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Report to Congressional Requesters

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CHICAGO FUTURES MARKET

Emergency Action Procedures

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The Honorable Tom Harkin
Chairman, Subcommittee on Nutrition
and Investigations
Committee on Agriculture,
Nutrition, and Forestry
United States Senate

The Honorable Tom Tauke
House of Representatives

In response to your requests, we are providing you with the results of our examination of Commodity Futures Trading Commission (CFTC) and Chicago Board of Trade (CBT) policies, procedures, and practices related to emergency actions. As requested, we are including information on how

- CFTC and CBT identify emergencies;
- CFTC and CBT use their emergency action authority;
- CBT controls leaks of nonpublic information related to emergency action decisionmaking;
- CBT avoids conflicts of interest in emergency action decisionmaking, including how its approach differs from that in proposed CFTC reauthorization legislation; and
- CFTC reviews exchange emergency actions.

Also, as agreed, we used the July 1989 soybean futures emergency action as a case study of how CFTC and CBT follow their policies and procedures.

On July 11, 1989, the CBT Board of Directors ordered everyone holding July 1989 soybean futures positions[1] in excess of the 3 million bushel speculative position limit[2] to liquidate those positions in a prescribed orderly manner to no more than 1 million bushels as of the expiration of trading on July 20, 1989. CBT officials said that they took this action to

[1] A futures position is a market commitment associated with the purchase or sale of a futures contract.

[2] A speculative position limit is a number of contracts, set by CFTC or an exchange, that a market participant cannot exceed except for the purpose of bona fide hedging as defined in CFTC or exchange rules. Bona fide hedging, according to CFTC regulations, means transactions or positions that normally represent a substitute for transactions or positions to be made or taken at a later time in a physical commodity and that are appropriate for reducing certain risks in the conduct and management of a commercial enterprise.

affecting a commodity, or any other major market disturbance that prevents the market from accurately reflecting supply and demand forces for such a commodity. CBT rules define an emergency as all emergency circumstances referenced in the Commodity Exchange Act and CFTC regulations, and all other circumstances in which an emergency can be lawfully declared by the Board of Directors. CBT rules also prohibit price manipulations and corners, and CFTC regulations require that exchanges enforce their rules by actively monitoring the markets.

CFTC and CBT officials said that they closely monitor the markets each day. They said that although CFTC and CBT have independent market surveillance programs, their market surveillance staffs freely share information on a daily basis. According to CFTC officials, CFTC staff brief the CFTC commissioners on market developments at least weekly to keep them informed of potential problems so that they will be prepared to take prompt action when necessary. CBT officials said that their staff also brief the CBT Business Conduct Committee on market developments at least weekly. The Business Conduct Committee has broad oversight responsibilities and can recommend that the CBT Board of Directors take emergency action. The Board of Directors can, by a two-thirds vote of the members voting, determine that an emergency exists and adopt emergency measures.

Our review of CFTC and CBT documents showed that CFTC and CBT began reviewing extensive market information on July soybean contracts in early June 1989. The information on the July soybean futures contract covered cash and futures prices, deliverable supplies, and the positions of large traders. The CFTC and CBT staffs prepared weekly summaries of market conditions relating to the July soybean futures contracts and, according to CFTC and CBT meeting minutes, they presented weekly briefings on the July soybean futures contract to the CFTC commissioners and the CBT Business Conduct Committee. Additionally, CFTC's chronology of the July soybean futures emergency shows that CFTC and CBT frequently exchanged market information.

Using Emergency Action Authority

The Commodity Exchange Act authorizes CFTC, if it determines an emergency exists, to direct an exchange to take such action as CFTC deems necessary to maintain or restore orderly trading in, or liquidation of, any futures contract. Under such authority, for example, the CFTC suspended grain futures trading for 2 days in 1980 after the President announced an embargo on the sale of grain to the Soviet Union.

Ferruzzi indicating that Ferruzzi would not cooperate with CBT's request to voluntarily liquidate its July soybean positions. The next day CBT issued its emergency order.

Controlling Leaks of Nonpublic Information

CFTC regulations require exchanges to have and enforce rules against their staffs and governing members using or disclosing material, nonpublic information. CBT has such rules. Also, according to CBT officials, the exchange takes steps to prevent leaks or use of nonpublic information related to emergency action decisionmaking by (1) reviewing reports that identify the largest market participants to detect if staff have positions in futures markets, (2) providing the information to committee members verbally rather than in writing, (3) securing confidentiality oaths from staff and committee members, and (4) scheduling Board of Directors' emergency action meetings after the close of trading. According to exchange officials, detection of improper use or disclosure of material, nonpublic information would result in CBT disciplinary action. CFTC officials said that CFTC could also choose to take enforcement action against the exchange or the violators if the exchange fails to act.

