Senate held hearings in 1921 on bills to regulate the trading of commodity futures generally. In those hearings privileges were strongly criticized as promoting excessive speculation, being gambling contracts, luring small investors who could ill-afford substantial losses, and enriching speculators (who neither owned nor desired to buy grain) to the detriment of farmers and grain dealers. A few witnesses testified that a privilege could serve as a useful hedging device. However, it was conceded that privileges were generally not used for this purpose but, rather, primarily for speculative purposes.

As a result of the 1921 hearings, the Congress enacted the Future Trading Act (42 Stat. 187) which, among other things, provided for a 20-cent tax on each bushel of grain ultimately underlying a privilege contract. The purpose of the tax, as made clear by the author of the law, was not to raise revenue but rather to put an end to "the pure unadulterated gambling in wheat futures."

The 20-cent tax effectively halted privilege trading until 1926, when the tax was struck down by the U.S. Supreme Court as an "unlawful scheme of regulation under guise of taxation." Following this decision, trading in privileges was resumed on the grain exchanges.

In the period 1927 to 1930, trading in privileges on the Chicago Board of Trade was the subject of a study by

the Federal Government's Grain Futures Administration, which found that:

--Privileges were not being used as risk-shifting devices. Large traders rarely purchased privileges to hedge their positions. They preferred to write them because, in the long-run, writers profited far more than did the purchasers of privileges. In essence, they were being used primarily for gambling.

--Small, unsophisticated traders were being lured into the futures markets to speculate. The study's authors said "from a social viewpoint this is not desirable as the very limited funds of the small trader could probably be used for better advantage elsewhere." Moreover, it was noted that opportunity for profit was limited because, on the average, market prices did not go "through" the bid or offer price more frequently than 1 day in perhaps 6 or 7. Even when the privileges were good, the gross profits were so small that, after commissions and taxes were deducted, the small trader frequently lost money, making them a poor investment.

--Large traders used privileges to cause artificial price movements--to manipulate or attempt to manipulate the price of the underlying commodity to their own advantage.

--Because of the number of "daily" privileges sold at the Chicago Board of Trade, congestion occurred frequently at the close of the market when privileges were exercised.

In July 1933 the wheat futures market collapsed following a 2-day decline of 30 cents a bushel. At an emergency conference between U.S. Department of Agriculture and grain trade representatives, the blame for the excessive price movements and the collapse of the market was placed on indemnities. The conference led to the grain exchanges' drafting a code of fair competition promulgated pursuant to the National Industrial Recovery Act (48 Stat. 195). The code provided, in part, that "each exchange by proper regulation, shall prohibit and prevent all trading on such exchanges, by or through its members, in indemnities and contracts known as 'bids,' 'offers,' 'puts,' or 'calls'."

In 1934 seven boards of trade, including the Chicago Board of Trade, petitioned the U.S. Grain Exchange Authority to allow trading in grain privileges, provided a trader did not hold privileges on more than 500,000 bushels in the aggregate. The exchanges evidently believed that limited

privilege trading would be less susceptible to abuses and could serve a hedging function which would attract traders back to the demoralized market. However, before the petitions could be ruled on, the National Industrial Recovery Act and its codes were declared unconstitutional in May 1935 by the U.S. Supreme Court. With all prohibitions thus lifted, privilege trading once more resumed and continued until enactment of the Commodity Exchange Act (49 Stat. 1491) in June 1936.

The Commodity Exchange Act banned option trading (including privileges, indemnities, puts, calls, bids, and offers) for all commodities regulated under the act. The legislative history of the 1936 act is not specific as to the exact reasons for this congressional ban, although it was taken against a background of repeated criticism, condemnation, and abuse of options as well as market disruptions and collapses occasioned by speculative excesses in their use.

At congressional hearings preceding enactment, an official of the Grain Futures Administration characterized puts and calls as "fraudulent activities" which would be outlawed by the proposed bill. The agency's Administrator condemned the use of privileges by speculators to depress the futures markets artificially, adding that larger traders operated short in the futures market because "the general public comes into the market on the buying side. They do not know how to sell short."

