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I. INTRODUCTION[1]

On the morning of January 19, 1989, while many of Chicago's preeminent commodities lawyers were discussing industry issues at the American Bar Association's Annual Futures Law Meeting on the island of St. Martin, the *Chicago Tribune* disclosed that the Federal Bureau of Investigation had been conducting a massive two-year investigation of the world's two largest futures exchanges: the Chicago Board of Trade (the "CBT") and the Chicago Mercantile Exchange (the "CME").[2] The FBI investigation focused on reported allegations of widespread fraud, market manipulation, and cheating of customers in the "pits"[3] of the two Chicago exchanges.[4]

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The views expressed herein are solely those of the author and in no way reflect the views of any other individual or entity. The author assumes full responsibility for the contents of the article.

1. This article covers developments relating to the controversy over the practice of dual trading in the commodity futures markets that occurred prior to September 1, 1989. New developments may have taken place after the preparation of this article but prior to its publication.

2. Chicago Tribune, Jan. 19, 1989, at 1, col. 4.

3. At both the CBT and the CME, trading is conducted in octagonal and polygonal pits with steps descending to the center of each pit. Generally, each pit is devoted to the trading of one particular commodity or futures contract on that exchange. Traders stand in groups on the steps or in the center of the pit depending on the contract month of the commodity which they are trading. Chicago Board of Trade, Commodity Trading Manual at 35 (1989).

4. The investigation was apparently launched partly in response to a complaint made by Archer Daniels Midland Co. ("ADM"), a $6.8 billion grain and soybean producer located in Decatur, Illinois. According to the Chicago Tribune, ADM is the world's largest processor of farm commodities, and it has its own floor operation at the CBT. Nevertheless, in several instances, ADM has alleged that it would place an order at a certain price and would encounter difficulty in getting its order filled because floor brokers, upon learning of the order, would give priority to their own accounts. ADM allegedly participated in the investigation by giving at least two FBI agents entry-level jobs at its commodities-trading subsidiary, ADM Investors, Inc. *Farm Firms's Complaint Led To Probe*, Chicago Tribune, Jan. 22, 1989, at 1, col. 2. *See also* Behof, *Life in the Pits Will Never be the Same*, BUS. WK., Feb. 6, 1989, at 32-35.

At the center of the controversy is the thirteen-year old Commodity Futures Trading Commission's's[5] sanctioned practice known as "dual trading."[6] Dual trading allows floor brokers,[7] who execute orders for customers[8] on behalf of futures commission merchants[9] ("FCMs"), to also trade for their own account during the same trading period. Critics of dual trading are quick to point out that, in their view, the inherent conflict of interest[10] created by dual trading has caused widespread abuse and has led to many of the alleged violations currently under investigation.[11] Two of the more egregious forms of abuse are "front-running"[12] and "bucketing."[13] What the critics ignore, however, are the valid purposes

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5. Congress delegated decision-making power to the Commodity Futures Trading Commission ("CFTC" or "Commission") with respect to permitting or prohibiting the practice of dual trading. *See* Commodities Exchange Act, 7 U.S.C. § 1-26, 6j(1)-(2) (1988) [hereinafter Act].

6. The floor broker is only one example of commodity futures professionals who engage in the practice of dual trading. Other examples include the broker who receives customers' telephone orders and who also trades for his own account, and the futures commission merchant who processes the customer order and trades for his own proprietary account. *Study of the Role of Broker Trading at The Chicago Board of Trade, MidAmerica Commodity Exchange and the Chicago Rice and Cotton Exchange*, Prepared by Staff of the Three Exchanges in Response to a CFTC Request of Mar. 8, 1989, at 9-10 [hereinafter CBT Report].

7. Section 2(a)(1)(A) of the Commodity Exchange Act defines a "floor broker" as "any person who, in or surrounding any 'pit', 'ring', 'post', or other place provided by a contract market for the meeting of persons similarly engaged, shall purchase or sell for any other person any commodity for future delivery on or subject to the rules of any contract market." 7 U.S.C. § 2(a)(1)(A) (1988).

8. Under Regulation section 1.3(k), "customer" and "commodity customer" have the same meaning and refer to a customer trading in any commodity named in the definition of commodity (see Regulation section 1.3(e) for definition of commodity), but does not include an owner of a proprietary account. 17 C.F.R. § 1.3(k) (1989). *See infra* note 60 (definition of "propriety account").

9. Section 2(a)(1)(A) of the Act defines "futures commission merchants" as "individuals, associations, partnerships, corporations, and trusts engaged in soliciting or in accepting orders for the purchase or sale of any commodity for future delivery on or subject to the rules of any contract market and that, in connection with such solicitation or acceptance of orders, accepts any money, securities or property (or extends credit in lieu thereof) to margin, guarantee, or secure any trades or contracts that result or may result therefrom." 7 U.S.C. § 2(a)(1)(A) (1988).

10. The Commission duly noted this point in the release proposing the dual trading regulations. 40 Fed. Reg. 58,660, 58,661, (1975), [1975-1977 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,118, at 20,842.

11. In a recent letter to the CME, the President of the National Cattlemen's Association stated: "[t]he FBI investigation of alleged fraud at the futures exchanges has renewed cattlemen's concerns about the ability of the exchanges to effectively police dual trading activity. . . . In light of this, NCA requests that the CME eliminate dual trading in the cattle contracts." Wortham, Jr., *Dual Trade Ban Requested*, W. LIVESTOCK J., Mar. 20, 1989, at 1. *See also* Wall St. J., Mar. 14, 1989, at C-1, col. 2.

12. *See infra* notes 113-14 and accompanying text.

13. *See infra* notes 115-20 and accompanying text.

and important role of dual trading in providing depth and liquidity to the commodity futures markets.

This Article will analyze both the arguments in favor of and against banning the practice of dual trading and will conclude that such a prohibition would be premature at the present time. Specifically, this Article will address the following: the historical development of CFTC-sanctioned dual trading, including the adoption by the CFTC and various self-regulatory organizations[14] of comprehensive regulations designed to restrict abuses associated with dual trading; fraudulent practices commonly associated with dual trading and the positive aspects of permitting dual trading; the stringent penalties already provided by the Commodity Exchange Act,[15] the rules thereunder and exchange rules for violations of dual trading regulations; and finally, recommendations for Congressional action during the 1989 CFTC reauthorization proceedings[16] with respect to improving but not eliminating the practice of dual trading.

II. History of Dual Trading

A. *Congressional Consideration of Dual Trading*

Section 6j(1)[17] and (2)[18] of the Act direct the CFTC[19] to deter-

14. Regulation section 1.3(ee) defines "self-regulatory organization" as a "contract market (as defined in section 1.3(h)) or a registered futures association under section 17" of the Commodity Exchange Act. 17 C.F.R. § 1.3(ee) (1989). The National Futures Association is currently the only registered futures association. For a further discussion of section 1.3(h), see *infra* note 27.

15. 7 U.S.C. § 1-26 (1988).

16. Section 101(b) of the Commodity Futures Trading Commission Act of 1974 amended section 12 of the Commodity Exchange Act regarding operations of the Commission, by appropriating funds to the CFTC for only four years so that Congress could review the Commission's operations at that time. This process of appropriating funds at set intervals and only after Congressional review is known as "reauthorization." The CFTC has been reauthorized every four years (with one exception) since 1974, by virtue of the Futures Trading Act of 1978, the Futures Trading Act of 1982 and the Futures Trading Act of 1986. Section 106 of the Futures Trading Act of 1986, however, amended subsection (d) of section 12 of the Commodity Exchange Act (7 U.S.C. § 16(d) (1988)) to provide for the appropriation of funds for only a three-year period. Consequently, appropriations for the current reauthorization period ended on September 30, 1989. For an excellent analysis of the CFTC reauthorization process, see Johnson, *The Commodity Futures Trading Commission Reauthorization Process: A View From the Trenches*, 1979 DET. C.L. REV. 1.

17. Section 6j(1) provides:

> The Commission shall within nine months after the effective date of the Commodity Futures Trading Commission Act of 1974, and subsequently when it determines that changes are required, make a determination, after notice and opportunity for hearing, whether or not a *floor broker* may trade for his own account or any account in which such broker has trading discretion, and also

mine, after notice and opportunity for hearing, whether the practice of dual trading should be permitted to continue (i.e., whether an FCM or floor broker should be permitted to trade for his own account or one over which he has discretion and at the same time be permitted to execute a customer order for the same futures contract). This section, originally section 203 of the Commodity Futures Trading Commission Act of 1974[20] (the "1974 Act"), resulted from Congressional concern over conflicts of interest inherent in the practice of dual trading. Congress was especially concerned that FCMs or floor brokers would fail to meet their duty of full loyalty[21] as agents to their customers if they were allowed to simultaneously trade as principal, directly benefitting themselves or their associates.[22] Congress was also concerned that

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> execute a customer's order for future delivery and, if the Commission determines that such trades and such executions shall be permitted, the Commission shall further determine the terms, conditions, and circumstances under which such trades and such executions shall be conducted: Provided, That any such determination shall, at a minimum, take into account the effect upon the liquidity of trading of each market: And provided further, That nothing herein shall be construed to prohibit the Commission from making separate determinations for different contract markets when such are warranted in the judgment of the Commission, or to prohibit contract markets from setting terms and conditions more restrictive than those set by the Commission.

7 U.S.C. § 6j(1) (1988) (emphasis added).

18. Section 6j(2) contains an identical provision regarding FCMs. *See* 7 U.S.C. § 6j(2) (1988).

19. The establishment of the CFTC is prescribed by section 4a of the Act which provides that the Commission shall be composed of five Commissioners, who shall be appointed by the President, by and with the advice and consent of the Senate. Not more than three members of the Commission shall be members of the same political party and each Commissioner shall hold office for a term of five years. Section 4a also provides that the President shall appoint, by and with the advice and consent of the Senate, a member of the Commission as Chairman, who shall serve at the pleasure of the President. 7 U.S.C. § 4a (1988).

20. Act of October 23, 1974, Pub. L. No. 93-463, 88 Stat. 1389, 1396 (1974).

21. H.R. REP. NO. 975, 93rd Cong., 2d Sess. 64 (1974).

22. Regulation section 1.3(aa) defines "associated person" as follows:

> any natural person who is associated in any of the following capacities with: (1) A futures commission merchant as a partner, officer, or employee (or any natural person occupying a similar status or performing similar functions), in any capacity which involves (i) the solicitation or acceptance of customers' or option customers' orders (other than in a clerical capacity) or (ii) the supervision of any person or persons so engaged; (2) An introducing broker as a partner, officer, employee, or agent (or any natural person occupying a similar status or performing similar functions), in any capacity which involves (i) the solicitation or acceptance of customer's or option customer's orders (other than in a clerical capacity) or (ii) the supervision of any person or persons so engaged; (3) A commodity pool operator as a partner, officer, employee, consultant, or agent (or any natural person occupying a similar status or performing similar functions), in any capacity which involves (i) the solicitation of funds, securities or

adequate procedural safeguards did not exist. At the time the 1974 Act was adopted, time-stamping[23] was not a required practice; consequently, the ability to detect dual trading abuses was extremely difficult. In this regard, a report of the Comptroller General of the United States concluded that:

> Since timing information is not required on a broker's personal trades, the abusive practice of a broker trading for his own account while he has a customer's order in hand is virtually impossible to detect because the time sequence of the broker's trades cannot be determined from the records.[24]

The legislative history of section 6j[25] indicates that Congress was aware of both the conflicts of interest inherent in the practice of dual trading as well as the positive aspects of dual trading[26] (i.e., that it promotes liquidity in the various contract markets[27] and expertise among floor brokers). Yet, Congress did not ban or even

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> property for a participation in a commodity pool, or (ii) the supervision of any person or persons so engaged; or (4) A commodity trading advisor as a partner, officer, employee, consultant, or agent (or any natural person occupying a similar status or performing similar functions), in any capacity which involves: (i) the solicitation of a client's or prospective client's discretionary account, or (ii) the supervision of any person or persons so engaged; and (5) A leverage transaction merchant as a partner, officer, employee, or agent (or any natural person occupying a similar status or performing similar functions), in any capacity which involves: (i) the solicitation or acceptance of leverage customers' orders (other than in a clerical capacity) for leverage transactions . . . or (ii) the supervision of any person or persons so engaged.

17 C.F.R. § 1.3(aa) (1989).

23. Time-stamping is required of any contract market member who receives a customer's or option customer's order not in the form of a written record. Upon receipt of such an order, the member must immediately prepare a written record, including the account identification and order number, and must record thereon, by time-stamp or other recording device, the date and time to the nearest minute the order is received. Subparagraph (3) of Regulation section 1.35, however, exempts from this requirement members of a contract market whose customer is another member, present on the floor when the order is received, and who, in executing such transaction, notes on his trading card or other record, the time of execution to the nearest minute. 17 C.F.R. § 1.35(a)(2)-(3) (1989).

24. Comptroller General of the United States, Report to the Congress on Improvements Needed in Regulation of Commodity Futures Trading (June 24, 1975), Comm. Fut. L. Rep. (CCH) ¶ 20,051, at 20,647-20, 20,652. *See also* Comm. Fut. L. Rep. (CCH) (Number 6, Extra Edition).

25. S. REP. NO. 93-1131, 93rd Cong., 2d Sess. 3, *reprinted in* 1974 U.S. CODE CONG. & ADMIN. NEWS 5843, 5871.

26. *See infra* notes 121-37 and accompanying text for a discussion regarding the positive aspects of dual trading.

