1982

Contract Market Self-Regulation under the Commodity Exchange Act

Marshall J. Nachbar

Follow this and additional works at: http://engagedscholarship.csuohio.edu/clevstlrev

Part of the Antitrust and Trade Regulation Commons, and the Securities Law Commons

How does access to this work benefit you? Let us know!

Recommended Citation


This Article is brought to you for free and open access by the Law Journals at EngagedScholarship@CSU. It has been accepted for inclusion in Cleveland State Law Review by an authorized administrator of EngagedScholarship@CSU. For more information, please contact library.es@csuohio.edu.
I. INTRODUCTION TO THE COMMODITY FUTURES INDUSTRY

In order to comprehend the self-regulatory functions and obligations of contract markets under the Commodity Exchange Act (CEA or Act) it is necessary to understand why and how such markets came to exist. Central markets existed in feudal England. These markets developed rudimentary trading practices and standards of conduct to regulate them. Essentially, these early markets were places to engage in spot transactions: cash transactions for immediate delivery. Only agricultural commodities were traded in these early markets.

The evolution of this unsophisticated central market into the modern futures exchange resulted from the changing needs of producers and processors of agricultural commodities. Conditions in agricultural markets were profoundly affected by supply and demand fluctuations in the nineteenth century. At times the farmers, the producers, were hurt by over-
production which resulted in an over-supply of goods which led the purchasers, the processors, to bid extremely low prices for their requirements. The farmer, desperate to sell, was forced to accept a low bid for his goods. On occasion, when the supply of goods far out-stripped the demand of the processors, it was not uncommon for produce to be dumped or destroyed.

Conversely, in situations where demand far out-stripped supply, as a result of a poor harvest, prices for the available crop were bid up by the processors. In these circumstances, farmers with something to sell went back to the farm with some cash. The processors who had been outbid had nothing to process and went home broke.

Clearly there was a need for a mechanism to protect producers and processors from the vagaries of the marketplace. This need became more pronounced as American agriculture grew with the opening of the West, the expansion of the railroads, and the vast European migrations. It became imperative to produce an effective means of feeding a widely dispersed and greatly increased population, for the processor and producer were needed to help assure a continuous food supply for the growing nation. To control their risks, farmers and processors developed forward contracting for the delivery of farm products. This involved agreements to make deliveries at specified times in the future, and at least assured some merchants and farmers of having sellers and buyers, respectively.

In 1848 the Chicago Board of Trade was founded. Cash trading and forward contracting were carried on at this new exchange. As useful as forward contracting was in finding buyers and sellers, it did nothing to control financial risk resulting from crop failures, inadequate transportation and storage facilities, or other circumstances beyond the control of the parties.

Futures contracts were developed to control these risks. One method by which futures contracts are used to control risk is called hedging. The regulations to the Commodity Exchange Act define bonafide hedging transactions as

transactions or positions in a contract for future delivery on any contract market, where such transactions or positions normally represent a substitute for transactions to be made or positions 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,

A futures contract is a binding agreement to take delivery of or to deliver a known quantity of a commodity which is of a uniform quality at a price specified at the time the contract is made. Delivery is to be at the seller's option and is to be made at a specified time during a specified delivery month.
or merchandises or anticipates owning, producing, manufacturing, processing or merchandising; (ii) the potential change in the value of liabilities which a person owes or anticipates incurring; or (iii) the potential change in the value of services which a person provides, purchases or anticipates providing or purchasing. 3

In addition to its hedging function, futures trading serves as a price-setting mechanism and finally as a potential profit-making vehicle for speculators. Commodity trading is no longer exclusively agricultural as in the early years. In fact, items not traditionally thought of as commodities have been defined as such by the Commodity Futures Trading Commission (CFTC or Commission) and are presently approved for trading on United States commodities exchanges. 4

3 17 C.F.R. § 1.3(z) (1982).

4 On the Chicago Board of Trade the following commodities have been approved for trading: corn, oats, soybeans, soybean meal, wheat, gold, iced broilers, plywood, silver, stud lumber, GNMA mortgages, commercial paper 90 days, long term T-bonds, GNMA mortgages CD, commercial paper 30 days, T-notes 4 to 6 years, domestic CD's 3 months, long term T-notes 61/2-10 years, short term T-notes 21-24 months, soybean seeds and Eurodollar time deposit rates 3 months.