The House report said that the bill would outlaw certain enumerated transactions, including puts and calls, as well as any transaction which caused a price to be reported or recorded which was not true or <u>bona fide</u>. The Senate report did not specifically discuss options, but one of the bill's sponsors stated on the Senate floor that privileges were simply gambling contracts. He also placed options in the same category as wash-sales and bucket shops and affirmed that "all fictitious transactions are prohibited by this bill."

Following the 1936 act's complete ban on option trading on the so-called "soft" commodities (the domestically produced agricultural commodities regulated under the act), options received relatively little public attention and scrutiny for a number of years. Then, in the late 1960s and early 1970s various fraudulent schemes involving options in the unregulated commodities (the "hard" commodities, such as metals, and the "world" commodities, such as coffee and cocoa) once again brought option abuses to public attention. The most publicized of these schemes was that of the firm of Goldstein, Samuelson, Inc. The firm's operations, which defrauded customers of millions of dollars (variously estimated at over

$70 million), were described as follows in the 1974 Senate hearings on the proposed Commodity Futures Trading Commission Act.

> "[Goldstein's] modus operandi * * * was startlingly simple, promote the organization by flamboyant advertising extolling the virtues of commodity options, while betting that the customer could not accurately predict price movements in the unregulated commodity markets. In the vast majority of cases, Goldstein was correct and he could keep the premiums paid by his customers. If the customer happened to get lucky, he could be paid off with funds acquired from new customers entering the market. Very little, if any, hedging with commodity futures contracts was done because it would tie up too much of the firm's capital in margin and margin calls on the futures markets. The result was a naked option writing operation with 40% of the funds acquired going to pay off the occasional winner, 40% for promotional activities and a handsome 20% profit for the firm.
>
> "By late 1972 it was becoming increasingly apparent that the commodity option houses were built on a rather shaky financial foundation. * * * [T]he Securities and Exchange Commission went into federal court to have a temporary receiver appointed for the organization. In May, 1973 Harold Goldstein was indicted on sixteen counts of mail fraud. He pleaded guilty to three of those counts and was sentenced to fifteen years' imprisonment.
>
> "Goldstein, Samuelson was not alone in its tangle with state and federal agencies. Many other commodity option firms came under fire and have since gone bankrupt or ceased operations."

The Goldstein, Samuelson options scandal and others like it led to a proposal in H.R. 11955 that the unregulated commodities be brought under the Federal Government's jurisdiction and that option trading in all commodities be prohibited.

Some witnesses who testified before the House Agriculture Committee urged that the Congress not ban option trading on the previously unregulated commodities because, in their view, various economic benefits could be derived from such trading. Cited as economic justification for option trading in the world commodities were

--the contention that the United States could lose both trade and access to world commodities if option trading was banned;

--the argument that options constituted a useful hedging instrument to traders against price changes affecting a cash or forward position; for example, it was stressed that options reduced the costs of maintaining an inventory, which in turn could reduce the cost of the commodity or associated product to the consumer; and

--the belief that options could serve as a means of stabilizing market prices by reducing the amplitude of speculative price movements.

Additional arguments for limited option trading included

--the limited risks of option trading, in that the losses are limited to the premium and commissions paid, and

--the apparent success which the London futures markets had had with options over many years.

Those who testified in support of options could not agree on the manner in which option trading should be regulated, if at all.

Witnesses who supported some regulation ranged from those who would have given the Federal Government explicit authority over all aspects of the commodity option market to those who argued in favor of limiting the Government's jurisdiction to domestic options, exempting foreign options from Government regulation entirely. Finally, the suggestion was made that the proposed Commodity Futures Trading Commission study the problem in depth and then promulgate regulations to prevent fraud in the issuance and sale of options.

The House decided to take this latter approach, abandoning the original proposal to ban all option trading and instead continuing an unqualified ban only on the previously regulated commodities. The House bill (H.R. 13113) provided that no person could enter into an option transaction in the previously unregulated commodities contrary to any regulation of the Commission prohibiting such transactions or allowing such transactions under terms and conditions as the Commission might prescribe. The bill also provided that the Commission study the matter and regulate, or ban, option trading in the previously unregulated commodities as it deemed appropriate, including setting different terms and conditions for different markets.