27. Regulation section 1.3(h) defines "contract market" as "a board of trade designated by the Commission as a contract market under the Commodity Exchange Act." 17 C.F.R. § 1.3(h) (1989).

restrict dual trading.[28] Rather, Congress delegated those determinations to the Commission, concluding that it did not have sufficient evidence to make such a determination on its own.[29]

B. CFTC Regulation of Dual Trading

Following the enactment of the 1974 Act, and pursuant to the mandate established under section 6j of the Act, the CFTC established an Advisory Committee on Regulation of Contract Markets and Self-Regulatory Associations (the "Advisory Committee"). The Advisory Committee concluded that dual trading was necessary to provide depth and liquidity to the contract markets, but regulation was also needed to control potential abuses of dual trading.[30] The Advisory Committee's report[31] further suggested that a study be conducted of time-stamping mechanisms or other systems that would permit more precise recordation of the time at which trades are executed. As a result of the Advisory Committee's study, on December 23, 1976, the Commission adopted the following regulations designed to prevent abuses associated with dual trading.[32]

1. Floor Broker Trading Standards

Regulation section 155.2[33] requires each contract market to adopt a set of rules to prevent abuses of the relationships between its floor broker members and the persons for whom such members execute transactions. The contract market rules are required, at a minimum, to include the provisions discussed below.

First, Regulation sections 155.2(a)[34] and (b),[35] generally referred to as the "customer first rules," prohibit the practice of "front-running"[36] or trading ahead of a customer. The customer first rules prohibit floor brokers from purchasing or selling any commodity

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28. 40 Fed. Reg. 58,660, 58,661 (1975), [1975-1977 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,118, at 20,842.

29. *Id.*

30. 41 Fed. Reg. 56,134 (1976), [1975-1977 Transfer Binder] Comm. Fut. L. Rep. (CCH), ¶ 20,242, at 20,842.

31. The Advisory Committee's report is known as the "Kane-Weinberg Report." Copies of the report are available for inspection at the Commission's offices at 2033 K Street, N.W., Washington, D.C. 20581.

32. 41 Fed. Reg. 56,134, 56,136 (1976), [1975-1977 Transfer Binder] Comm. Fut. L. Rep. (CCH), ¶ 20,242, at 21,293.

33. 17 C.F.R. § 155.2 (1989).

34. 17 C.F.R. § 155.2(a) (1989).

35. 17 C.F.R. § 155.2(b) (1989).

36. *See infra* notes 113-14 and accompanying text.

for future delivery for his own account or for any account in which he has an interest while holding another person's order for the purchase or sale of the same commodity, which is executable at the market price[37] or the price at which such purchase or sale can be made for the floor broker's own account. Floor brokers, however, are allowed to trade in the opposite direction of their customers.[38]

Second, Regulation section 155.2(c)[39] is designed to prevent a floor broker from trading ahead of customers, not for the benefit of his own account but for those customer accounts over which the floor broker has discretion.[40] It requires that the contract market rules prohibit each floor broker from executing any transaction for another person's account for which buying and/or selling orders can be placed or originated, or for which transactions can be executed by such floor broker, without the prior specific consent of the account owner, except that orders for such accounts may be placed with another floor broker on the contract market for execution.[41] This prohibition, however, does not extend to accounts in which the floor broker's discretion is limited to selecting the precise time and price at which a customer originated order is executed.[42]

Third, Regulation section 155.2(d)-(h),[43] respectively, require that each floor broker be prohibited from: (1) disclosing the orders of other persons;[44] (2) taking the other side of any order of another

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37. The CFTC has declined to clarify the term "market price," but it has stated that a floor broker who is holding a customer order that is executable at or near the market price should concentrate his efforts on executing that order and not on trading for his own account. The Commission has stated the "regulation is intended to require that under all circumstances the customer must come first." 41 Fed. Reg. 56,134, 56,136 (1976), [1975-1977 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,242, at 21,293.

38. The Commission maintains that this practice may benefit customers by softening the impact of their orders on the market, thereby helping the customer to get a better execution of his order. *Id.*

39. 17 C.F.R. § 155.2(c) (1989).

40. Regulation section 15.00(h) defines "discretionary account" as a "commodity futures or commodity option trading account for which buying and/or selling orders can be placed or originated, or for which transactions can be effected, under a general authorization and without specific consent of the customer, whether the general authorization for such orders or transactions is pursuant to a written agreement, power of attorney, or otherwise." 17 C.F.R. § 15.00(h) (1989).

41. 17 C.F.R. § 155.2(c) (1989). According to the Commission, this regulation "is designed to prevent floor brokers from placing their personal trading interests ahead of their customer's interests when exercising trading discretion over such customer's accounts." 41 Fed. Reg. 56,134, 54,136 (1976), [1975-1977 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,242, at 21,294.

42. *Id.* at 21,295.

43. 17 C.F.R. § 155.2(d)-(h) (1989).

44. The underlying purpose of this regulation is to prohibit a floor broker from disclosing customer orders to other persons who may take advantage of that knowledge.

person revealed to a floor broker by reason of his relationship to such other person (except with such other person's prior consent and in conformity with contract market rules);[45] (3) prearranging trades;[46] (4) allocating trades among accounts;[47] or (5) withholding or withdrawing from the market any order or part of an order of another person for the convenience of another member of the con-

Yet, such disclosure may be made in the normal course of "legitimate business activities," such as when a floor broker places orders for a discretionary account with another floor broker (as required by Regulation section 155.2(c)). This type of disclosure would clearly be permitted. 41 Fed. Reg. 56,134, 56,137 (1976), [1975-1977 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,242, at 21,295.

45. This, in effect, allows a customer to waive his right to a fully competitive execution. *See* 1 P. JOHNSON & T. HAZEN, COMMODITIES REGULATION 310 (1989).

46. The prohibition on prearranged trading is designed to augment the requirement set forth in Regulation section 1.38 that "all purchases and sales of any commodity for future delivery on or subject to the rules of a contract market shall be executed openly and competitively by open outcry or posting of bids and offers or by other equally open and competitive methods . . . ." 17 C.F.R. § 1.38 (1989).

47. This regulation "is designed to prohibit floor brokers from allocating the best trades to their own accounts and the accounts of their preferred customers to the detriment of their other customers." 41 Fed. Reg. 56,134, 56,137 (1976), [1975-1977 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,242, at 21,295. For example, a floor broker or FCM may receive a large number of customer orders to be executed "at the market." Frequently, these orders will be executed by the floor broker or FCM in a block, although not usually in a single trade. This type of execution will often result in different prices for various trades. It is at this point that a floor broker or FCM must allocate the trades among his customers. Yet, the CFTC has stated that the broker is required to apply a first in, best execution price type of allocation when such allocation is necessitated by the rare situation of a broker holding multiple individual orders for the purchase or sale of the same number of contracts in the same commodity and delivery month.

For example, assume the facts in the following situation: Dewey, Cheatham & Howe ("DCH"), a registered FCM with its own floor operation at the CBT, receives five nearly simultaneous buy orders for ten contracts each (50,000 bushels per order) of August soybeans. When the orders are placed, soybean contracts are trading at an index of 5.75 1/2. The five orders are from the following individuals and are received by DCH at the times indicated in parenthesis: Able (10:35:10 a.m.), Baker (10:35:12 a.m.), Charlie (10:35:14 a.m.), Daniel (10:35:16 a.m.), and Edward (10:35:18 a.m.). Able, Baker, and Charlie are infrequent customers of DCH, whereas Daniel and Edward are preferred customers.

Assume further that the orders are executed as follows: Edward's order is executed first at 10:42:15 a.m. at an index of 5.75 1/2; Daniel's order is executed second at 10:42:20 a.m. at an index of 5.77 1/2; Charlie's order is executed third at 10:42:25 at an index of 5.78; Baker's order is executed fourth at 10:42:30 at an index of 5.82 1/4; and Able's order is executed fifth at 10:42:35 at an index of 5.84. Even though all five orders were received by DCH within two seconds of each other, and notwithstanding the fact that Edward's and Daniel's orders were executed first and second, respectively, applying the first in, best execution price type of allocation, DCH cannot allocate the two lowest trades (5.75 1/2 and 5.77 1/2), to the accounts of its preferred customers, Daniel and Edward. Instead, it must allocate the best trades in the order that they were received by DCH. *Cf.* 1 P. JOHNSON & T. HAZEN, *supra* note 45, at 152-53 (recently, the CFTC has indicated that other methods of allocating trades may be appropriate).

tract market.[48]

Finally, with respect to clearing member confirmations, Regulation section 155.2(i)[49] requires that every execution of a transaction on the floor by a member be confirmed promptly with the opposite floor broker or floor trader.[50] The confirmation must identify price or premium, quantity, future or commodity option, and respective clearing members.[51] This regulation further provides that the Commission may exempt a contract market from this requirement if: (1) the contract market can explain "why it cannot require the prompt identification of respective clearing members without seriously disrupting the functions of its marketplace;" and (2) the contract market proposes a "rule which will insure that the opposite sides of every trade executed on the contract market can be effectively matched and will be accepted by a clearing member for clearance or will be otherwise sufficiently guaranteed."[52] With respect to the former, the contract market must make a significant showing of market disruption in order to propose an alternative rule.[53] According to the CFTC Release adopting the dual trading regulations, the Commission was concerned that the failure to require prompt confirmation with opposing clearing members might create situations in which the opposite sides of transactions would be improperly matched.[54] The Commission felt that this would make effective transaction time sequence reconstruction and trading surveillance more difficult and might lead to dual trading abuses.

48. This regulation is designed to prevent floor brokers from acting against the best interests of their customers for the benefit of other floor brokers and traders. For example, a floor broker holding a large sell order in a particular contract would be prevented from withholding that order while other brokers and traders first get out of their positions in that contract. 41 Fed. Reg. 56,134, 56,137 (1976), [1975-1977 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,242, at 21,295.

49. 17 C.F.R. § 155.2(i) (1989).

50. According to the CFTC, "prompt confirmation" serves two purposes: first, it insures accurate matching of trades, which reduces the number of out-trades; and second, it insures, to the extent possible, that each transaction will be guaranteed by the financial integrity of both the particular clearing member and the clearing house of the contract market. 41 Fed. Reg. 56,134, 56,138 (1976), [1975-1977 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,242, at 21,296.

51. 17 C.F.R. § 155.2(i) (1989). Regulation section 1.3(c) defines the term "clearing member" as "any person who is a member of, or enjoys the privilege of clearing trades in his own name through the clearing organization of a contract market." 17 C.F.R. § 1.3(c) (1989).

52. 17 C.F.R. § 155.2(c) (1989).

53. 41 Fed. Reg. 56,134, 56,137 (1976), [1975-1977 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,242, at 21,296.

54. *Id.*

2. FCM Trading Standards

With respect to FCMs, the Commission chose not to require contract markets to adopt rules that conform to the minimum standards set forth above for floor brokers. Rather, it decided to impose a direct obligation upon each FCM to establish and to enforce internal rules, procedures and controls in order to prevent abuses of the relationship of the FCM and its affiliated persons[55] to customers.[56] The CFTC based its determination on its perception of "the present inadequacies in the rule enforcement programs of many contract markets."[57] Therefore, the CFTC adopted Regulation section 155.3,[58] which establishes certain minimum safeguards that must be adopted by all FCMs. It includes the provisions discussed below.

First, Regulation section 155.3(a)(1),[59] also known as the "customer first rule," requires customer orders executable at or near the market price to be transmitted to the appropriate contract market floor *before* orders for the FCM's proprietary account[60] (or or-

55. Regulation section 155.1 defines the term "affiliated person" of a futures commission merchant or of an introducing broker as "any general partner, officer, director, owner of more than ten percent of the equity interest, associated person or employee of the futures commission merchant or of the introducing broker, and any relative or spouse of any of the foregoing persons, or any relative of such spouse, who shares the same home as any of the foregoing persons." 17 C.F.R. § 155.1 (1989).

56. 41 Fed. Reg. 56,134, 56,137 (1976), [1975-1977 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,242, at 21,297.

57. 41 Fed. Reg. 56,134, 56,138 (1976), [1975-1977 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,242, at 21,298.

58. 17 C.F.R. § 155.3 (1989).

59. 17 C.F.R. § 155.3(a)(1) (1989).

60. Regulation section 1.3(y) defines "proprietary account" as

> a commodity futures or commodity option trading account carried on the books and records of an individual, a partnership, corporation or other type association, (1) for one of the following persons, or (2) of which ten percent or more is owned by one of the following persons, or an aggregate of ten percent or more of which is owned by more than one of the following persons: (i) Such individual himself, or such partnership, corporation or association itself; (ii) In the case of a partnership, a general partner in such partnership; (iii) In the case of a limited partnership, a limited or special partner in such partnership whose duties include: (A) The management of the partnership business or any part thereof, (B) The handling of the trades or customer funds of customers or option customers of such partnership, (C) The keeping of records pertaining to the trades or customer funds of customers or option customers of such partnership, or (D) The signing or co-signing of checks or drafts on behalf of such partnership; (iv) In the case of a corporation or association, an officer, director or owner of ten percent or more of the capital stock, of such organization; (v) An employee of such an individual, partnership, corporation or association whose duties include: (A) The management of the business of such individual, partnership, corporation or association or any part thereof, (B) The handling of the

ders for accounts in which it has an interest or over which it exercises discretion) in the same commodity are transmitted to the floor of that contract market.[61] Regulation section 155.3(a)(2)[62] imposes this same obligation on the FCM's affiliates.[63] Therefore, it requires that each FCM take appropriate measures to prevent its affiliated persons from circumventing the requirement set forth in subparagraph (1) of the rule by placing orders with other FCMs.

With respect to order confidentiality, Regulation section 155.3(b)(1)[64] makes it unlawful for an FCM to unnecessarily disclose an order of another being held by it or its affiliate. Lastly, Regulation section 155.3(b)(2)[65] prohibits any FCM from knowingly taking the other side of an order of another person, revealed to them by reason of their relationship to such other person, except with the prior consent of such person and in conformity with contract market rules.[66]

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trades or customer funds of customers or option customers of such individual, partnership, corporation or association, (C) The keeping of records pertaining to the trades or customer funds of customers or option customers of such individual, partnership, corporation, or association, or (D) The signing or co-signing of checks or drafts on behalf of such individual, partnership, corporation or association; (vi) A spouse or minor dependent living in the same household of any of the foregoing persons; (vii) A business affiliate that directly or indirectly controls such individual, partnership, corporation or association; (viii) A business affiliate that, directly or indirectly is controlled by or is under common control with, such individual, partnership, corporation or association. *Provided however,* That an account owned by any shareholder or member of a cooperative association of producers, within the meaning of section 5e and 6a of the Act, which association is registered as a futures commission merchant and carries such account on its records, shall be deemed to be an account of a customer or option customer and not a proprietary account of such association, unless the shareholder or member is an officer, director or manager of the association.