On The Chicago Mercantile Exchange the following commodities have been approved for trading: butter, live cattle, feeder cattle, eggs, frozen pork bellies, frozen boneless beef, skinned hams, grain sorghums, Russet Burbank potatoes, live hogs, lumber, turkeys, Canadian dollars, copper, Deutsche marks, Dutch guilders, French francs, gold, Japanese yen, Mexican pesos, pounds sterling, Swiss francs, U.S. silver coins, T-bills 90 days, platinum, stud lumber, T-bills 1 year, T-notes 4 years, fresh broiler chickens, plywood, domestic CD's 3 months, Italian lira and Eurodollar time deposit rates 3 months.

On the Commodity Exchange, Inc. the following have been approved for trading: copper, gold, silver, zinc, T-bills 90 days, GNMA and T-notes 2 years.

On the Kansas City Board of Trade the following have been approved for trading: corn, grain sorghums, wheat and value line average stock index.

On the Midamerica Commodity Exchange the following have been approved for trading: corn, hogs, oats, soybeans, wheat, gold, silver, U.S. silver coins, live cattle, T-bonds long term and T-bills 90 days.

On the Minneapolis Grain Exchange the following have been approved for trading: barley, corn, flaxseed, frozen pork bellies, oats, rye, soybeans, wheat, Durum wheat and sunflower seeds.

On the New Orleans Commodity Exchange the following have been approved for trading: milled rice (long grain), rough rice, cotton and soybeans.

On the New York Coffee, Sugar, and Cocoa Exchange the following have been approved for trading: cocoa (nos. 11 and 12), coffee (B and C) and sugar.

On the New York Cotton Exchange Citrus Association the following have been approved for trade: cotton (nos. 1 and 2) and frozen concentrated orange juice.

The Petroleum Association approves crude oil and liquid propane for trading.

The Wool Association approves only wool for trading.

The New York Futures Exchange approves the following for trading: foreign currencies (British pounds, Canadian dollars, Deutsche marks, Japanese yen and Swiss francs), T-bills 90 days, T-bonds 20 years, bank CD's, GNMA CD and Eurodollar time deposit rates 3 months.

The New York Mercantile Exchange approves the following for trading: frozen
By 1982, contract markets had become even more exotic in their trading vehicles. As more and more nonagricultural commodities were traded in response to economic needs, volume for such commodities soared. Financial instrument pits in Chicago are as hectic as the more traditional bean pits.

There has been a move away from agricultural commodities to the various financial instruments. From this it may be stated that as the economy has changed, futures markets have changed, moving to meet new demands. This has led to a much greater public participation in futures trading as more commodities can be traded as hedges by an ordinary investor trying to protect himself from large swings in interest rates or wishing to diversify his investments so that he is not as vulnerable as he would be if all his investments were in one area. As noted in a House Committee on Energy and Commerce report in regard to financial futures, “these derivative instruments have been used to speculate on and hedge against, not only price changes in the specific underlying instruments, but also changes in interest rates generally. The financial futures market has emerged in a few short years as a critical adjunct to the cash market.”

The modern commodity exchange has grown and changed with the times. Today such exchanges are the centers of some of the most highly specialized computer terminals in the financial world. Yet, in the midst of all this sophisticated electronic equipment, orders to buy and sell billions

boneless beef, round white potatoes, Belgian francs, British pounds, Canadian dollars, Deutsche marks, Dutch guilders, kilo gold, heating oil, industrial fuel oil, Italian lira, Japanese yen, Mexican pesos, Swiss francs, palladium, platinum, butter, industrial fuel oil (U.S. delivery), heating oil (U.S. delivery), Gulf coast no. 2 heating oil, N.Y. harbor leaded regular gasoline, N.Y. harbor unleaded regular gasoline, Gulf coast leaded regular gasoline and Gulf coast unleaded regular gasoline.