The House bill did not specifically outlaw "naked" options (of the Goldstein, Samuelson type), but the House Agriculture Committee report said:

> "The discretionary authority granted to the CFTC to regulate or ban trading in options and commodities not specifically named in Section 2(a)(1) of the present law [the Commodity Exchange Act, as amended] is not to be exercised by the Commission to approve any transaction of the character of, or commonly known as, an 'option' * * * if the option or transaction named does not guarantee the purchase of the futures contract in fulfillment of the option, should the purchaser seek to exercise the option. The Committee intends the Commission act as expeditiously as possible to prohibit such transactions."

Two of the three bills introduced in the Senat provided for banning all option trading. The Senate Agricul e and Forestry Committee held hearings on those bills as well as on H.R. 13113. The Senate ultimately chose the House bill as the appropriate vehicle to amend the Commodity Exchange Act and made only two changes in the sections which concerned options: a clarification that the new Commission would have exclusive jurisdiction over option trading and a requirement that the Commission promulgate regulations for option trading within 1 year. The Senate Committee indicated its intention "that options not be traded except on organized exchanges and in conformity with the rules and regulations of the Commission." H.R. 13113 was referred to the Conference Committee in this form.

The Conference Committee approved the Senate's language clarifying the Commission's exclusive jurisdiction over options but modified the Senate's time limit for promulgating regulations so as to permit the Commission to take longer if it notified the Senate Committee on Agriculture and Forestry and the House Committee on Agriculture that it needed additional time. The Conference Committee made no other changes in the bill with respect to options, and its report provided no additional guidance on congressional thought concerning option trading.

The floor debates on the final version of H.R. 13113 touched only briefly on option trading. They were concerned primarily with the Commission's jurisdiction over option trading, although the sponsor of one of the Senate bills which would have banned option trading reiterated the view that trading of options should occur only through designated exchanges and be cleared through clearinghouses.

H.R. 13113 was enacted into law as the Commodity Futures Trading Commission Act of 1974 (Public Law 93-463, 88 Stat. 1389), which substantially amended the Commodity Exchange Act. The two sections of the amended act which have greatest relevance for option trading are:

--Section 4c (7 U.S.C. 6c) which bans option trading in the previously regulated commodities and details the Commission's authority to issue, after notice and opportunity for hearings, rules, regulations, or orders either to prohibit option transactions in the previously unregulated commodities or to allow such transactions under terms and conditions that it was to prescribe within 1 year, or later if it notified the Senate and House agriculture committees of a need for additional time.

--Section 2(a)(1) (7 U.S.C. 2) which specifically enumerates those previously regulated commodities for which option trading is banned and provides for the Commission's exclusive jurisdiction over option trading.

CHRONOLOGY OF CFTC

INITIATIVES IN PLANNING

Our conversations with Commission staff as well as our examination of CFTC records indicated that in late 1976 and early 1977 the Commission staff attempted to build on earlier short term planning initiatives by introducing and attempting to win support for strategic long-range planning at CFTC. A November 24, 1976, memorandum from the Executive Director to the Director of the Office of Policy and Planning expressed encouragement at the latter's attempts to develop drafts of long-range strategic planning materials. The Executive Director noted that:

> "* * * without clear statements of strategic direction * * * we will be forced to continue to dwell on the budget and our resources as an end unto themselves."

He commented also that:

> "The long range strategic plan * * * should describe a comprehensive approach to improving long-term regulatory effectiveness by identifying opportunities with specific expected policy results in mind. It should enable the CFTC to anticipate strategic problems or to grasp opportunities before they occur thereby allowing sufficient lead time for an appropriate course of action to be developed. Policy planning provides the means, through the constant reexamination of the environment in which CFTC operates, to reduce, if not eliminate a 'crisis to crisis' style of operating control by broadening management's time span perspective and providing an opportunity to deal with substantive program matters."

On February 16, 1977, the Commission held a meeting devoted to consideration of long term strategic planning. In a February 11, 1977, memorandum to the Commission, the Director of the Office of Policy and Planning stated:

> "We believe that long term planning is an evolving and continuing process. Recognizing this, we hope [the February 16, 1977] meeting can be a good first step in introducing the subject to the Commission. All of the outstanding questions are not answered, nor will they be. However, we want to establish a dialogue with you and hope progress can be made in the following areas:

"--increased awareness of the impact that external factors may have on CFTC and the impacts CFTC is having on affected parties,

"--better specification of CFTC's role, what we'd like to see in the future and our long term objectives * * *,

"--greater support for the planning process which can provide the opportunity to make better decisions on future policies, strategies and programs, and

"--determine what further efforts are needed, such as additional data gathering, in order to complete the process."