Our review showed that to the extent the activities of the CBT Business Conduct Committee and Board of Directors were documented, the documentation indicated that CBT followed its steps for preventing leaks during the July soybean emergency. For example, the written briefing materials presented to the Business Conduct Committee, as well as the committee's and board's minutes, did not contain any material nonpublic information. Also, CBT had on file signed copies of confidentiality oaths for members of the Business Conduct Committee. The July 11, 1989, Board of Directors emergency action meeting was held at 2:15 p.m., after the 1:15 p.m. close of trading. However, CBT did not document its confidentiality practices involving the exchange staff during the July soybean futures emergency action.

Avoiding Conflicts of Interest

CFTC Interpretative Letter 79-2, issued July 26, 1979, by CFTC's Office of General Counsel, seeks to ensure that exchange emergency actions are not taken in bad faith. The courts have ruled that a decision made in bad faith is one in which directors, governors, and officers of an exchange act in their self-interest and for personal gain.

CBT seeks to avoid bad faith in its emergency decisionmaking by excluding members with conflicts of interest from emergency action meetings.

diversity of the members making emergency action decisions. CBT officials added that this would be inconsistent with a Senate bill requirement that governing boards have meaningful representation of a diversity of interests. A CBT official said that under the House act, enough members could be excluded to prevent a quorum at decisionmaking meetings.

Our review of CFTC data indicated that the CBT July soybean emergency action decision would not have been affected had the proposed House conflict-of-interest standard been applied and been interpreted to exclude from voting on the emergency action decision (1) all CBT Board of Directors members with personal positions in July soybean futures; or (2) members who were employees, officers, or owners of firms with proprietary or customer positions in July soybean futures. However, a CBT official said that the direct financial interest standard contained in the House act could have been interpreted to include futures positions in other soybean futures contract months in addition to July, as well as cash market soybean positions. Under this interpretation, additional members would have been excluded from the Board of Directors meeting, thereby preventing a quorum.

Although the Senate bill requires exchange oversight committees and governing boards to assess the proprietary and customer positions of members' affiliated firms in making recusal decisions, it gives the exchanges discretion in determining who should be recused. CME officials said that they currently follow a practice similar to the Senate proposal by routinely reviewing the size of proprietary and customer positions of members' affiliated firms and using this information in deciding who may attend Business Conduct Committee meetings. However, a CBT official said that it does not support a discretionary standard because the standard would make the exchange's conflict-of-interest decisions contingent on a subjective rather than an objective review standard and would therefore put an additional, unnecessary burden of proof on the exchange.

Reviewing Exchange Emergency Actions

Exchange emergency actions are to meet the requirements of CFTC regulations and CFTC Interpretative Letter 79-2, including that (1) an emergency existed and (2) exchange actions were necessary or appropriate to meet the emergency. According to CFTC officials, after an exchange takes an emergency action, CFTC reviews the action to determine if the exchange met these CFTC requirements. A CFTC official told us that it reviews a variety of data from sources that include exchange meeting

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minutes, trading records and interviews with exchange members, exchange staff, and market participants to determine if CFTC requirements are met.

Our review of CFTC documents confirmed that CFTC had analyzed relevant data from these sources during its review of the July soybean emergency. Our review also confirmed that the data supported CFTC's conclusion that CBT was in compliance with CFTC requirements.

As arranged with your offices, unless you publicly announce its contents earlier, we plan no further distribution of this report until 2 days from its issue date. At that time, we will provide copies of the report to other interested Members of Congress and executive branch agencies. We will also send copies to CBT and CME and will make copies available to others upon request.

The major contributors to this report are listed in appendix I. Please contact me at 275-8678 if you or your staffs have any questions concerning this report.

Craig A. Simmons
Director, Financial Institutions
and Markets Issues

According to CBT officials, CBT requires Business Conduct Committee and Board of Directors members to recuse themselves from emergency action meetings if they own or control any positions in the futures contract under review. CBT officials told us that they use this standard because it prevents actual conflicts of interest and is unambiguous in its application.

Neither the Commodity Exchange Act, CFTC regulations, CFTC Interpretative Letter 79-2, nor the judicial record provide a specific standard governing a member's recusal from a board decision because of a potential conflict of interest. Given the latitude the current law allows, we have concluded that CBT's recusal standard is legally acceptable.

Our review of CFTC data also showed that all CBT Business Conduct Committee and Board of Directors members owning or controlling positions in the July soybean contract recused themselves from Business Conduct Committee and Board of Directors meetings that discussed the emergency action. CFTC's review of the July soybean emergency action concluded that no CBT governing member participating in the emergency action decision had a conflict of interest.