5 In 1980-81, the volume of trading on exchanges expanded greatly from 1979-80. In thousand contracts, the volume of trade at the Chicago Board of Trade increased from 38,433.6 in 1979-80 to 57,474.1 in 1980-81. Similarly, on the Midamerica Commodity Exchange, trade increased in thousand contracts from 2,584.9 to 3,086.4. Even the Kansas City Board of Trade registered an increase from 1,201.5 to 1,204.5 thousand contracts. Although the Minneapolis Grain Exchange registered a decrease in 1980-81, the Chicago Mercantile Exchange and the International Monetary Market enjoyed an increase from 21,308.0 in 1979-80 to 23,748.1 thousand contracts in 1980-81. There was a dramatic increase in trade volume at the New York Mercantile Exchange from 905.8 in 1979-80 to 1,726.9 thousand contracts in 1980-81. There were trading volume decreases at the New York Cotton Exchange and Associates and the Coffee, Sugar and Cocoa Exchange, but the Commodity Exchange, Inc. experienced a trade volume increase from 10,300.5 in 1979-80 to 13,328.5 in 1980-81 as did the New York Futures Exchange from 66.1 to 378.0 thousand contracts. S. REP. No. 384, 97th Cong., 2d Sess. 182-86 Appendix C (1982).

of dollars worth of commodities each year are executed manually through a system of bids and offers made openly at a ring or pit. The exchanges are policed via a system of self-regulation.

---

7 Senate U.C. Bill 2109, the 1982 reauthorization of the Commodity Futures Trading Commission, included the following explanation of the mechanics of commodities futures trading:

*Placing Orders*

The customer contacts a solicitor or account executive who in turn transmits the order either directly or through a central office, to the exchange trading floor. The order is received on the trading floor by the firm's phone man. After recording and timestamping the order, he gives it to a runner who carries the order to a floor broker in the designated areas for that commodity. These trading areas are called pits or rings and each delivery month of a commodity is generally traded in a certain area of that pit or ring. Some firms no longer telephone orders to the floor. Instead, the orders are fed through a computerized system that transmits them to the floor via teletype.

*Execution of Trades*

The actual trading of futures contracts takes place in the noisy boisterous setting of an auction-type market. The Commodity Exchange Act requires that all futures transactions be executed on a commodity exchange designated as a "contract market." Both the Commodity Exchange Act and the rules and regulations of the commodity exchange require that futures transactions be executed openly in a competitive manner. Section 1.38 of the regulations under the Commodity Exchange Act reads in part as follows:

"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, in the trading pit or ring or similar place provided by the contract market, during the regular hours prescribed by the contract market for the trading in such commodity."

Certain carefully prescribed exceptions to competitive trading are allowed, but they do not nullify the general requirement of open and competitive trading.

The purpose of this requirement is to ensure that all trades are executed at competitive prices and that all trades are focused into the centralized market place to participate in the competitive determination of the price of futures contracts. This system also provides ready access to the market for all orders and results in a continuous flow of price information to the public.

The rules requiring competitive trading also require that all trades be executed in the area and during the hours designated by the contract market. Other exchanges can trade virtually identical contracts for the same commodity, provided they meet the requirements of a contract market as specified by the Commodity Exchange Act and are so designated by the Commission.

*Clearing Trades*

After a trade has been executed, the confirmation of the trade retraces the path of the initial order within a few minutes. Final confirmation, however, cannot be made until the trade goes through the clearing house. In the clearing house, both sides of the trade must be matched, and any
It must be noted that self-regulation under the Commodity Exchange Act is aimed to a great extent at assuring that the system of "open outcry" bids and offers is carried out in a manner which assures that all orders are entered at the ring and executed fairly, so that every public customer is certain of getting the best possible price for his order. To be more succinct, the purpose of self-regulation is to protect the integrity of the marketplace. An exchange which does not assure the public customer of a fair deal will suffer a large number of dormant contracts.

The self-regulation of this trading process by the several commodity differences between the buyer and seller must be referred to the clearing firms involved for reconciliation. The clearing procedure for futures trading points out one of the major distinctions between futures and securities trading. Unlike securities, there is no certificate or document exchanged in a futures transaction. The futures contract is embodied in the rules and regulations of the contract market. The clearing house (or clearing association) performs the functions of matching all buys and sells which are executed each day and of assuring the financial integrity of all futures transactions. As trades are matched and confirmed at the end of each trading session, the clearing house takes the opposite side of every transaction. It becomes the seller of all "buys" and the buyer of all "sells." Thus, when a trader establishes a position in the market, he does so with the clearing house, and when he offsets his position he offsets it with the clearing house. The clearing house assumes the legal responsibility for the opposite side of every transaction made on the contract market.