A March 10, 1977, memorandum prepared by the Office of Policy and Planning summarized the results of the February 16 long term planning meeting and attempted to list the courses of action which had been identified in the discussion. The writer pointed out that the action steps "provide a start towards gaining better control of and providing clearer guidance for staff efforts in the coming and future years." Their special significance for our evaluation of Commission planning is that the identification of these courses of action took place nearly 2 years after CFTC began its operations. The following is a partial listing of those action steps:

I. Develop Broad Regulatory Guidelines

--Refine regulatory strategy in order to determine what functions to undertake, the Commission's regulatory role, and criteria for the allocation of resources.

--Link planning to decisionmaking in order to understand the consequences of present decisions, the full range of options, and potential outcomes and to integrate this data into Commission decisionmaking.

--Control and direct policy development process by instituting monthly discussions of major initiatives, providing early direction to staff in policy discussions, and broadening analysis to include costs and burdens on CFTC and industry and expected effectiveness of alternative means.

II. Expand Communications, Broaden Constituency, Improve Access to Information

III. Address Current Policy Issues

--Review reparations program to determine changes needed and possible to meet workload increases and to improve its functioning.

--Encourage/support the development of new trading and order-handling mechanisms.

--Determine Commission policy regarding title III and develop standards in order to clarify CFTC's role and responsibility.

--Clarify role of CFTC in contract development and improvement versus the exchange's role.

IV. Tentative Identification of Statutory Requirements Needing Attention (areas where CFTC actions have been inadequate to meet statutory requirements or other needs)

--Preventing the dissemination of false or misleading prices or other information.

--Provisions relating to cash markets.

--Study of computerized trading.

--Leverage contract regulations.

In a March 18, 1977, memorandum the Director of the Office of Policy and Planning forwarded to the Commission for its consideration a draft proposal on short and long term Commission objectives. The memorandum also contained modifications of the four goals originally adopted by the Commission in June 1976. Two of the goals--market utility and customer protection--were described as basic and primary functions of CFTC. The two remaining goals--regulatory effectiveness and internal efficiency--were viewed as more ancillary to the basic mission of CFTC. The memorandum reiterated the importance of establishing agreed on objectives. Objectives, it noted, represent Commission views about desired outcomes and about how Commission goals can be best achieved. "The primary importance of setting objectives is to ensure Commission guidance and direction for the more detailed planning to be done at the staff levels."

The memo also stressed the importance of objectives for accountability purposes. "The clarification of [Commission] objectives" the memorandum stated,

> "will facilitate this Office's efforts to provide you with evaluation studies on mission accomplishment. Moreover, clear objectives are absolutely essential to the implementation of zero-based budgeting. Rather than reducing ZBB to a technical and administrative chore, your input at this early stage can help insure its utility as a decisionmaking tool. For example, programs, resource expenditures and staff allocations can be grouped according to those objectives you have identified; and as better data becomes available, decisions or resource allocations can be made on the basis of the relative effectiveness of programs in meeting overall goals."

Efforts to establish CFTC objectives continued in March and April 1977 with operational planning sessions held on March 30-31 and April 6-7. These efforts were given impetus by the administration's requirement that the fiscal year 1979 budget be prepared using the zero-based budgeting system which carries with it the requirement that the agency focus on a comprehensive analysis of objectives, priorities, and needs. An Office of Policy and Planning document dated April 22, 1977, attempted for the first time to relate historical data on resource allocation to Commission goals and to some of the major objectives which had been tentatively identified by the Commission and staff. This comparison revealed, in many cases, a significant incongruence between those objectives and supporting functions which had been identified as high priorities and the actual resources which had been devoted to these ostensibly important areas. Examples of the disparities noted included:

--Ensuring and Enhancing Market Utility. It was found that programs serving this goal represented only 16 percent of CFTC resources. Despite the fact that the Commission had supposedly determined to put its highest priority on preventing market disruptions, distortions and manipulations, it was noted that most CFTC activities in this area were primarily short term and reactive, not long term and preventative.