Both the House act and Senate bill include new conflict-of-interest standards. The House act would prohibit a member of a committee or governing board from voting on a proposed emergency action if (1) the member; (2) a legal entity of which the member is an officer or employee; (3) a legal entity in which the member owns a substantial interest; or (4) a legal entity, which is the parent or subsidiary of any legal entity specified in (2) or (3) had a direct financial interest in the action under discussion. The Senate bill would require an exchange's disciplinary committees and governing board to consider whether any exchange committee or board member must abstain from participating in emergency action decisionmaking due to the (1) positions held by such a member; or (2) positions, including customer positions, held at any firm with which such a member is affiliated.

The effect of the House act on who may attend emergency action decisionmaking meetings depends on how its direct financial interest provision is interpreted. A CBT official said that it could be interpreted to exclude all members whose firms have any involvement in the market under discussion. The official said that CBT opposes the House act because, although the proposed standard might eliminate some perceived conflicts of interest, it would lower the quality of exchange emergency action decisionmaking by reducing the level of expertise and the

CFTC regulations give the exchanges even broader authority to declare an emergency. The exchanges may intervene in the markets under any circumstance that, in the opinion of the exchange governing board, requires immediate action.

Although CFTC and CBT have broad emergency action authority, their officials said that they use it only as a last resort. Because of CFTC's emphasis on self-regulation, and because the circumstances under which it can declare an emergency are more limited than those allowed to the exchanges, CFTC officials said they expect the exchanges to take needed emergency actions and usually give them the opportunity to do so. CFTC and CBT officials said, however, that because they wish to minimize market disruption, they prefer market participants to voluntarily comply with requests to take steps to avert an emergency.

CFTC did not declare an emergency in the July soybean futures market and did not direct CBT to intervene in the markets. Instead, between May 25, and July 11, 1989, CFTC documents show that the agency asked a major market participant, a group of subsidiaries of Ferruzzi Finanziaria S.p.A. (Ferruzzi), at least 10 times to voluntarily reduce its large position in July soybean futures. CFTC documents indicate that requests were made by telephone and face-to-face. CFTC records also show that CFTC contacted Ferruzzi at least three other times on matters related to the July soybean market. Finally, on July 11, 1989, CFTC told Ferruzzi that it would not accept as bona fide hedging any of Ferruzzi's July soybean futures positions that were held against anticipated soybean processing requirements during the last 3 days of trading. According to a CFTC official, the CFTC action would have forced Ferruzzi to substantially reduce its July soybean futures position even if CBT had not taken emergency action on that same day. Also, according to CFTC testimony, CFTC officials discussed emergency action alternatives with CBT officials immediately before CBT's emergency action.

A CBT official told us that the exchange had not recommended emergency action in the July soybean futures market prior to July 11, 1989, because only then had it become clear that attempts to obtain voluntary action would not succeed. CBT documents indicate that the exchange contacted Ferruzzi at least six times to seek voluntary action. These contacts were face-to-face and by letter. In addition, CBT officials reported that they made numerous additional telephone calls to Ferruzzi between July 6, and July 10, 1989. Our review of CBT documents indicates that on July 10, 1989, 10 calendar days before the July soybean futures contract expired, CBT's Business Conduct Committee received a letter from prevent a potential disorderly expiration and defaults in the July soybean futures contract. Available data indicate that during the July soybean futures emergency action, CFTC and CBT followed their policies and procedures concerning emergency actions.

Objectives, Scope, and Methodology

To identify the policies, procedures, and practices that CFTC and CBT follow in market emergencies, we interviewed CFTC and CBT officials and reviewed a variety of materials and sources dealing with emergency actions, including the Commodity Exchange Act, CFTC regulations, CFTC and CBT procedures, and CBT rules. We verified whether CFTC and CBT had followed these procedures and practices during the July 1989 soybean market emergency by reviewing available documentation, including CFTC and CBT market surveillance files, CBT minutes from decisionmaking meetings, CFTC's analysis of CBT members' trading activity, and CFTC's documentation of interviews with CBT officials and members.

We also reviewed pending CFTC reauthorization legislation—the House act (H.R. 2869) and the Senate bill (S. 1729)—that includes new conflict-of-interest provisions. In addition to discussing these provisions with CBT officials, we interviewed Chicago Mercantile Exchange (CME) officials and reviewed their emergency action procedures to compare their approach to handling conflicts of interest to the approach in the proposed reauthorization legislation.

Our work was done at CFTC's headquarters and Chicago offices and at CBT and CME from October 1989 through January 1990. We did our review in accordance with generally accepted government auditing standards. Responsible CFTC, CBT, and CME officials reviewed a draft of this report and were in general agreement with it. They also provided technical clarifications that are incorporated into the report.

Identifying Emergencies

For the purposes of CFTC taking action, the Commodity Exchange Act defines emergencies as threatened or actual market manipulations[3] and corners,[4] as well as any act of the United States or a foreign government

[3]Market or price manipulation can be described as any intentional act or conduct that causes or maintains an artificial price.

[4]A corner can be described as someone having such control of the deliverable cash commodity that its futures price can be manipulated.