17 C.F.R. § 1.3(y) (1989).

61. With respect to branch offices of an FCM, however, the Commission has rejected the view that Regulation section 155.3(a)(1) requires "that clerical employees, such as teletype operators, who receive orders from several associated persons continuously and often simultaneously for mechanical transmission to the appropriate contract market for execution, arrange those orders so that customer's orders are always submitted prior to proprietary orders." 41 Fed. Reg. 56,134, 56,139 n.19 (1976), [1975-1977 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,242, at 21,298 n.18.

62. 17 C.F.R. § 155.3(a)(2) (1989).

63. For a definition of "affiliated person," see *supra* note 55.

64. 17 C.F.R. § 155.3(b)(1) (1989).

65. 17 C.F.R. § 155.3(b)(2) (1989).

66. This regulation augments section 6b(D) of the Act, which makes it unlawful for any member of a contract market to, among other things, "become the buyer in respect to any selling order . . . or become the seller in respect to any buying order" of a customer without his consent. 7 U.S.C. § 6(b)(D) (1988). *See infra* text accompanying note 167.

3. FCMs' Affiliated Person Trading Standards[67]

The CFTC adopted Regulation sections 155.3(c) and (d) to assist FCMs in supervising the trading activities of their affiliated persons. This section generally provides FCMs with notification and information concerning the accounts maintained by their affiliated persons with other FCMs.

Regulation section 155.3(c)[68] makes it unlawful for any FCM to "knowingly handle the account of any affiliated person of another FCM" unless: (1) the FCM handles the account pursuant to written authorization by a person employed by the other FCM having responsibility for surveillance over such account; (2) upon receipt of such order the FCM immediately prepares a written record of such order and records thereon the date and time, to the nearest minute at which the order was received, by time-stamp or other device; and (3) the FCM transmits, on a regular basis to the other FCM with which such person is affiliated, copies of all statements for the account of such person and copies of all written, time-stamped records prepared upon the receipt of orders for such account.

Regulation section 155.3(d)[69] additionally prohibits any affiliated person of an FCM to have an account, directly or indirectly, with another FCM unless: (1) written authorization is received from a designated official of the FCM with which such person is affiliated for the maintenance of such account; and (2) upon receipt of orders for such account, copies of all statements for it and copies of all written, time-stamped records prepared by such other FCM are transmitted on a regular basis to the FCM with which such person is affiliated.

4. Transaction Time Sequence Reconstruction Capability

In adopting record-keeping requirements regarding dual trading, the Commission stated:

> [D]rawing a meaningful conclusion with respect to the significance of dual trading abuses in the absence of a rapid and accurate transaction time sequence reconstruction capability . . . [and] . . . [t]he ability of the Commission to analyze in a meaningful way the effects of dual trading on market liquidity in the absence

67. *See* 41 Fed. Reg. 56,134, 56,139 (1976), [1975-1977 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,242, at 21,299.

68. 17 C.F.R. § 155.3(c) (1989).

69. 17 C.F.R. § 155.3(d) (1989).

of such reconstruction capability is . . . hampered.[70]

The Commission was concerned that, under their then-current systems and procedures, the exchanges would be unable to detect abuses such as front-running and bucketing,[71] even if they were occurring with some frequency.[72] The Commission likely took the view that it could not completely fulfill its statutory responsibilities under section 4j[73] of the Act if the contract markets did not have the ability to rapidly and accurately reconstruct the time and sequence of transactions during any given trading period. Accordingly, the Commission adopted the following amendments to Regulation section 1.35.[74]

The CFTC adopted Regulation section 1.35(h),[75] which requires all contract markets to establish and maintain a price change register capable of recording each change in price within ten seconds after such change. In addition, Regulation section 135(g)(2)[76] requires the contract markets to implement, as soon as possible, timing and record-keeping systems and procedures that will enable them to show the mechanically or electronically verified execution time of each futures trade to at least the nearest minute.[77]

Finally, pursuant to Regulation section 1.35(e),[78] all information required by the regulation must be kept in a single record that shows the following: transaction date, time, quantity and, as applicable, underlying commodity, contract for future delivery or physical,[79] price or premium,[80] delivery month[81] or expiration date

70. 41 Fed. Reg. 56,134, 56,139 (1976), [1975-1977 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,242, at 21,300.

71. *See infra* notes 113-20 and accompanying text (further discussion of front-running and bucketing).

72. *Id.*

73. 7 U.S.C. § 6j (1988).

74. 17 C.F.R. § 1.35 (1989).

75. 17 C.F.R. § 1.35(h) (1989).

76. 17 C.F.R. § 1.35(g)(1) (1989). Section 1.35(g)(1) was amended in 1986. It previously required the exchanges to determine only the thirty-minute period within which each trade was executed.

77. The one-minute bracket in which exchanges identify futures transactions has been criticized by the Government Accounting Office ("GAO") as insufficient to record the actual price of the transaction. Due to the efficiency of floor traders, several trades can be executed within one minute. *Chicago Futures Market: Initial Observations on Trade Practice Abuses*, United States General Accounting Office Report to the Chairman, Committee on Agriculture, Nutrition and Forestry U.S. Senate GAO/GGD-89-58 (Mar. 1989) [hereinafter GAO Report]. *See infra* text accompanying note 138 (a more detailed discussion of the GAO Report).

78. 17 C.F.R. § 1.35(e) (1989).

79. 17 C.F.R. § 1.3(ll) (1989). "Physical" means "any good, article, service, right or interest upon which a commodity option may be traded in accordance with the Act and . . . regulations." *Id.*

whether the transaction involved a put or a call, strike price,[82] floor broker or floor trader buying, clearing member buying, floor broker or floor trader selling, or clearing member selling. In addition, both the buying and selling customer type indicators[83] must be shown on the record of each futures trade. The records must be kept in computer readable form on compatible magnetic tapes or discs for a sixty-day period in a format and coding structure approved by the CFTC.

C. *Exchange Regulation of Dual Trading*

Pursuant to the requirement set forth in Regulation section 155.2,[84] the commodity futures exchanges have adopted rules designed to comply with the CFTC's dual trading regulations. Both the CBT[85] and the CME[86] have adopted rules that are sub-

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80. 17 C.F.R. § 1.3(ii) (1989).

81. 17 C.F.R. § 1.3(l) (1989).

82. 17 C.F.R. § 1.3(kk) (1989).

83. 17 C.F.R. § 1.35(e) (1989). Regulation section 1.35(e) states that the "customer and option customer type indicators shall show, with respect to each person executing the trade, whether such person: (1) Was trading for his own account; (2) Was trading for his clearing member's house account; (3) Was trading for another member present on the exchange floor, or an account controlled by such member; or (4) Was trading for any other type of customer or option customer." *Id.*

84. 17 C.F.R. § 155.2 (1989).

85. The CBT has adopted the following rules regulating the practice of dual trading: Rule 350.05(a)-(b) (substantially similar to the prohibition on dual trading in proprietary and affiliate's accounts found in Regulation § 155.2(a)-(b)); Rule 350.05(c) (substantially similar to the prohibition on dual trading in discretionary accounts found in Regulation § 155.2(c)); Rule 350.05(d) (substantially similar to the prohibition on disclosing orders of other persons found in Regulation § 155.2(d)); Rule 350.05(e) (substantially similar to the prohibition on taking the other side of orders of another person as set forth in Regulation § 155.2(e)); Rule 350.05(f) (substantially similar to the prohibition against prearranged trading found in Regulation § 155.2(f)); Rule 350.05(g) (substantially similar to the prohibition against withholding or withdrawing from the market any order or part of an order of another person for the convenience of another member of the contract market found in Regulation § 155.2(h)); Rule 350.05(k) (substantially similar to the prohibition on allocating trades among accounts found in Regulation § 155.2(g)); and Rule 350.05(j) (substantially similar to the requirement set forth in Regulation § 1.35(g)(1) that parties to a transaction properly notify the pit recorder of the price at which trades have been consummated). In addition to those rules tracking the CFTC regulations in language and format, the CBT has also adopted rules prohibiting the practices commonly referred to as "accommodation trading" (Rule 350.05(i)) and "curb trading" (Rule 350.05(h)) (*see infra* notes 105 and 109, respectively, for definitions of these terms). Board of Trade of the City of Chicago Rules and Regulations, Exchange Floor Operations and Procedures Rule 350.05(a)-(l), at 316 (July 1989) [hereinafter Rules of the CBT].

86. Similarly, the CME has adopted the following rules regulating the practice of dual trading: Rule 530—Priority of Customers' Orders; Rule 531—Trading Against Customers' Orders Prohibited; Rule 532—Disclosing Orders Prohibited; Rule 533—Simultaneous Buying and Selling Orders for Different Principals Executed by One Trader; Rule 534—Simultaneous Buying and Selling Orders for the Same Principals Prohibited;

stantially similar to both the language and format of the CFTC regulations. The CME, however, has deviated slightly by adopting a rule that restricts the practice of dual trading on the top step of the S&P 500 futures pit.[87] In addition, other exchanges have adopted rules designed to comply with Regulation section 155.2, for example, the Board of Trade of Kansas City, Missouri, Inc. ("KCBT"),[88] the Coffee, Sugar and Cocoa Exchange ("CSCE"),[89] the Commodity Exchange ("COMEX"),[90] the Minneapolis Grain Exchange ("MGE"),[91] the New York Cotton Exchange ("NYCE"),[92] the New York Futures Exchange ("NYFE"),[93] and the New York Mercantile Exchange ("NYMEX").[94]

It is readily apparent, from this recitation of CFTC and exchange rules, that procedures already exist for the detection and prevention of abuses associated with dual trading. The exchanges have clearly met their mandate under Regulation section 155.2[95] to

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Rule 536—Record for Orders and Personal Transactions; Rule 537—Confirmations to Customers; Rule 528—Change in Last Sale Price; and Rule 529—Withholding Orders Prohibited. Rules of the Chicago Mercantile Exchange (revised and amended and effective through June 30, 1989) [hereinafter Rules of the CME].

87. The so-called "Top Step Rule" provides that "[a] member shall not trade an S&P 500 futures contract for his own account while on the top step of the S&P 500 futures pit, except that a member may liquidate a position that resulted from an error. A member who has executed an S&P 500 futures contract order while on the top step of the S&P 500 futures pit, shall not thereafter on the same day trade S&P 500 futures contracts for his own account." Rules of the CME, Closing Date Orders Rule 541 at 23, *supra* note 86, ch. 5, at 15. The Top Step Rule is the indirect result of a petition filed by local traders and signed by more than 800 floor members in 1987. The petition requested a complete ban on dual trading in the entire S&P 500 futures pit but was rejected in a membership vote on April 13, 1987. The CME board recommended the adoption of the "Top Step Rule" as a compromise measure and contended that 95% of all customer orders were executed on the top step. *How Pit Practices Are Shaking S&P 500 Image*, FUTURES, May 1987, at 42; see *also* Pierog & Wilson, *Open Season On Open Outcry?* FUTURES, Mar. 1989, at 60; *How S&P Rules Could Change*, FUTURES, May 1987, at 48; Chicago Sun Times, Mar. 3, 1987, at 45, col. 1. *See infra* note 114 for an explanation of the S&P index.

88. By-Laws, Rules and Regulations of the Board of Trade of Kansas City, Missouri, Inc., Floor Broker Rules 1130.00-1138.00, at 1107-08.

89. Coffee, Sugar & Cocoa Exchange, Guide Inc. (CCH) ¶ 2091, Dual Trading Rule 3.10 (Apr. 1988).

90. Commodity Exchange Inc., By-laws and Rules, Dual Trading Rule 4.31, at 4-15 (adopted Oct. 4, 1982).

91. Rules and Regulations of the Minneapolis Grain Exchange, Futures and Options, Trading Rule 750.00, at 706 (July 1, 1987).

92. By-Laws and Rules of the New York Cotton Exchange, Thirty-Third Edition, Trading Standards for Floor Brokers Rule 1.05, at 266 (May 1989).

93. New York Futures Exchange Guide (CCH) ¶ 3085, Trading Rule 416 (Mar. 1983).

94. New York Mercantile Exchange Guide (CCH) ¶ 3609, Trading Standards For Floor Brokers Rule 1.05, at 266 (May 1989).

95. 17 C.F.R. § 155.2 (1989).

comply with the minimum requirements of the CFTC's dual trading regulations. Nevertheless, thirteen years have passed since the Commission adopted its dual trading regulations. Technological changes in the way futures contracts are traded clearly will necessitate refining current rules. A review of specific recommendations for Congressional action regarding such rule changes will be set forth in Section VI below.

III. NEGATIVE ASPECTS OF DUAL TRADING: PROHIBITED PRACTICES, INCLUDING "FRONT-RUNNING" AND "BUCKETING"

In order to understand the way in which dual trading can lead to abuses, one must be familiar with the process of how futures contracts are traded.[96] Generally, there is a ten-step process in commodity futures trading, although some steps in the process occur simultaneously. First, the customer places a buy or sell order with an FCM through either a telephone or computer terminal. The FCM prepares an office order ticket, which is then time-stamped. Second, the order is transmitted by the FCM to a trading booth on the exchange trading floor by telephone, teletype or electronic order routing system.[97] A floor order ticket is prepared and the order is time-stamped "in." Third, a floor runner physically carries the customer's order from the trading booth to a floor broker or floor trader[98] in the pit located in the middle of the trading floor, or

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96. GAO Report, *supra* note 77, ch. 1, at 10.