--Assure Protection of Customers/Integrity of Market Place Participants. It was noted that 22 percent of total first quarter FY 1977 resources had been devoted to furthering the protection of customers. However, the cost effectiveness of these expenditures

was questioned. Particularly acute problems were noted in the case of audits, the registration program, and trade practice investigations where it was noted that the customer protections provided are minimal in relation to the costs of the activities. The reparations program was cited as the most readily discernible example of disproportionate resource allocations with only 0.2 percent of CFTC first quarter FY 1977 expenditures. "Given the volume of cases and the level of resources," it was noted, "we can safely assume that we are currently doing very little more than clerical processing of claims before forwarding to Hearings and Appeals."

--Maximize Regulatory Effectiveness and Efficiency. The analysis of resource expenditures concluded that too little was being done to improve exchange self-regulatory effectiveness and too much in resources was being allocated to internal management efficiency. For the first quarter of fiscal year 1977, internal efficiency represented 31 percent of resources and 23 percent with headquarters indirect costs excluded. The report noted that this latter figure was "just 2 percentage points less than <u>all</u> the activities devoted to market utility and 1 % <u>more</u> than activities devoted directly to customer protection." The report concluded, "something (a lot of things) must clearly be out of kilter."

On May 3, 1977, the Commission appointed a task group to clarify and modify principal management objectives for fiscal year 1979. The report of this group was forwarded to the Commission with a recommendation for adoption on May 12, 1977. The report was approved by the Commission on May 21, 1977.

Also in May 1977 another initiative was begun which was intended to make planning and priority setting more effective by linking them more meaningfully to activities performed at the operating staff level. These efforts centered around improvements in scheduling of the Commission's calendar. A May 31, 1977, memorandum to the Commission, signed by both the Executive Director and the Director of Office of Policy Review, noted that there was a serious problem with the Commission's calendar going far beyond the desirability of knowing what is coming up for review and decision. The problem, they pointed out, involves assuring that the relative priority afforded to various issues implicit in the calendar is fully congruent with Commission priorities. The effort to assure such congruence is the primary challenge in developing a long term calendar.

The two directors reminded the Commission that:

"the Staff will have made numerous assumptions about actual Commission priorities of the pending issues. Thus, changes in scheduling and priorities will be needed to assure the calendar reflects collective Commission priorities * * *."

Efforts of the Commission and senior CFTC staff to improve the planning process continued throughout the second half of 1977. On June 9, 1977, the Executive Director and Director of Office of Policy Review submitted to the Commission a memorandum which attempted to project the Commission calendar through November 1977. The memorandum presented calendar information at three levels of specificity in scheduling.

(1) what was considered to be an accurate and complete summary of publicly pending CFTC actions (mostly having to do with public hearings and with publication and implementation of CFTC rules),

(2) a tentatively scheduled listing of staff activities related to the various Commission goals served by the activities, and

(3) unscheduled items. This latter category contained a number of issues which the two directors explained had to remain unscheduled for a wide variety of reasons.

"In some cases, there was no staff response; some issues were considered 'unassigned', in other cases there was confusion over primary responsibility; and some issues [were] deferred because of resource constraints."

A few examples of the important issues and topics which it was not possible to schedule include:

--Advisory Committee on States (dealing with State jurisdiction and responsibilities).

--Speculative limits.

--Study of fixed fees.

--General policy statement on exchange ownership.

--Policy on composition of exchange boards.

--A trade practice investigation program.

--Clarification of the status of enforcement investigations and litigation.

--Plans for external education efforts.

--Proficiency exams for industry professionals.

In documents sent to the Commission on July 25 and 26, 1977, the Office of Policy Review attempted once again to review and evaluate CFTC resource expenditures (this time for the third quarter of fiscal year 1977) in terms of the objectives and priorities which had been adopted by the Commission to guide its efforts. Once again, the analysis showed that actual resource use differed significantly, in many respects, from that which would have been expected on the basis of announced Commission goals, objectives, and priorities.

> Goal I: Ensure and Enhance Market Utility. The analysis revealed that "only 19 percent of total CFTC expenditures are devoted to ensuring the utility of futures markets. Surveillance and other related preventative activities account for 1 percent of expenditures; 5 percent goes to related enforcement activities. Most notably low shares of resources are devoted to fostering competitive markets (2 percent) and improving understanding of market performance and utility (2 percent)." It was noted that during the first three quarters of fiscal year 1977 CFTC's Maine Potato investigation accounted for nearly $200,000 of enforcement expenditures and over 15,000 staff hours. This was about 25 percent of the total resources expended on all investigations by the Division of Enforcement during that period.

> Goal II: Assure Protection of Customers/Integrity of Market Place and Participants. It was found that 17 percent of third quarter expenditures directly served this goal. Registration and audit (described in the body of our report as weak and problem plagued protections) accounted for 9 percent. Trade practice investigations, development of regulations, and enforcement activities absorbed 6 percent of total resources. Only 3 percent of all expenditures were devoted to assuring effective procedures for redress of customer complaints.

Goal III: Maximize Regulatory Effectiveness and Efficiency. Third quarter fiscal year 1977 statistics showed that 11 percent of CFTC resources were serving this goal. Rule reviews, rule enforcement studies, and efforts to improve recordkeeping accounted for 3 percent of expenditures. Four percent of resources were devoted to clarifying regulatory roles (75 percent of which were diverse Office of General Counsel activities). Public Information, Congressional Relations, and Intergovernmental Affairs accounted for 3 percent of expenditures. Less than 0.3 percent was devoted to assessing the impact or effectiveness of regulatory policies.

Goal IV: Manage CFTC Programs to Achieve Maximum Efficiency and Effectiveness. Analysis of third-quarter data showed that 26 percent of expenditures were devoted to this goal (excludes the 17 percent of resources going to headquarters indirect costs and regional office rent). One percent of expenditures was directed toward improving allocation of resources (primarily budget development and accounting). The memorandum noted that the potential for efforts in this area to meet the stated goal is seriously constrained, if not precluded, by the absence of program or Commission-wide evaluation efforts. Another 1 percent went to improving staff understanding through training and internal education. Twenty-three percent of the total resources, an alarmingly high proportion, were devoted to management and administration. Only 0.5 percent was devoted to developing an improved management information system.

Building on the staff work and Commission consideration devoted to fiscal year 1979 planning between March and July 1977, the Executive Director presented to the Commission on July 27, 1977, just prior to the effective date of his resignation from CFTC, an Operating Plan for FY 1979 with zero-based budget guidelines. The Executive Director's memorandum called on the Commission to decide the staffing and funding levels of the fiscal year 1979 budget submission to meet previously agreed on goals and principal management objectives. This Commission guidance, in turn, was to serve as the basis for preparing detailed budget justifications which would be submitted simultaneously on September 1, 1977, to the Office of Management and Budget and the Congress. The Executive Director noted that the necessary decisions of the Commission

were those of "confirming priorities and establishing program levels for the detailed development, review and submission" of budget justifications.

ıded that:

"* * * The linkage of programs to overall CFTC goals through the Principal Management Objectives with explicit priorities is emerging as a significant management process. It has the potential over time to assure the CFTC's 'working on the right activities at the right time at the right level.'" [Emphasis supplied.]

An August 1, 1977, memorandum from the Office of Policy Review to the Commission on the subject of the fiscal year 1979 plan and priorities and resource allocations needed to assure furtherance of goals had the following comments on the Executive Director's July 27 memorandum:

1. "The Executive Director's Office has applied zero based budgeting principles in its formulation of recommended priorities. Unfortunately, the perennial errors in the coding system seriously limit the reliability of those recommendations * * * and seriously skew the effects of the OED's recommended funding priorities. * * * We have attempted, in the time available, to correct these coding errors and adjust the OED's summaries and recommendations to reflect those changes. * * * Accurate goal identification is important for a number of reasons--but most important in this zero based review, because the goals identified by offices determine the funding priority of each activity (whether it will serve the goal well, or even at all).

2. "The justification for many programs is premised on the inadequacy of exchange rule enforcement. Planning should start now to assure improvements in exchange surveillance, contract review and adjustment, research, manipulation investigations, audits, rule enforcement, etc., to assure effective self-regulation; minimize duplication and develop an effective oversight posture for the CFTC. * * *

3. "Better understanding of the impact and effectiveness of CFTC programs and regulations is essential to sound planning and good government. Program and Commission-wide reviews are needed to assure CFTC activities are maximizing our service of the public

interest. In addition, emphasis should be given to eliminating unnecessary (or ineffective) interference with the market by CFTC actions.