97. The CME is developing two systems, known as TOPS (trade order-processing system) and CUBS (CME universal broker station), that are designed to speed up the execution time of customer orders by giving FCMs the capability to transmit customer orders from its office terminal to CUBS located on the periphery of the trading pits. By reducing the distance that presently exists between floor trading booths and the pits, the TOPS/CUBS systems will eliminate the need for runners. A significant feature of the TOPS/CUBS systems will be the ability to pinpoint the exact time customer orders enter and exit the pits, thereby improving transaction time sequence reconstruction capabilities. Similarly, the CBT has begun testing a prototype for its new electronic order routing system ("EOS"). In contrast to the TOPS/CUBS system, EOS will print out orders on the top step of the two Treasury Bond Pits where floor brokers stand. Behof, *You Can Almost Hear A Sigh Of Relief In The Pits*, BUS. WK., Feb. 20, 1989, at 33; *see also*, *Technology Already Set To Enhance Audit Trail*, FUTURES, Mar. 1989, at 64; McGraw Hill, *CBT Plans To Begin Testing Prototype For New Order-Routing System June 1*, SEC. WK., May 15, 1989, at 7. For further discussion of the Chicago exchanges' computer technology, see *infra* note 102 and accompanying text.

98. According to Regulation section 1.3(x), "this term means a member of a contract market who, on the floor of such contract market, executes a futures trade or a commodity option transaction for his own account or an account controlled by him, or has such a futures trade or commodity option transaction made for him." 17 C.F.R. § 1.3(x) (1989).

the order is "flashed"[99] into the pit through headsets worn by floor brokers or floor traders. Fourth, the floor broker or floor trader attempts to find matching orders by using "open outcry"[100] and hand signals to communicate price and quantity terms with other floor brokers and traders.

Fifth, after the customer's order is filled, the floor broker confirms the trade with the opposite party and records on his trading card the price and quantity at which the order was filled, the time of execution and the identity of the opposing side of the trade. Sixth, a floor runner then picks up the floor order tickets and returns them to the trading booth, or the information is "flashed" back to the trading booth where the order ticket is time-stamped "out." Seventh, the trading booth reports the trade execution to the FCM, who records the trade price on the office order ticket and time-stamps it. Eighth, the customer is provided with a written confirmation of the trade. Ninth, the exchange price reporter relays price changes as they occur to central quotation computers. The central price quotation computers then transmit price information to electronic priceboards facing the trading floor. This information is simultaneously transmitted around the world to the offices of trading companies through computerized information systems such as Telerate, Intex or Reuters. Finally, clearing firms pick up the trading cards,[101] which are generally confirmed with the customer the next morning. The Clearing House then calls for losses to be paid-up and redistributes profits. This process is referred to as "marking contracts to market." It is designed to insure that the Clearing House has sufficient funds to guarantee each of its clearing members' ability to pay off its debts to other members.

Notwithstanding the adoption of dual trading regulations by the CFTC and the exchanges, as well as the implementation of com-

99. The use of wired headsets at the CBT was first introduced in 1986 and was designed to allow orders to be more efficiently executed as they are received on the exchange floor. Currently, the two Chicago exchanges are working on developing handheld computer terminals to be used by all floor brokers and traders. The system, called Automated Data Input Terminal ("AUDITs"), would replace the manual trading card system now used. Chicago Sun-Times, Aug. 17, 1989, at 77, ch. 1, col. 2.

100. Open outcry is a method of public auction in which bids and offers are verbally and openly offered to all floor participants. GAO Report, *supra* note 77, at 8.

101. At the CBT, clearing firms are required to pick up trading cards "at such times and in such manner as designated by the Board of Directors." Card Collection Rule 332.05, Rules of the CBT, *supra* note 85, at 313. Presently, the Board requires CBT clearing firms to pick up trading cards twice daily—at 10:30 a.m. and at the close of trading. The CBT, however, has recently proposed a requirement that clearing firms pick up their clearing members' trading cards at one-hour intervals throughout the day. *See infra* notes 224-25 and accompanying text.

puterized tracking systems[102] by the latter, the recent FBI investigation has brought to light reported allegations of various abuses

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102. Trading through computers is believed to provide a better transaction time sequence reconstruction capability than is presently provided by the "open outcry" system. The CME has developed GLOBEX, an after-hours system for automated trading that the CFTC recently approved and which has been successful in attracting the New York Mercantile Exchange, the Sydney Futures Exchange and the Matif Exchange in Paris as GLOBEX participants. The CBT had also begun developing its own system, named Aurora, which the CBT asserted would be more advanced than the mere order-matching capabilities of GLOBEX. Aurora, the CBT argued, would continue the tradition of open outcry by displaying all orders and allowing traders to view the market as a whole, much as they presently can. Recently, however, the two Chicago exchanges have stated that they may scrap plans to create two separate systems, in favor of a single, after-hours electronic trading system to be developed jointly by them. Nevertheless, neither GLOBEX, Aurora, nor any hybrid system will be capable of providing adequate transaction time sequence reconstruction capabilities until all trading, and not just after-hours trading, is done electronically. In the meantime, the exchanges must use current systems, which are dependent upon human input of raw data. Journal of Commerce, Mar. 3, 1989, at 9A, col. 2; *see also*, Chicago Tribune, May 31, 1989, § 3, at 1, col. 2; Financial Times, May 31, 1989, at 26.

Currently, the two Chicago exchanges employ similar computer systems for analyzing audit trail data. The CBT has developed the Computerized Trade Reconstruction System ("CTR" system); it gathers information from exchange member's trading cards, including the executing broker, executing firm, order entry time, quantity, price, order or trading card number, opposite broker and firm, and half-hour time bracket for every trade. In addition, independent CBT employees enter each price change and the time thereof into the CTR system. The CBT then attempts to correlate the data and to calculate the time of each trade to the nearest minute or less. The CBT then uses what it calls CTR Plus, a surveillance system that analyzes the CTR data and attempts to detect potential violations of exchange rules. CTR Plus attempts to isolate patterns of trading activity between two or more traders. Recently, the Board of Directors of the CBT set aside a $1 million fund to pay for a new surveillance system called Oracle. CBT Report, *supra* note 6, at 38-43. The CME system is called Compliance Automated Trade Surveillance System ("CATSS") and employs a similar methodology in correlating data.

In contrast to the CBT and the CME, NYMEX employs a "pit card submission system" that requires transaction-by-transaction submission of trade data (similar to that required by the two Chicago exchanges), to independent exchange officials who time-stamp the pit card immediately upon receipt. The data from the pit cards is then entered into NYMEX's computer system where it is analyzed by the Compliance Department of the exchange. NYMEX also uses the data from the pit cards to create a "Streetbook" that provides a chronological trade sequence based on the time-stamped pit cards. The potential advantage of the NYMEX system, at least in comparison to the system used by the two Chicago exchanges, is the requirement of transaction-by-transaction submission of the pit cards. By requiring such immediate disposition of the cards, the exchange arguably reduces the amount of time in which a floor broker or trader might falsify information. New York Mercantile Exchange Guide (CCH) ¶ 3644, Trading Standards for Floor Brokers Rule 6.90. *See also* United States Committee on Agriculture, Nutrition and Forestry (May 17, 1989) (statement of Z. Lou Guttman, Chairman of the Board of Directors of the New York Mercantile Exchange at 3-4).

In addition to the foregoing, and as previously noted, the two Chicago exchanges are currently developing order-processing systems that may increase transaction time sequence reconstruction capabilities and complement existing CTR systems. *See supra* note 97 (for further discussion of these systems).

by floor brokers and floor traders at both the CBT and the CME.[103] These include the following types of actions, all of which share the common objective of avoiding competitive order execution: (1) prearranged trading,[104] (2) accommodation trading,[105] (3) front-running,[106] (4) bucketing,[107] (5) wash trading,[108] (6) curb trading,[109] (7) cuffing,[110] and (8) cross-trading.[111] Although each of these activities may be engaged in by "dual traders," they are not all unique to them, and in fact, may be engaged in by other market participants. Nevertheless, some of the alleged abuses most commonly associated with dual trading are unique to that practice, although not necessarily inherent in it, and therefore deserve greater analysis.[112]

103. Widespread abuse associated with dual trading also has been reportedly alleged against other exchanges, such as the five New York exchanges and, most notably, the New York Mercantile Exchange. On May 4, 1989, the CFTC served subpoenas at four of the New York Commodity exchanges. Wall St. J., Mar. 1, 1989, at C-1, col. 2; *see also* Zigas, *The CFTC Drops Its Kid Gloves*, BUS. WK., May 22, 1989, at 142.

104. Agreeing to some aspect of a transaction before it is openly executed on the exchange floor. GAO Report, *supra* note 77, ch. 1, at 11.

105. Entering transactions in which one floor broker, in order to assist another floor participant in indirectly taking the other side of a customer's order, buys and sells from the broker, the same quantity of the same future at the same price. *Id. See also* 1 T. RUSSO, REGULATION OF THE COMMODITIES, FUTURES AND OPTIONS MARKETS § 12.48 (1983).

106. Trading for one's personal account or an account in which one has an interest, while having in hand any executable customer order in that contract. *See infra* notes 113-14 and accompanying text.

107. Failure to introduce an order to the marketplace, traditionally occurring when a broker noncompetitively takes the other side of a customer order to the detriment of the customer or other members. *See infra* notes 115-20 and accompanying text.

108. Entering or purporting to enter into transactions to provide the appearance of trading activity without resulting in a change in market position. 1 T. RUSSO, *supra* note 105, at § 12.49. According to one commentator, wash trades "are employed to give a false appearance of trading and to cause prices to be registered which are not true prices. They may be entered and recorded as real trades, but by private agreement between the parties they are either cancelled or washed out by other traders." *Id.*

109. Trading after the official close of trading. Cohen, *Life in the Pits*, Chicago Tribune, Jan. 29, 1989, at 1.

110. Delaying the filling of customer orders to benefit another member. *Id.*

111. Matching one's own customer's orders without offering them competitively on the trading floor. *Id.*

112. The distinction among those abuses that do not require the ability of a floor broker or floor trader to act as both principal and agent in order to accomplish the fraudulent activity is critical because it underscores the argument that eliminating the practice of dual trading will not eradicate all, or even any, of the alleged abuses. Dual trading itself is not an abuse, but rather the vehicle through which various abuses may be achieved. In this regard, the CBT Report made an illustrative analogy: "[p]rohibition or restriction of the practice of check writing to eliminate or reduce the use of fraudulent checks would be . . . misdirected . . . . The abuse may still continue through another vehicle . . . perhaps, misuse of credit cards." Similarly, a ban on dual trading will not

A. *"Front-running"*

"Front-running" is a practice engaged in by some floor brokers and FCM's and involves knowingly trading ahead of customer orders that are large enough to move the market (i.e., change the market price of a particular contract in which the broker or FCM either has, or intends to establish, an open position). Typically, the trader, after learning of such an order by a customer, first trades as a principal for himself or a friend, before trading the customer's order as an agent.[113] The following hypothetical illustrates the practice of front-running a customer's buy order.

Assume that a customer places a market order to purchase 500 September S&P 500 stock index futures contracts.[114] The floor broker who receives the order knows that such a large buy order is likely to drive the price of the contract up when other floor brokers begin to sense the strong demand. Therefore, when the order is received on the floor of the exchange, the floor broker signals to a confederate that a large buy order is about to be executed. The confederate then quietly purchases 100 contracts. Assume for purposes of this example, that at the time of the confederate's purchase, such contracts are trading at the prevailing index of 350.10 or $17,505,000.

After the confederate completes the purchase, the floor broker begins soliciting sales in 100 lot increments from other brokers and traders in order to fill his or her buy order. As expected, other brokers in the pit anticipate a large buy order and begin to bid the price of the contract higher. By the time the first four hundred contracts have been purchased, the index has risen to 353.50. The floor broker then purchases the remaining 100 contracts from the confederate at 353.50, or $17,675,000. The confederate, who purchased the contracts for $17,505,000, then pockets a substantial profit of $170,000. Typically, the floor broker and the confederate will either divide the profit, or the confederate will repay the floor broker with a similar favor in the future.

It is also possible to front-run a sell order. For example, assume

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eliminate such abuses but will merely change the way in which they are accomplished. CBT Report, *supra* note 6, at 44.

113. 1 P. JOHNSON & T. HAZEN, *supra* note 45, at § 2.32.

114. The Standard & Poors ("S&P") 500 stock index futures contract is based on the stock prices of 500 NYSE-listed companies. The profile of the index consists of 80% industrial companies, 8% utility companies, 4% transportation companies, and 8% financial institutions. The contract is dollar-valued at $500 times the prevailing index. The "tick" size, or minimum trading price change, is .05 and is valued at $25. *See generally* Rules of the CME, *supra* note 86, at ch. 40.

that, anticipating a rise in the price of soybeans, a floor broker purchases ten soybean contracts for his own speculative account. Later that same day, the floor broker receives a large customer sell order for 1,000 soybean contracts from a grain dealer located in southern Illinois. Fearing that he has incorrectly predicted the market trend, and armed with the knowledge that the customer's large market order will have a depressing effect on the price of soybean contracts, the floor broker decides to sell for his own account first, in order to mitigate losses. Only after the floor broker has liquidated his position is the customer's order executed, thereby driving down the price of the soybean contracts.

B. "Bucketing"

"Bucketing"[115] is a way of shifting losses to clients and profits to floor brokers. Although the term "bucketing" has been used to describe a variety of abusive trade practices, it originally denoted the intentional withholding of an order from the competitive execution process in order to book the trade privately.[116] Upon receiving a customer's order, the broker may simply "bucket" the trade by placing it in his waste basket and representing to his customer that the trade was executed in the pit. If it is a losing trade, the broker will pocket the customer's funds; but if it is a winning trade, the broker will attempt to cover the trade for the benefit of the unsuspecting customer. On many occasions, brokers have been unable to cover their customer's trades. Large customer losses from "bucket shop" operations led to the enactment of an express prohibition on bucketing under the Act, as well as under a variety of exchange rules.[117]

In its broader sense, an order may be bucketed whenever, regardless of the method used, the customer's order is considered to have been executed even though it was not offered openly and competitively to all participants in the market.[118] Thus, so-called "accommodation trading" can also take the form of bucketing in the sense it denies competitive execution of customer orders.[119] In

115. Although not defined in the Act, "bucketing" is specifically prohibited by section 4b(D), which makes it an unlawful practice to bucket any trade. 7 U.S.C. § 6b(D) (1988). One commentator has stated: "The term *bucket* lacks a precise meaning but can be broadly described as any failure to introduce the order into the competitive marketplace." 1 P. JOHNSON & T. HAZEN, *supra* note 45, at § 2.27.