4. "Basic regulation of futures, including some progress toward all related goals, requires more resources than our present base. The CFTC Act requires more regulatory activities and responsibilities than we can effectively address within our resource constraints. Consideration should be given, to highlighting this problem during CFTC's Reauthorization in FY 78. Because many programs are already seriously underfunded and their effectiveness is in jeopardy, the opportunity costs of regulating commodity options are extremely high. Consideration should be given to delaying finalization of options regulations, pending the FY 78 Reauthorization."

In the weeks and months since the departure of the Executive Director (August 1, 1977) and the completion and submission of the CFTC fiscal year 1979 budget (September 1977) much of the thrust for continued development and improvement of CFTC's planning process has come from CFTC's Office of Policy Review. Examples of that office's initiatives to improve planning would include the following.

In an August 10, 1977, memorandum to the Commission on the subject of "Random Management Issues" the Director of Policy Review noted that while many of the issues regarding CFTC organizational structure are settled, a number of important procedural questions remain that deal with planning, implementation, and evaluation of Commission policies. He observed that all parts of the agency should participate in planning CFTC activities, but that with externally imposed deadlines and many internal participants planning can never operate effectively without careful coordination. The logical place for this coordinative function, he noted, was the Office of Executive Director, especially in view of the Executive Director's responsibilities for budget administration and policy implementation. A concomitant part of this planning and coordination function, he felt, should be responsibility for a major role in preparation of the Commission agenda--in collaboration with operating units, Commissioners, and Commission staff support offices--in order to ensure that planning considerations assume a significant place in Commission deliberations throughout the year.

The memorandum also stressed the importance of assessment in the context of planning, dividing assessment into

two functions: monitoring and evaluation. Monitoring, it was noted, is the process of assessing whether or not staff units are actually doing what the Commission wanted them to do when it established its goals and objectives. Evaluation is the process of assessing whether or not these activities contribute to the achievement of Commission goals. "To be effective," the Director commented, "we need to do both." In the opinion of most CFTC staff we have consulted, the Commission is presently performing poorly in both respects.

Following on the August 10, 1977, initiative to improve Commission followup and oversight of staff activity, the Office of Policy Review prepared a proposal for improved "accountability procedures" designed to improve the process by which new efforts to implement Commission goals and objectives are authorized and by which Commission policies are established. The proposal also included procedures and responsibilities for submission, scheduling, and control of Commission calendar and agenda items. The "accountability" guidelines were distributed to the Commission and staff in the form of a memorandum from the Chairman dated September 21, 1977.

The primary purpose of the guidelines was to outline a process by which the Commission could best decide whether or not to undertake new policy or program initiatives in response to unanticipated occurrences within the agency or its environment. The new procedures were intended to give the staff a chance to quickly get to the Commission with a brief outline of any new staff policy or program initiatives or any new work project assignments made by the Commission--before any detailed work was started. This, in turn, would give the Commission an opportunity to consider (or reconsider) these unbudgeted assignments within the context of overall Commission priorities and resource contraints. The decisionmaking process was viewed as having three stages: (1) an initial proposal stage, (2) a Commission authorization stage, and (3) an implementation and monitoring stage.

The "initial proposal" stage, we believe, is a particularly interesting and noteworthy feature of the procedures. In it staff units requesting new policy or program initiatives must submit a brief draft proposal which includes:

1. Description of the proposal, including background and a short abstract.

2. Explanation of the policy implications of the proposal and their contribution to the achievement of Commission goals and objectives.

3. Discussion of alternative approaches, including preliminary assessments of:

   a. relative costs, both direct and indirect, to CFTC, the industry, and the public;

   b. industry competitiveness implications; (section 15 of the act);

   c. relative legislative and regulatory constraints; and

   d. regulatory effectiveness.

4. Recommended approach to ensure public involvement.

5. Other work to be deferred if project is undertaken.

We view such innovations in Commission decisionmaking as highly salutary--if long overdue--improvements in the agency's overall process of planning and plan implementation. It is precisely this kind of continuous stock taking, assessment of alternative courses of action, and monitoring of performance which are required, in our opinion, to make planning an effective management tool.

In view of the acute need for these procedures and in view of their significant potential for improving the overall process of planning and directing CFTC efforts, we were surprised to learn in early January 1978 that they had never been implemented. Through conversations with senior staff, undertaken with a view to learning about the operation and effectiveness of the new accountability measures, we learned that shortly after circulating his September 21, 1977, memorandum the Chairman announced to the heads of operating divisions that he would not require them to comply with the procedures outlined in his memorandum. This indicates to us that the Commission continues to be less than fully committed to the need to better plan, direct, and monitor staff effort to ensure that CFTC resource expenditures truly serve the goals and objectives established by the Commission and that they do so in the most efficient and effective manner possible.

An October 26, 1977, memorandum of the Office of Policy Review, written by a staff member who was unaware at the time of the Chairman's decision not to implement the accountability procedures, attempted to assess the progress made by the agency in fiscal year 1977 in moving toward a planned operation. The memorandum, entitled "Review of FY 1977 Accomplishments," noted that:

"During the course of this past year the Commission has endeavored to appraise overall performance towards its goals. By means of quarterly reviews, some indication of progress has been possible. However, without benefit of distinct objectives until late in the year, the reviews were generally limited in depth and scope. The quarterly reporting of expenditures did not facilitate assessment of progress toward the achievement of long term goals.

"Utilizing the guidelines provided in the Commission's FY 79 plan as a goal structure for 1977 has enabled us to compare actual FY 77 resource expenditures to the established 1979 allocations by objective. This in effect provides the Commission with the necessary foundation upon which to assess our current posture and to develop plans that will align the Commission's activities and priorities with its FY 1979 goals and objectives. To that end, the first span of this 'bridge' planning concept will be the upcoming discussion of a six-month calendar scheduled for November 8. Given proper direction and priorities, the planning efforts can then be focused on the alignment of the Commission activities for the remainder of 1978.

"In addition to strict detailed guidance and compliance from within the Commission, the planning strategy will require close supervision and still needed improvements to certain reporting aspects of the existing system. The program framework has been in the developmental stage for sometime but the progress thus far, as reflected in this review, indicates that the Commission is currently in a posture to finalize the development and to implement a program for assuring that its activit and resource allocations are contributing to the achievement of Commission goals and objectives.

"Many noteworthy accomplishments have been made by the Commission during the past year. Our review, however, indicates limited progress towards the achievement of Commission objectives. * * * [With several exceptions,] it does not appear that the major constraint to the achievement of Commission goals is only inadequate funding. Rather, we believe improved program direction, emphasizing contribution to Commission objectives, will go a long way in improving both the efficiency and effectiveness of Commission expenditures." [Emphasis added.]

PRINCIPAL OFFICIALS OF THE COMMODITY FUTURES TRADING COMMISSION RESPONSIBLE FOR THE ACTIVITIES DISCUSSED IN THIS REPORT

	Tenure of office	
	From	To
CHAIRMAN:		
William T. Bagley	Apr. 1975	Present
VICE CHAIRMAN:		
John V. Rainbolt III	Apr. 1975	Present
COMMISSIONERS:		
Gary L. Seevers	Apr. 1975	Present
Read P. Dunn	Apr. 1975	Present
Robert L. Martin	June 1975	Present
EXECUTIVE DIRECTOR:		
Donald Tendick (acting)	Aug. 1977	Present
Anthony McDonald (acting)	Nov. 1975	Aug. 1977
Beverly Splane (acting)	June 1975	Nov. 1975
GENERAL COUNSEL:		
John Gaine	June 1977	Present
Richard Nathan (acting)	Jan. 1977	June 1977
Howard Schneider	May 1975	Jan. 1977
DIRECTOR, DIVISION OF TRADING AND MARKETS:		
Terry Claassen	Aug. 1977	Present
Vacant	Apr. 1977	Aug. 1977
Thomas Russo	June 1975	Apr. 1977
DIRECTOR, DIVISION OF ENFORCEMENT:		
John Field III	Oct. 1977	Present
William Schief	Oct. 1975	Oct. 1977
DIRECTOR, OFFICE OF POLICY REVIEW:		
Michael Caughlin	June 1977	Present
Michael Caughlin (acting)	Apr. 1977	June 1977
Pamela Pecarich	Oct. 1975	Apr. 1977
CHIEF ECONOMIST:		
Blake Imel (acting)	Dec. 1977	Present
Mark Powers	Aug. 1975	Dec. 1977

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