116. *Id.* at 309.

117. *Id.*

118. 1 T. RUSSO, *supra* note 105, at § 12.49.

119. According to one source, "the specific reference to 'accommodation trades' in section 4c(a)(A) rather than in section 4b, where bucketing is addressed, suggests that

such a case, the broker who receives the order, in effect takes the other side of that order through the use of a confederate.

The following hypothetical is an example of this type of bucketing. Assume that an independent floor broker receives a customer's market order to sell ten Frozen Pork Belly futures contracts[120] at the prevailing market price. When the order reaches the floor broker, pork belly futures contracts are trading at 43.15 cents per pound. Therefore, if all ten contracts were sold at this index, the customer would receive $172,600. However, the floor broker waits as the price falls to 41.80 cents per pound, or $167,200. When he feels that the price is rising again, the floor broker sells the contracts to a confederate for 42.25, predicting that the prices will rise even higher. When the index once again reaches 43.15 cents per pound, the confederate sells the ten contracts to another floor broker or trader. The confederate bought the ten contracts for $169,000 and sold them for $172,600, thereby pocketing a profit of $3,600. The floor broker then sends a confirmation to the customer indicating that the customer's ten Pork Belly Futures contracts were sold at 42.25. It is virtually impossible for the customer to detect any fraud because the markets move so rapidly.

The following is an example of bucketing losses into a customer's account. Assume Customer *A* places an order to purchase ten S&P 500 stock index futures contracts when they are trading at the prevailing index of 350.10. In a volatile market, the index could rise to 350.30 by the time the floor broker receives the order, drop within a short time to 349.65, and rise again to 350.30. If the floor broker is unable to fill the order when the index rises above 350.10, he is still liable to give the trade to the customer at that price. To avoid losing money on the transaction, the floor broker may ask a confederate to sell him a similar contract at 350.10, or .10 points below the prevailing index. The confederate will then get out of the position by buying at the then-current index of 350.35, incurring a loss of $125 on each contract. Rather than incur the loss of $1,125.00 personally, the floor broker will bucket the loss into Customer *B*'s account. For example, to repay the confederate, the floor broker may take Customer *B*'s order for five S&P 500 futures contracts and complete the trade with the confed-

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Congress did not equate the two practices." 1 P. JOHNSON & T. HAZEN, *supra* note 45, at § 2.29.

120. The CME's Frozen Pork Belly futures contract is based on 40,000 pounds of USDA-inspected 12-14 or 14-16 pound pork bellies. The contract is valued at the prevailing rate of (market) cents per pound and the minimum price fluctuation is .025, or $10.00. *See generally* Rules of the CME, *supra* note 86, at ch. 14.

erate at a price determined through their collusion. This price would be lower than the market price at that time, so the confederate could recoup his loss from Customer *A*'s transaction.

IV. Positive Aspects of Dual Trading

In light of the inordinate amount of criticism that has been made of dual trading, there is surprisingly little commentary or statistical data supporting its positive aspects. It appears that the only meaningful discussion on the subject, at least prior to the recent investigation, is contained in a study published by the CME in 1976[121] (the "CME Study") and in testimony of a CBT representative before the CFTC on March 15, 1976 (the "CBT Testimony").[122] Both the CME Study and the CBT Testimony were prepared in response to the Commission's proposed rule-making regarding the practice of dual trading. Notwithstanding the lack of information, however, it is possible to state in general terms the following positive aspects of dual trading. First, dual trading increases market liquidity and trading volume by expanding the number of, and activity associated with, market participants. Second, dual trading creates an incentive for floor brokers to act as "market makers" during periods of volatility; thus, dual trading enables floor brokers to serve as "shock absorbers" for the markets. Third, dual trading increases transaction cost efficiency by reducing the bid/ask spread on contracts. Fourth, it promotes expertise among floor brokers who also execute orders for customer's accounts. Finally, permitting dual trading arguably increases or at least helps maintain the competitive market share of U.S. commodity futures exchanges because it serves to create more active markets.

With respect to the first aspect, liquidity and trading volume, the CME Study concluded that:

> Liquidity can be assumed to flow from two sectors: (1) market makers or speculators operating in the pit; and (2) hedgers and speculators operating outside the pits and away from the Exchange floor . . . the former specifically functions as an offset to intertemporal imbalances between buy and sell orders reaching the floor of the Exchange . . . ."[123]

The CME Study provides statistical support for the proposition

121. Chicago Mercantile Exchange, An Inquiry Into the Benefits Of Dual Trading On Organized Futures Markets, Chicago Mercantile Exchange, Mar. 8, 1976 [hereinafter CME Study].

122. Statement of Warren W. Lebeck On Behalf of the Board of Trade of the City of Chicago Before the Commodity Futures Trading Commission (Mar. 15, 1976).

123. CME Study, *supra* note 121, at 3.

that dual traders have historically predominated on a percentage basis, over non-dual trading brokers handling only customer accounts, as well as brokers trading solely for their own accounts.[124] Therefore, a potential consequence of eliminating the practice of dual trading might be to seriously diminish liquidity in the various contract markets. The most recent analysis of the importance of dual trading to market liquidity can be found in the responses by the commodity futures exchanges to a March 8, 1989, request by the CFTC.[125] The responses indicate that, on average,[126] the percentage of volume attributable to dual traders in each exchange's most active contract is approximately 48.2%.[127]

A second benefit of dual trading is that it provides an opportunity for floor brokers to become "market makers" who act as "shock absorbers" during periods of extreme volatility. When the demand for brokerage services is low, floor brokers who engage in dual trading, in this instance for their own account, can provide liquidity or market making services. The increased liquidity provided by the market making activities of floor brokers serves to reduce the bid/ask spread on contracts and results in higher prices for sellers and lower prices for buyers. In less active commodity futures markets, such as soybean meal, soybean oil, coffee, and cocoa, there may not be enough order volume to allow hedgers[128] to

124. *Id.* at 8-9.

125. *See* CBT Report, *supra* note 6.

126. This average is weighted and is based on the average daily trading volume in each exchange's most active contract.

127. CBT Report, *supra* note 6, at Appendix B. For example, dual trading accounted for 45.4% of the total average daily volume in the CBT's U.S. Treasury Bond pit; 50.6% of the total average daily volume in the CME's Eurodollar pit; 76% of the total average daily volume in the CSCE's sugar 11 pit; 61.8% of the total average daily volume in COMEX's gold futures pit; 36% of the total average daily volume in the KCBT's wheat futures pit; 36-40% of the total average daily volume in the MGE's spring wheat futures pit; 80% of the total average daily volume in the NYCE's cotton futures pit; 36% of the total average daily volume in the NYFE's NYSE Composite Index futures pit; and 35% of the total average daily volume of NYMEX's crude oil futures pit. Pierog & Stawick, *CFTC Gets Dual Trading Stats, Defenses*, FUTURES, July, 1989, at 52.

128. Although the rules promulgated under the Act do not contain a definition of the term "hedger," they define "bona fide hedging transactions or positions" as

> transactions or positions in a contract for future delivery on any contract market, or in a commodity option, where such transactions or positions normally represent a substitute for transactions to be made or to be taken at a later time in a physical marketing channel, and where they are economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise, and where they arise from: (i) The potential change in the value of assets, which a person owns, produces, manufactures, processes, or merchandises or anticipates owning, producing, manufacturing, processing, or merchandising, (ii) The potential change in the value of liabilities which a person owes or antici-

find matching orders. Proponents of free markets argue that the local speculators,[129] who populate the pits at the two Chicago exchanges, enhance liquidity in those contract markets by betting on future price directions and taking the risk from institutional investors as well as from the producers and users of the commodities themselves. The loss of certain contract markets could hurt investors and, particularly, corporations that have come to rely on financial futures contracts to protect against financial risk.[130] This particular beneficial aspect of dual trading is discussed at length in a report from the CBT.[131]

A third positive aspect of dual trading is that it reduces the bid/ask spread on any given contract because dual traders in the pits can intersperse their personal trades when wide spreads would otherwise result in a high transaction cost to market participants.[132] The presence of dual traders in the pits effects a reduction of spread differential, which passes transaction cost savings to customers. The CME Study, which documented the increase in transaction cost efficiency, also correctly noted that it would be manifestly unfair to impose additional transaction costs on market participants solely on the basis of alleged, indeed, undocumented abuses.[133] Such action could also have a deleterious effect on the competitive position of U.S. commodity futures exchanges.

A fourth benefit of dual trading is the development of trader expertise. Many proprietary traders, who are largely responsible for providing added volume and liquidity to the markets, began as dual traders. It has been argued that, absent such initial experience as dual traders, many of these persons would not have developed the expertise necessary to trade a proprietary account. Therefore, market liquidity and trading volume would be adversely affected by their absence from the pits.[134]

According to the CME Study, dual trading by FCMs promotes market efficiency by effectively utilizing the administrative, organi-

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> pates incurring, or (iii) The potential change in the value of services which a person provides, purchases or anticipates providing or purchasing.

17 C.F.R. § 1.3(z) (1989).

129. Although the Act does not define the term "speculator," a person involved in transactions and positions and whose purpose is not to offset price risks incidental to commercial cash or spot operations, will most likely be considered a speculator for purposes of section 4(a) of the Act. 17 C.F.R. § 1.3(z)(1) (1989).

130. Chicago Tribune, Jan. 22, 1989, § 7, at 1, col. 5.

131. *See* CBT Report, *supra* note 6, at 33-34.

132. CME Study, *supra* note 121, at 7.

133. *Id.*

134. *Id.* at 8-9.

zational and developmental skills of traders.[135] The traditional argument advanced is that principals of FCMs who also have their own money in the markets are more likely to have their attention focused on these markets. Similarly, because floor brokers also trade for their own account, they have an obvious incentive to learn how the markets function and how to track market directions. The development of this type of expertise, certainly enhanced by the floor broker's own profit motive, is therefore available for the benefit of public customers as well.

A fifth benefit of dual trading is that it allows U.S. exchanges to maintain their market share at a time when globalized trading has eroded their preeminent position vis-à-vis their foreign counterparts.[136] Commodity futures exchanges in the United States will likely continue to lose their market share as financial risk management and futures trading catches on in other parts of the world.[137] If Congress imposes a complete or even partial ban on dual trading practices, the volume and liquidity currently provided by the U.S. commodity futures exchanges may dissipate, resulting in higher transactions costs that will accelerate the trend toward foreign futures trading.

The positive aspects of dual trading are well documented by the CME Study and the CBT Testimony. Dual trading provides the necessary elements for successful risk management by creating deeper, more liquid markets, by providing an incentive for floor

135. *Id.* at 5.

136. Together, the CBT and the CME have garnered about 60% of global futures and options trading. Financial Times, Mar. 8, 1989, § 3, at 1-2. Foreign exchanges, however, are challenging traditional U.S. dominance in financial futures such as interest rate and foreign currency futures. While the CBT's volume nearly doubled in the last four years, its global marketshare fell four points to 33%. *Future Shock is Rattling the Futures Pits*, BUS. WK., Apr. 17, 1989, at 93-94.

137. The following futures and options exchanges have already been established outside of the United States: in Europe, Amsterdam's European Options Exchange (EOE), the Baltic Futures Exchange (BFE), the German Futures and Options Exchange (Deutsche TerminBoerse or DBT), the Guarantee Fund for Danish Options and Futures, the Irish Futures and Options Exchange, the London International Financial Futures Exchange (LIFFE), the London Metal Exchange (LME), the London Potato Futures Exchange (LPFE), the Marche a Terme d'Instruments Financiers (Matif), the Rotterdam Energy Futures Exchange (ROEFEX), the Stockholm Options Market (OM Sweden), Sweden's Options and Futures Exchange (SOFE) (now defunct) and the Swiss Options and Futures Exchange (SOFFEX); in Canada, the Montreal Exchange, the Toronto Futures Exchange (TFE), Trans Canada Options of Toronto (TCO), and the Winnipeg Commodity Exchange (WCE); in South America, the Bolsa Mercantil y De Futuros in Sao Paulo, Brazil; and in the Pacific Rim, the Hong Kong Futures Exchange (HKFE), the New Zealand Futures Exchange (NZFE), the Osaka Futures Exchange (OSE), the Singapore International Money Exchange (SIMEX), the Sydney Futures Exchange (SFE), and the Tokyo Financial Futures Exchange.

brokers to act as market makers, and by reducing transaction costs for market participants. It also fosters trader expertise, which helps make U.S. markets more competitive in the international arena. The fundamental purposes fulfilled by permitting the practice of dual trading clearly outweigh the negative aspects that sometimes accompany it. Therefore, Congress should enact legislation that will reduce or eliminate these negative aspects, without entirely eliminating the practice of dual trading.

V. Surveillance Methods, Disciplinary and Enforcement Actions, and Penalty Provisions

Having now examined both the negative and positive aspects of dual trading, it is appropriate at this point to look at the empirical evidence. Specifically, this section of the Article will analyze the surveillance systems employed by the two Chicago exchanges, the record of disciplinary and enforcement actions taken by the exchanges and the CFTC, and the effectiveness of the penalty provisions provided under the Act and by the various exchange rules.

A. The Government Accounting Office Report

On March 13, 1989, the United States Government Accounting Office (the "GAO") issued a report (the "GAO Report")[138] to the Senate Agriculture Committee in which it severely criticized the number and nature of disciplinary actions taken by the two Chicago exchanges from 1984 through 1988. The GAO Report identified three factors that it used to determine "the intensity of CFTC and exchange efforts to detect and punish trade practice abusers . . . ."[139]

First, GAO examined the surveillance systems employed by the CFTC and the two Chicago exchanges.[140] It found that both the CBT and the CME identify and investigate trade practice abuses by similar means, through a Computerized Trade Reconstruction System (the "CTR System").[141] It also noted that the CFTC has an oversight program that includes rule enforcement reviews of exchange actions and review of data from exchange audit trails.[142] The GAO Report further noted that the CFTC, through its oversight program, has concluded that the CME has a more effective

138. GAO Report, *supra* note 77.
139. *Id.* ch. 1, at 2.
140. *Id.* ch. 2, at 16-32.
141. *Id.* ch. 2, at 17. For a further discussion of the CTR system, see *supra* note 102.
142. GAO Report, *supra* note 77, ch. 1, at 23.

CTR System and trade practice surveillance system than the CBT.[143] GAO stated that the institution of the one-minute audit trail time standard has increased the framework of controls at the CFTC and the exchanges, but "[b]ecause the systems are new, the process for improving them is evolving."[144] In fact, the exchanges have been unable to meet the one-minute standard; consequently, they are only required to bracket their trades within thirty-minute intervals.

Second, the GAO Report examined the number and nature of disciplinary and enforcement actions taken by the CFTC and the exchanges.[145] Specifically, GAO gathered information on exchange disciplinary actions such as fines, suspensions, and expulsions, as well as CFTC enforcement actions. Regarding exchange disciplinary actions in general, from 1984 to 1988, the number of such actions increased significantly at the CME[146] but remained almost stationary at the CBT.[147] With respect to fines, GAO found that the CME fined members significantly more than the CBT fined its members during this same period.[148] Generally speaking, the number of permanent expulsions at both exchanges was relatively equal, while the number of suspensions[149] varied widely. Finally, GAO found that from 1986 through February 13, 1989, the CFTC assessed over $1.4 million in penalties, issued forty-five cease and desist orders, forty-nine trading suspensions, and thirty-two registration suspensions.[150]

Third, GAO examined the effectiveness with which oversight results are used by the CFTC to detect patterns of violations and other abuses of trade practice rules.[151] The GAO made a limited finding that trade information and disciplinary action information "is not routinely aggregated for management's use."[152] As recently as March 9, 1989, the CFTC criticized the CBT's computerized

143. *Id.* ch. 1, at 24-25.

144. *Id.* ch. 1, at 31.

145. *Id.* ch. 2, at 33-37.

146. *Id.* ch. 1, at 34. During this period, the number of CME floor participants sanctioned for violations rose from 13 in 1984 to 105 in 1988. *Id.*

147. *Id.* During the same time period, the number of sanctions at the CBT was eight in 1985, thirty-two in 1986, and only thirteen in 1988. *Id.*

148. *Id.* From 1984 to 1988, the CME fined its members a total of $3.6 million, while CBT fines for the same period totalled only $812,000. *Id.*

149. *Id.* Suspensions at the CME increased from 238 days in 1986 to 12,392 days in 1987. *Id.* At the CBT, there were only 55 days of suspensions in 1984 and only 5,587 in 1986. *Id.*

150. *Id.* ch. 1, at 35.

151. *Id.* ch. 4, at 38.

152. *Id.*

tracking system for failing to generate more disciplinary cases.[153] In an interview after a Senate Agriculture Committee hearing that raised questions about the CFTC's performance in monitoring trading practices, Andrea Corcoran, Director of the Division of Trading and Markets of the CFTC, stated that the CBT's system "has been used, if at all, very infrequently" as a basis for investigating questionable trades by CBT members.[154] At the same hearing, CFTC Chairman Wendy L. Gramm disclosed that the CBT has initiated only sixteen of sixty-eight total investigations into trading abuses over the last three years, on the basis of information generated by its own enforcement staff.[155] This, along with evidence of a better tracking record at the CME, would seem to indicate that the problem lies not so much in the technological tracking capabilities of the various exchanges but in the apparent inability of small, poorly financed enforcement staffs to monitor available information.

Because the GAO Report did not address the various resources available to the CFTC and the exchanges, any meaningful analysis of the enforcement process must take into consideration the financial and man-power commitment of these organizations. The enforcement budget for the CME in 1988 was $7.8 million, and the CBT's budget was less than half, or approximately $3.6 million.[156] In contrast, in 1988, the New York Stock Exchange (the "NYSE"), spent $68.6 million on surveillance measures and enforcement actions.[157]

Furthermore, although the CME and the CBT have roughly equivalently sized enforcement staffs,[158] the CME initiated a greater percentage of investigations into trading abuses than did the CBT.[159] Arguably, the vast disparity in the enforcement budgets of the two Chicago exchanges explains the difference in their enforcement records. It is possible to generalize from this disparity that the enforcement problem is caused by inadequate financial resources and enforcement staff, rather than an inherent inability or unwillingness on the part of the exchanges to perform their statu-

153. Drew, *CBOT Draws Fire As A Tracker*, Chicago Tribune, Mar. 10, 1989, § 3, at 1, col. 4.

154. *Id.*

155. *Id.* at 2, col. 2.

156. *Id.* at 1, col. 6.

157. Wall St. J., Mar. 10, 1989, at C-13 (The NYSE has also reported that it maintains a regulatory staff consisting of approximately 544 persons).

158. Drew, *supra* note 153, at 2, col. 2. The CME has an eighty-nine member enforcement division and the CBT has an eighty-three member enforcement staff. *Id.*

159. *Id.*

torily-imposed duty to detect and punish alleged abuses. The Final CFTC Staff Report on the Stock Index Futures and Cash Market Activity—October 1987[160] supports this explanation with its conclusion that:

> The trade practice surveillance systems in place at the Commission *have the demonstrated capacity to review large amounts of trading data on an expedited schedule*. . . . This trade practice surveillance activity did not identify any pattern of futures or options on futures trading which indicates violative activity.[161]

Although not addressed by the GAO Report, any meaningful discussion regarding the adequacy of the existing system for detecting and preventing dual trading abuses must also take into consideration the penalty provisions provided by the CFTC and the exchanges. Indeed, one of the underlying purposes of any punitory system is to establish a deterrent effect. The CFTC and the exchanges, pursuant to the Act and their various internal rules and bylaws, respectively, already possess the ability to impose severe penalties for violations of the trade practice rules. The antifraud provision of the Act, section 6b,[162] prohibits any member of a contract market or other person, in or in connection with any order to make, or in connection with the making of any contract of sale of any commodity in interstate commerce, from cheating or defrauding or attempting to cheat or defraud any person;[163] from willfully making any false report, statement, or record;[164] from willfully deceiving or attempting to deceive another person respecting any contract;[165] from willfully or knowingly bucketing any order or filling any order by offset against the order(s) of any other person;[166] or from taking the other side of any customer's order without his prior consent.[167]

Section 9[168] of the Act provides several remedies for violations of section 6b. First, section 9 provides that the Commission may institute an administrative action against any person for violations of any provisions of the Act or the rules, regulations and orders promulgated thereunder.[169] Second, the Commission may prohibit

160. Comm. Fut. L. R. (CCH) No. 321, Special Report, Feb. 5, 1988, at 176.
161. *Id.* (emphasis added).
162. 7 U.S.C. § 6b (1988).
163. 7 U.S.C. § 6b(A) (1988).
164. 7 U.S.C. § 6b(B) (1988).
165. 7 U.S.C. § 6b(C) (1988).
166. 7 U.S.C. § 6b(D) (1988).
167. 7 U.S.C. § 6b (1988).
168. 7 U.S.C. § 9 (1988).
169. *Id.*

such persons from trading for such period as may be specified by order, suspend such person for a period not to exceed six months, or revoke the registration of such person.[170] Third, the Commission may assess against such person a civil money penalty of not more than $100,000 for each violation.[171] Finally, the Commission may bring an action in an United States district court to enjoin any person who has engaged, is engaging, or is about to engage in any act or practice constituting a violation of the Act, any rule, regulation, or order thereunder, or who is restraining trading in any commodity for future delivery.[172]

Although the CFTC is the commodity futures industry's primary regulator, the various contract markets have been given the power to police themselves as self-regulatory organizations.[173] The exchanges have therefore adopted rules that define various major and minor offenses and that impose certain penalties for violations of such rules. For example, the CBT has adopted Rule 560.00,[174] which permits its Board of Directors, upon a vote of the majority of Board members present, to suspend any person for a period of time to be determined by the Board. Rule 560.00 further provides that a person may be expelled from membership or a suspended person may be deemed ineligible for reinstatement upon the vote of two-thirds of the Board members present.[175] Finally, Rule 560.00 also provides that the Board, upon majority vote of the members present, may impose a fine of up to $75,000 upon any member or member firm for each rule or regulation violated.[176]

Similarly, the CME has adopted Rule 430,[177] which provides for the classification of major offenses and minor offenses. Major offenses are punishable by expulsion, suspension and/or a fine of not more than $250,000, plus the monetary value of any benefit received as a result of such offense.[178] A minor offense is punishable by a fine of not more than $25,000 plus the monetary value of any benefit received as a result of such offense.[179] In addition, a second violation of such minor offense within a twenty-four month period

170. *Id.*
171. *Id.*
172. 7 U.S.C. § 6c (1988).
173. *See supra* note 14 (definition of self regulatory organization).
174. Rule 560.00, Rules of the CBT, *supra* note 85, at 518.
175. *Id.*
176. *Id. See also infra* note 192 and accompanying text (proposed increase in the amount of this fine).
177. Rule 430, Rules of the CME, *supra* note 86, ch. 4, at 23-24.
178. *Id.* at 23.
179. *Id.* at 23-24.

will result in the imposition of a penalty reserved for major offenses.[180] The CME has also adopted Rule 440,[181] which provides for the indemnification of the exchange by any member for the full amount of any judgments or settlements paid by the CME with respect to any legal proceeding brought against the exchange as a result of an alleged violation by such member or the failure of the CME to detect or prevent such violation.

The CFTC and the exchanges have provided appropriately stringent penalties for violations of the Act and CFTC or exchange rules. The power to suspend, expel and/or impose large monetary fines on members who violate the rules, the Commission's injunctive power, and the power to demand indemnification at the CME, should surely serve to deter most exchange members from engaging in violative activities. Nevertheless, the penalty provisions imposed by the two Chicago exchanges are inconsistent and should be harmonized. Recommendations for Congressional action regarding this subject will be considered below.[182]

B. The Exchange Reports

On March 8, 1989, the CFTC requested that the exchanges begin compiling data on the effects of dual trading in the commodity futures markets.[183] Specifically, the exchanges were asked to select a period of at least one week in late 1988 to study dual trading by brokers in the following three categories: each exchange's most active contract, a moderately active contract and a less active contract. Each exchange was asked to identify all dual traders who deal in those three contracts and to note the volume attributable to their activity.[184] The reports, which were submitted to the CFTC on April 30, 1989, will be discussed hereafter.

Surprisingly, the two reports suggest a significant dichotomy in

180. *Id.* at 24.

181. *Id.* at 27.

182. *See infra* Part VI.

183. The CFTC's directive is apparently the result of a request from the Senate Agriculture Committee that the Commission respond to a series of proposals to strengthen enforcement mechanisms, including imposing various restrictions on dual trading in any pits when the audit trail cannot meet a ninety percent accuracy rate and when liquidity is adequate. Letter to Mr. William J. Brodsky, President of the Chicago Mercantile Exchange from Andrea M. Corcoran, Director of the Division of Trading and Markets, Commodity Futures Trading Commission (Mar. 8, 1989). *See also* McMurray, *Futures Exchanges Told To Compile Dual Trading Data*, Wall. St. J., Mar. 9, 1989, at C-13, col. 1.

184. *Probe Into Dual Trading*, AUSTL. FIN. REV., Mar. 10, 1989, at 84; *see also*, *CFTC To Continue Dual Trade Studies*, W. LIVESTOCK J., Mar. 13, 1989, at 5.

the approach to be taken by Congress during the 1989 CFTC reauthorization proceedings. The CME Report tentatively proposed a partial ban on the practice of dual trading, while the CBT Report argued against such a ban, focusing instead on the need for improved transaction time sequence reconstruction capabilities and enhanced compliance procedures and penalties for violators. The remainder of this Article will therefore review the pertinent recommendations made by the two Chicago exchanges, highlight the differences between them, and conclude with a review of specific proposals for congressional action during the 1989 CFTC reauthorization proceedings.

1. The CBT Report

The CBT Report[185] generally reviewed the principal benefits of broker trading[186] and recommended that no prohibition, either partial or total, be imposed on dual trading.[187] The CBT's position is that "[t]he only reasonable approach to any problem of customer abuse involves enhancement of detection capabilities and imposition of appropriately large penalties for those found committing an abuse."[188] The CBT Report, therefore, reviewed the CTR Plus surveillance system and cited the Brady Report's conclusion that the audit trail systems of the U.S. commodity futures markets are superior to those found in other financial markets.[189] Nevertheless, the CBT Report also acknowledged that improvements are needed and reported that the exchanges intend to spend approximately $1 million on enhancing their system further.[190] Moreover, the CBT

185. CBT Report, *supra*, note 6.

186. According to the CBT, the term "broker trading" is more descriptive than the term dual trading. "Broker trading is practiced by any individual or firm that functions in a fiduciary relationship for a client as an agent or advisor and trades as principal for its own benefit as well." *Id.* at 4 n.2, 9.

187. *Id.* at 21. According to the CBT Report:

> In general, broker trading provides benefits for futures market participants in three ways. First, broker trading enhances futures market performance by increasing market liquidity, yielding tighter bid/ask spreads and increased market depth. . . . Second, customers of broker traders benefit through better execution prices that are available through unique trading techniques and the increased trading flexibility that the ability to broker trade[s] gives a broker. Finally, broker trading benefits all potential futures market brokerage customers by maintaining a residual supply of brokerage services to meet a volatile changing demand.

Id.

188. *Id.* at 46.

189. *Id.* at 39-40. *See Brady Report of the Presidential Task Force on Market Mechanisms*, Jan. 1988, at 67.

190. CBT Report, *supra* note 6, at 40.

Report listed nine trade practice resolutions, designed to further increase the capabilities of the CTR and the CTR Plus systems in detecting trade practice abuses.[191] Finally, the CBT Report also stated that a $250,000 penalty has been proposed to replace the current $75,000 penalty presently levied against members who violate the rules.[192]

2. The CME Report

In contrast to the CBT Report, the CME Report[193] on trading practices tentatively recommended a partial[194] ban on dual trading in all contract months that have reached a level of "mature liquidity,"[195] as determined by the CME Board of Governors, taking into consideration market conditions and the advice of the CME Research Department, industry experts, and market participants.[196] However, three categories of persons would be exempt from this ban: (1) floor brokers who receive specific written permission from the ultimate customer on an annual basis; (2) floor brokers who predominantly conduct spread business on a continuous basis between "mature liquidity" months and "non-mature liquidity" months as determined by the compliance staff of the CME;[197] and (3) floor brokers executing orders for other members.[198]

The CME Report also recommended that a member who begins the trading session by filling orders in a "mature liquidity" month be prohibited from trading directly or indirectly on that same day for his personal account, in any month of the market within which

191. *Id.* The various proposals are discussed below. *See infra* notes 219-28 and accompanying text.

192. *Id.* at 37-38 n.8.

193. Report of the Chicago Mercantile Exchange Special Committee to Review Trading Practices to the Board of Governors (Apr. 19, 1989) [hereinafter CME Report].

194. The CME Report states that "under present market conditions, the recommended dual trading ban would affect approximately 80 percent of all transactions on the CME." *Id.* at 9.

195. A "mature liquidity" designation would be given to every contract month of every contract that "has reached a level of maturity, transaction volume, and consistency of bids and offers that is sufficient to maintain an efficient and viable market without dual trading." *Id.*

196. *Id.* at 7.

197. *Id.* at 9. According to the CME Report, "[i]f spread brokers were prohibited from taking an opposite position in a liquid month because of a ban on dual trading, they would not trade in the non-liquid month, thereby reducing liquidity in those contract months where it is most needed." *Id.*

198. *Id.* The CME Report asserts that this type of dual trading should be exempted because public customer order execution is unaffected by such activity and because members of an exchange are better able to monitor their own trade executions by other members. *Id.*

the order was filled. The latter prohibition, however, would not affect a member who begins the trading session trading solely for his own account, unless he thereafter registers to become a trader in a "mature liquidity" month. At such time, the prohibition shall apply to him, whether trading directly or indirectly for his own account.[199]

VI. REVIEW OF RECOMMENDATIONS FOR CONGRESSIONAL ACTION[200]

The findings in the GAO Report, and a review of the penalty provisions provided by the Act and exchange rules, demonstrate

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199. CME Report, *supra* note 193, at 7.

200. Congress is already considering the "Commodity Futures Improvements Act of 1989," a bipartisan bill that would ban the practice of dual trading in any futures contract having an average daily trading volume of 7,000 contracts or more. H.R. 2869, 101st Cong., 1st Sess. 135 CONG. REC. H5603-30 (daily ed. Sept. 20, 1989) [hereinafter H.R. 2869]. Depending upon price volatility, widening of bid/ask spreads, and other market disruptions, this threshold level of trading volume may be adjusted by the CFTC, upon its giving notice within three days of such action to the Committee on Agriculture of the House of Representatives and the Committee on Agriculture, Nutrition and Forestry of the Senate. *Id.* at 5605.

The bill provides for certain limited exceptions to this ban, namely, for spread trades for a floor broker's own account, and for proprietary trading at the opening of the market in order to settle trading errors from the previous day. *Id.* at 5615. In addition, the bill recognizes an exception for floor brokers who receive specific annual written permission from their public customers to engage in dual trading. The bill would also allow the CFTC to issue an exemptive order to any commodity futures exchange that can demonstrate that its audit trail can detect any and all instances of trading violations attributable to dual trading and that such detection capabilities are fully verifiable. *Id.*

Within one year from the effective date of the bill, H.R. 2869 would also require the exchanges to be able to verify to the minute, the time of execution of any transaction. *Id.* Moreover, within three years from the effective date of the bill, the exchanges would be required to pinpoint the time of execution of any transaction to within thirty seconds. *Id.*

In addition, H.R. 2869 would make it unlawful for any member of a broker association to execute a customer order with another member of such association, either for the personal account of the other member, or for the account of the association. *Id.* The bill would also limit the percentage of trading activity among members of such associations to twenty-five percent of each member's total monthly transactions, irrespective of the underlying account being traded. *Id.* This practice has already been instituted at the CME.

Finally, the proposed bill would make it unlawful for any person to act as a floor trader unless such person has registered under the Act, with the CFTC, and such registration has not expired, been suspended or revoked. *Id.* at 5616. This provision of the bill is apparently designed to subject floor traders to the same disqualification criteria as floor brokers who trade for customer accounts.

The Senate is considering a bill that would allow the CFTC to issue deficiency lettters and suspend dual trading until such time as an exchange can comply with certain stringent surveillance criteria.

The Congress is also considering two other bills, H.R. 603 and H.R. 606, that would ban dual trading in financial futures. The bills, one of which was first introduced in 1987, that reform is needed in order to prevent further abuses of the practice of dual trading. Unfortunately, however, the reports of the two exchanges suggest a significant dichotomy in the course of action to be taken by the Congress during the 1989 CFTC reauthorization process with respect to reforming the practice of dual trading. This dichotomy between the two industry leaders will undoubtedly strengthen the arguments of those persons who seek to impose a ban on the practice of dual trading.

It is this writer's opinion that any proposal to ban dual trading, either partially or completely, is ill-conceived and premature at the present time. The CME's Special Committee to Review Trading Practices stated in the CME Report that dual trading has been defended by the CME in the past on the basis that it is a common practice at most futures exchanges, that it is a critical element in insuring market depth and liquidity, and that exchange surveillance programs are adequate to detect and prevent trade practice

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were reintroduced by Rep. Neal Smith (D-Iowa). H.R. 603 & 606, 101st Cong., 1st Sess., 135 CONG. REC. H93 (daily ed. Jan. 20, 1989) [hereinafter H.R. 603 & H.R. 606].

House Bill 606 is limited to futures contracts based on securities or stock indexes and proposes to amend the Securities Exchange Act of 1934 (the "1934 Act"), rather than the Commodity Exchange Act. It would insert a new subsection to section 10 of the 1934 Act as follows:

> No trader, who trades for their own account or any account in which such trader has trading discretion and also executes orders for any other person or persons, shall own, control or have a beneficial interest in, or enter into any contract or contract for future delivery in any financial instrument, stock index, or any contract for future delivery based in any way on securities or equity securities on any contract market.

H.R. 606, 101st Congress, 1st Sess. (1989). The bill was purposefully drafted this way in order to bring it in front of the House Energy and Commerce Committee rather than the House Agriculture Committee. The Energy and Commerce Committee has been more supportive of a ban on dual trading than the Agriculture Committee, which traditionally has jurisdiction over the commodity futures industry. Opponents of the bill have argued that a ban on dual trading is clearly outside the Energy and Commerce Committee's jurisdiction.

The second bill, House Bill 603, would amend section 8 of the Act by inserting a new subsection as follows: "(d)(1) As used in this subsection "insider" means any individual who has access to material information, not generally available to the public, about present or anticipated cash or futures trading or present or anticipated cash or futures positions, to which such individual is not a party, in any commodity of any other persons, where such trading or positions are in amounts at or above Commission designated reporting levels as specified pursuant to § 4i of this Act . . . (2) No insider shall, own, control, have a beneficial interest in, or enter into any contract or contract for future delivery in any such commodity on any contract market." H.R. 603, 101st Congress, 1st Sess. (1989). Hence, H.R. 603 would effectively prohibit exchange officials from using material non-public information about the futures markets to trade for their own accounts. *See Smith Proposes Dual Trading Ban Amid Calls For Market Reforms*, SEC. WK., Feb. 6, 1989, at 9; *House Stuns Futures Industry By Referring Dual Trading Bill To Dingell*, SEC. WK., Feb. 16, 1987, at 1.

abuses.[201] Nevertheless, the Special Committee went on to state "[w]hile the foregoing is still valid, it has become painfully evident that the public image of futures markets and their members has been adversely impacted by the widely-held belief that dual trading in futures leads to customer abuses."[202] Although this may certainly be true, a number of factors mitigate against the acceptability of this premise as the basis for a recommendation to impose a partial ban on dual trading.

First, there is some question as to whether it is in fact a widely held belief that dual trading in futures leads to customer abuses. Media reports of "widespread fraud" and "cheating of customers" in the pits of the two Chicago exchanges have themselves been the subject of much criticism by other media members.[203] Moreover, volume at the CME was record-breaking in the months following the investigation.[204] Second, a partial ban would be premature in light of the fact that, as of the date of this publication, only forty-six indictments have been issued.[205] Moreover, industry insiders now place the number of persons under investigation at as few as one-hundred traders.[206] Finally, the CBT Report aptly demonstrates the differences between those types of trade practice abuses that are uniquely available to dual traders and those that are available to non-dual traders who trade solely for their own account.[207] Such a distinction is critical because it highlights the futility of imposing a partial or complete ban on dual trading in order to eradicate all of the alleged abuses currently under investigation. The

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201. CME Report, *supra* note 193, at 7.

202. *Id.* at 8.

203. *See* Protess, *Commodities Investigation-The Story Behind The Story*, CHI. LAW., Mar. 1989, at 1; *There's No Such Thing As A Free Leak*, CHI. LAW., Mar. 1989, at 12; Deutsch, *Passing Sentence Before Trial*, N.Y. Times, Feb. 19, 1989, § 3, at 1.

204. Chicago Tribune, Apr. 4, 1989, § 3, at 1; CBOT, *CME Fight For Self-Regulation Edge in Automation*, FUTURES, Apr. 1989, at 74.

205. Bailey & McMurray, *Futures Shock: Traders Are Indicted For Running The Pits By Their Own Rules*, Wall St. J., Aug. 3, 1989, at A-1, col 6.

206. Greb, *Futures Trading: No Need To Panic*, Chicago Tribune, Feb. 24, 1989, § 1 at 17, col. 2. As one commentator has noted: "This is not a number to be treated lightly. . . . [I]t represents a small percentage of Chicago's more than 7,400 futures traders, the 6,200-plus members of the Chicago Board of Trade and the Chicago Mercantile Exchange and 1,200 on the secondary MidAmerica Commodity Exchange." *Id. See also*, *Lawyers See Hurdles For Futures Inquiry*, New York Times, Feb. 20, 1989, § D at 2, col. 4 (placing the number of persons under investigation at about twenty to twenty-five people); *Futures Shock-Digging the Dirt in Chicago*, AUSTL. FIN. REV., Feb. 24, 1989, at 1 (Weekend Special); *FBI Probe May Be Smaller Than Originally Thought*, DROVERS J., Mar. 2, 1989, at 2; *You Can Almost Hear A Sigh Of Relief In The Pits*, BUS. WK., Feb. 20, 1989, at 33.

207. *See supra* note 112 and accompanying text.

difficulty presented by this dichotomy is that where the CME Report was perhaps too responsive to public perception, the CBT Report did not offer enough of an olive branch to the CFTC and Congress.

The status of H.R. 2869 and the other legislation pending before Congress is uncertain at the present time. Undoubtedly, various floor amendments will be introduced to modify the current text of those proposals. It would be impossible to predict with any degree of accuracy which provisions will be included in the final version of any legislation; hence, any attempt to analyze the various bills would be somewhat unproductive at this time.[208] Nevertheless, this section of the article will set forth the various suggestions that have been made (including some of those set forth in the various bills) for reforming the practice of dual trading, and it will make some conclusions on the reasonable alternatives that exist for further regulating without banning the practice of dual trading.

There are several ways that Congress may effectively police dual trading practices, thereby eliminating the need to impose a complete ban on such activity. First, transaction time sequence reconstruction capabilities could be improved. Second, compliance measures could be further refined. Third, exchanges could eliminate or uniformly restrict dual trading among members of broker groups.[209] Fourth, the CFTC could permit block trading, which could partially alleviate the alleged abuses currently under investigation. Fifth, federal agents could be placed permanently on the exchange floors in an effort to create a "worry factor" among floor brokers. Sixth, the CFTC could require floor traders to register with it before conducting proprietary trading in the pits. Seventh, a partial ban rather than a total ban could be imposed on heavily traded contracts when liquidity and volume concerns are less serious. Finally, Congress could impose a complete ban on dual trading.

With respect to the first recommendation, one of the frequent arguments made in support of permitting dual trading is that abuses can be controlled if the contract markets have adequate transaction time sequence reconstruction capabilities. As noted above, this was a central goal of the 1974 Amendments to Regulation sections 1.35(e),[210] (g)(1),[211] and (h).[212] Until 1986, the com-

208. For a discussion of the key provisions of the various bills, see *supra* note 200.
209. *See infra* note 234 and accompanying text (a discussion of broker groups).
210. 17 C.F.R. § 1.35(e) (1989).
211. 17 C.F.R. § 1.35(g)(1) (1989).

modity futures exchanges were required under section 1.35(g)(1) to record the thirty-minute period within which each trade was executed. In an effort to enhance trade practice surveillance measures, that section was amended to require each exchange to implement timing and record-keeping systems that enable it to show the mechanically or electronically verified time of execution of each trade to at least the nearest minute.[213]

Unfortunately, however, most of the exchanges have been unable to meet the one-minute standard.[214] The exchanges' surveillance systems currently use data input from sequentially numbered trading cards and order tickets, including the entry time-stamps, the manually recorded time of execution, and thirty-minute bracket designations.[215] Recently, the two Chicago exchanges have tightened this latter requirement by requiring bracketing of trades every fifteen minutes.[216] An even tougher standard has been introduced in proposed H.R. 2869, which would require the exchanges to verify, to within one minute, the time of execution of any transaction by one year from the effective date of the bill, and to within thirty seconds by three years.

One of the problems inherent in the exchanges' trade reconstruction process is that it depends in part upon the input of data from the floor participants themselves, who may intentionally or inadvertently make reporting errors. Nevertheless, a reduction in the amount of time in which floor brokers and floor traders can report trades may result in less of an opportunity to fabricate trading data. Therefore, the requirement of one-minute bracketing of trades, as set forth in H.R. 2869, may theoretically serve to enhance transaction time sequence reconstruction capabilities. A second problem with the trade reconstruction process results from the fact that, in active markets, hundreds of trades may take place within a one-minute period. This fact creates additional support for the requirement in H.R. 2869 that the exchanges be capable of verifying to within thirty seconds, the time of execution of any transaction, by three years of the effective date of the bill.[217] Market liquidity, however, may be severely diminished because open outcry requires constant participation. If floor brokers and traders

212. 17 C.F.R. § 1.35(h) (1989).

213. 17 C.F.R. § 1.35(g)(2) (1989).

214. *See supra* note 144 and accompanying text.

215. *Id.*

216. *See infra* notes 220-23 and accompanying text.

217. H.R. 2869, 101st Cong., 1st Sess. 135 CONG. REC. H5603-30 (daily ed. Sept. 20, 1989).

have to leave the pit every minute to turn in their trading cards, there will be less of an opportunity to match orders.

Perhaps the strongest argument against a one-minute or thirty-second bracketing requirement is that recordation by the floor broker or trader interferes with his ability to quickly execute orders in active markets. Industry regulators, on the other hand, have argued that this type of requirement would affect floor participants uniformly and any detriment resulting from a decrease in the speed with which orders are executed will be offset by the benefit of increased trade reconstruction capabilities. Moreover, regulators argue that the ability to pinpoint the time of execution of trades may lead to an increased perception of market integrity at U.S. commodity futures exchanges. What they fail to understand, however, is that such an onerous requirement would eliminate the reason for the success of the domestic exchanges — open outcry. A more reasonable approach would be to allow the exchanges a period of time in which to develop new technologies that could accomplish this purpose without adversely affecting market liquidity.

The most significant defect in H.R. 2869 is that the ability of each exchange to permit dual trading is dependent upon its ability to demonstrate that it can meet the one-minute bracketing requirement. The two Chicago exchanges have already adopted various ruled designed to enhance their surveillance systems and have agreed to cooperate in developing the AUDITs system.[218] Therefore, rather than withdraw the dual trading ban after the exchanges can demonstrate their compliance with the bill's audit trail goals, Congress should elect to allow dual trading to continue while the exchanges develop such new technologies. If the exchanges are unable to verify their capabilities by the designated times, then and only then should their members be subject to a ban on dual trading.

Second, exchanges could further refine compliance measures. Indeed, the CBT and the CME have already taken action in this regard.[219] Recently, the CBT's Board of Directors unanimously approved the following nine actions designed to improve compliance and surveillance systems. First, the CBT voted to change the "standard" time bracket[220] increment to fifteen minutes from thirty

218. *See supra* note 99.

219. *CBT Approves Plan To Improve Audit Surveillance*, LIVESTOCK MKT. DIG., Mar. 20, 1989, at 5.

220. "Bracketing" of a trade is the identification of the trade as having been executed during a specified time period during the trading day. [1975-1977 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,242, at 21,291 n.6.

minutes.[221] Second, the CBT has established a period of fewer than fifteen minutes as the first[222] and last[223] time bracket for all contract's respective trading sessions. The exchange has also established a system of accountability for members and clearing firms for all sequentially numbered trading cards on a daily basis,[224] and will require that member's trading cards be picked up by clearing firms at one-hour intervals throughout the day and remitted to the CBT's Clearing Corporation one hour after that.[225] The CBT will also require that all trading cards receive an exchange-designated time-stamp as they are taken from the trading floor.[226] Finally, the CBT will establish an exchange floor "master clock" system, accurate to the nearest second, by which all time-stamp machines on the floor will be synchronized,[227] and it will install an "automatic bell" on the trading floor to designate a change of time bracket.[228]

The CME has also taken initiatives in this area by implementing the first order-routing system on its trading floor. The Trade Order Processing System ("TOPS")[229] is an order entry and fill reporting system that is designed to speed the flow of non-arbitraged paper orders to the floor.[230] The goal of TOPS will be to enhance timely order delivery and fill reporting and to reduce transcription errors. TOPS will also improve the efficiency of the CME clearing system and improve transaction time sequence reconstruction capabilities.[231]

One area that has not yet been addressed, but which should be further refined, is the exchanges' penalty provisions for violations

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221. Rule 332.02, Rules of the CBT, *supra* note 85, at 312. Currently, when filling in trading cards, CBT traders and brokers are only required to mark down the time of trades to within thirty minutes accuracy. *Id.*

222. *Id.* CBT traders and brokers will be required to be even more precise in recording the time of trades shortly after the opening of trading and just before closing. This change was prompted by reports that the early and final moments of trading in the pits are more susceptible to cheating. *Id.*

223. *Id.*

224. Rules 332.04 and 332.05, Rules of the CBT, *supra* note 85, at 312-13.

225. Rule 332.05, Rules of the CBT, *supra* note 85, at 313 and note 101. At the present time, CBT clearing firms only pick up trader's and broker's transaction cards twice daily—at 10:30 a.m. and at the close of trading. *Id.*

226. *Id.* This change is designed to monitor the holders of trading cards at any given time. *Id.*

227. Rules of the CBT, *supra* note 85, New Rule (undesignated).

228. *Id.* The new bell will ring every quarter-hour to remind traders that they have entered a new time bracket. *Id.*

229. *See supra* note 97 (discussing TOPS).

230. Henderson, *CME/CBT Add Controls As The Heat Rises*, DROVERS J., Mar. 16, 1989, at 24.

231. *Id.*

of trade reporting requirements. CBT Rule 519.01(b)(ii)[232] currently provides for a fine of up to $1,000 for a fourth offense involving either errors or omissions in reporting bracketing of trades, or errors or omissions involving the submission of computerized trade reconstruction data. Similarly, CME Rule 421[233] provides that the exchange's Computerized Trade Reconstruction Committee shall have the responsibility for reviewing clearing members' and members' compliance with CTR rules and shall have the authority to fine up to $5,000 for noncompliance with such rules.

These rules should be refined to provide more stringent monetary penalties for violations of trade reporting rules. The most reasonable way to eliminate or reduce trade practice abuses is to make the cost of such abuses prohibitive. By increasing monetary penalties, the CFTC and exchanges will reduce reporting violations, thereby improving transaction time sequence reconstruction capabilities. Such improved capabilities may lead to detection of the type of trading abuses that will trigger the penalties of up to $250,000 and $75,000 previously mentioned. In essence, by mandating harsher penalties for violations of members' trade reporting requirements, the Commission and the exchanges will close an existing loophole in the enforcement process.

Third, the exchanges could adopt rules designed to eliminate or uniformly restrict the practice of dual trading among members of broker groups.[234] In the past, broker groups have been criticized on the basis that they foster the opportunity to engage in illegal activity, such as front-running and bucketing. One view is that because broker groups share revenues and pool expenses, their members have an incentive to assist each other in illegal schemes. A contrary view is that broker groups provide a means for individual brokers to share the costs of trading mistakes, thereby reducing the risks of trading as an individual. As with dual trading itself, illegal activity is not inherent in the mere existence of broker groups. Therefore, Congress should not prohibit the formation of such associations; rather, it should acknowledge the valid purposes

232. Rule 519.01, Rules of the CBT, *supra* note 85, at 505-06.

233. Rule 421, Rules of the CME, *supra* note 86, ch. 4, at 23.

234. Broker groups are associations of individual floor brokers, usually members of the same pit, who share revenues and pool their expenses. Although legally sanctioned by the two Chicago exchanges, broker groups are required to register as such with the exchanges, and, at the CME, their members are limited in the percentage of trades they can execute with each other. Violating those limits can result in the imposition of a $5,000 fine. The CBT, however, does not impose such a limitation. *See generally Broker Study By Exchange in Chicago*, N.Y. Times, Feb. 9, 1989, § D, at 5, col. 1.

they serve and seek to subject such groups to more stringent penalties for violations of intragroup trading limits. Moreover, all exchanges should be required to impose such intragroup trading limits to create uniformity throughout the industry. By so doing, those who engage in fraudulent activity will be appropriately punished and those who do not engage in such activity will be permitted to continue their valuable membership in such associations.

Fourth, the CFTC could modify the current open outcry system and permit block trading as the stock exchanges already do. Block trading, also known as "sunshine trading," would permit members of an exchange to preannounce large orders being sent to the market at a particular time. Exchange members would submit advance written notice of their intentions to trade a large block of futures or options contracts to the exchange, which would then announce the member's order. One potential concern with regard to permitting block trading is the likelihood of confusion as to whether such activity constitutes prearranged trading, in violation of the Act and the regulations promulgated thereunder. Currently, prearranged trading is prohibited by section 6b[235] of the Act and Commission Regulation section 155.2(f).[236] Therefore, any effort by the CFTC to permit block trading must take into consideration the ability of exchange enforcement staff to distinguish between permitted prearranged trading in the form of block trades and unpermitted prearranged trading. The CFTC should consider the possibility of establishing a safe harbor for compliance with whatever block trading regulations are adopted. By so doing, exchange members will be able to engage in block trading activities without fear of violating the Act or the regulations promulgated thereunder.

A second concern involves the rights of exchange members who, because of limited financial resources, cannot participate in block trading. Many local traders believe that they have the right to participate in any trade that takes place on the exchange floor. Yet, many floor traders will be unable to accommodate large block trades. One compromise position that has been advanced is to allow floor traders to participate in block trading—if they can offer a better price than the one previously agreed to by the larger wirehouses.[237] Block trading could potentially reduce the abuses associated with dual trading because large institutional investors

235. 7 U.S.C. § 6b (1988).

236. 17 C.F.R. § 155.2(f) (1989).

237. *FBI Probe Heightens New York Firms' Push To Accommodate Block Trades*, SEC. WK., Mar. 13, 1989, at 7-8.

would be on both sides of the transaction and they would have already agreed on the price and quantity terms. By engaging in block trading, such investors could eliminate the risk of what might happen in the pits by establishing full disclosure of the terms of any given transaction prior to its execution. One potential disadvantage of this alternative, however, is that it will not protect smaller market participants who cannot accommodate large orders.[238]

Fifth, the CFTC and the exchanges could permanently plant Federal agents in the pits in order to create a worry factor among floor brokers and traders and deter further abuses. Indeed, this suggestion has been made by Representative Glenn English (D., Okla.), the Chairman of the House subcommittee responsible for examining futures trading regulations.[239] Yet, this proposed alternative has several defects. One problem is that the cost of planting Federal agents in the pits on an anonymous basis would be prohibitive. Seats on the exchanges and other costs associated with maintaining a permanent cover for Federal agents could run into the millions of dollars. Indeed, the current investigation, which has lasted two and a half years, is estimated to have cost taxpayers at least \$1 million.[240] Another difficulty is that most of the alleged fraud would go undetected insofar as many members will only commit illegal acts with those persons whom they know and trust. Consequently, undercover agents would merely be able to observe instances of fraud and manipulation engaged in by others. Unfortunately, the pits are too crowded and chaotic for agents to be an effective deterrent for floor brokers and traders.

Sixth, the CFTC could require floor traders to register with it before commencing proprietary trading in the pits. Currently, only floor brokers who trade for public customers, as well as their own accounts, must register with the CFTC. Requiring floor traders to register with the CFTC would enable regulators to disapprove applications of prospective members with unsavory backgrounds; therefore, this requirement should be adopted.

A seventh alternative would be for the CFTC to exercise its

238. Power, *Futures Exchanges Urged To Allow Block Trading,* Wall St. J., Mar. 3, 1989, at C-12, col. 4. For example, in the securities markets, large orders may only be purchased and sold in minimum lots of 10,000 shares or more. *Id.*

239. Spear, *Panel To Consider Using Federal Agents; Electronic Trading Unveiled By CBT,* Feedstuffs, Mar. 20, 1989, at 22, col. 1.

240. Baquet & Burton, *Trader Probe Is Stingingly Sophisticated,* Chicago Tribune, Aug. 6, 1989, at 1, col. 5.

power under section 6j[241] of the Act to make separate determinations for different contract markets and to take into account the effect upon the liquidity of trading in each market. Thus, the CFTC could decide to ban dual trading in any contract markets, except those where dual trading is essential in order to provide depth and liquidity for hedgers who need the market to function in order to protect against risk. A similar suggestion has already been incorporated into a draft of H.R. 2869.[242] The problem with this approach is that if FCMs and floor brokers, who cannot survive economically unless permitted to dual trade, switch contract markets solely on the basis that dual trading is permitted in one market and not in the other, market depth in the contract dually traded may be artificially inflated.

Finally, another alternative would be to impose a complete ban on dual trading even though, at this time, there is no empirical evidence that widespread abuses result from the practice of dual trading itself. The probable consequence of this alternative is that some existing markets would be greatly hampered, if not eliminated. In markets with low trading volumes, when there is no customer order to take the opposite side of a trade, a ban on dual trading would eliminate an active market for that particular contract because a floor broker or FCM would be unable to trade for his or its own account or one in which the floor broker or FCM has an interest. The difficulty with this approach is that it represents a drastic solution to a problem, the cause of which has not yet been determined.

VII. CONCLUSION

The current investigation of the Chicago and New York exchanges has raised the question of whether dual trading should be banned. Although critics point to the allegations of widespread abuse associated with dual trading (i.e., front-running and bucketing), at this time, there is little empirical evidence to substantiate a causal relationship between them. While the rules regulating the practice of dual trading are clearly in need of reform, there is also little doubt that the practice is vitally important to the strength of the United States commodity futures industry. Opponents of dual

241. Sections 6j(1) and (2) each provide "that nothing herein shall be construed to prohibit the Commission from making separate determinations for different contract markets when such are warranted in the judgement of the Commission . . . ." 7 U.S.C. § 6j(1)-(2) (1988).

242. *See supra* note 200.

trading have failed to demonstrate a nexus between the alleged abuses and the practice of dual trading itself. Therefore, the CFTC and the exchanges should be given an opportunity to first study and implement the recommended alternatives to either a partial or complete ban on dual trading. Imposing any ban on dual trading is clearly premature at this time, and Congress should not act in a way that may eliminate certain markets merely because 1989 happens to be a reauthorization year.