The clearing house requires that its members deposit margins to secure their firm's futures transactions. The clearing members in turn require margins from their customers. If the market moves against the open contracts of a clearing firm, that firm's initial margin is impaired and additional margin will be required.

Daily payments or receipts also occur between the clearing house and its members to account for daily price changes. The clearing house maintains the open accounts of member firms at the current market prices. At the end of each day, these accounts are adjusted to the day's settlement price for each contract. Firms with net gains receive payment from the clearing house, while firms with net losses make payments to the clearing house. The receipts and payment of the clearing house exactly offset one another, with the clearing house merely transferring equity from losers to winners.

Deliveries

Deliveries on futures contracts are also made through the clearing house. A seller wishing to make delivery on a futures contract during the delivery month files a delivery notice with the clearing house on the day prior to the intended delivery. The clearing house then assigns the notice to clearing members having long positions in the particular future. Assignment of the delivery notice is generally to the clearing member having the oldest long position, although some exchanges allocate the assignments to other bases. At this point, the clearing house has completed its role, and the delivery must be consummated between the buyer and seller in accordance with exchange rules.

exchanges is complicated not only by the new vehicles being offered for trading but also by the vast increases in the market itself. But, even with this rapid expansion of the industry, the exchanges have maintained efficient enforcement departments in keeping with the requirements of the Act.

II. CONTRACT MARKET SELF-REGULATION

The obligation of contract markets to regulate themselves is contained in various sections of the Act and the accompanying CFTC regulations and guidelines.9 Section 5a(8) of the Act10 must be reviewed to properly analyze this obligation of self-regulation. This section sets forth what is required of a commodity exchange to regulate itself. It states that each contract market shall:

(8) enforce all bylaws, rules, regulations, and resolutions, made or issued by it or by the governing board thereof or any committee, that (i) have been approved by the Commission pursuant to paragraph (12) of this section, (ii) have become effective under such paragraph, or (iii) must be enforced pursuant to any Commission rule, regulation, or order; and revoke and not enforce any bylaw, rule, regulation, or resolution, made, issued, or proposed by it or by the governing board thereof or any committee, that has been disapproved by the Commission; . . . .

In order to effectuate this section of the Act, the CFTC, pursuant to its authority granted by section 8A(5),11 enacted certain regulations. For example, regulation section 1.51 entitled Contract Market Program for Enforcement12 sets forth what an exchange must do in order to comply with the provisions of the Act. This section calls for an affirmative action program to be exercised with due diligence in order to assure compliance with sections 5, 5a, 5b, 6(a), 6b, 8(a)(7), 8(a)(9) and 8(c) of the Act.13 More specifically, regulation 1.51 states that an enforcement program is to include:

(1) Surveillance of market activity for indications of possible congestion or other market situations conducive to possible price distortion;

---

13 7 U.S.C. §§ 7, 7a, 7b, 8, 9, 10a(9), 10c, 12a(7), 12a(9), 12c (1976 and Supp. V. 1981).
(2) Surveillance of trading practices on the floor of such contract market;
(3) Examination of the books and records kept by contract market members relating to their business of dealing in commodity futures, commodity options, and cash commodities, insofar as such business relates to their dealing on such contract market;
(4) Investigation of complaints received from customers or options customers concerning the handling of their accounts or orders;
(5) Investigation of all other alleged or apparent violation of such by-laws, rules, regulations and resolutions;
(6) Such other surveillance, record examination and investigation as is necessary to enforce such by-laws, rules, regulations and resolutions; and
(7) A procedure which results in the taking of prompt, effective disciplinary action for any violation which is found to have been committed. 14

In addition, the regulation provides that exchanges keep full, complete and accurate records of their disciplinary processes. 15 To further clarify the preceding requirements the CFTC issued Guideline 2. 16 These three elements form the basis of an exchange's self-regulatory obligations under the Act and will be discussed further in succeeding Sections of this Article.

III. EXCHANGE DISCIPLINARY PROCEDURE

As previously noted, regulation section 1.51 17 requires that an exchange establish a disciplinary mechanism to take action against its members for rule violations. Part 8 of the regulations was adopted by the Commission to provide standards for the contract markets to follow in the establishment of a disciplinary process that would comply with the requirements of the Act. 18

Each of the active commodity exchanges in the United States has prepared rules, regulations and by-laws to govern trade practices: the actual trading on the floor of the exchange. The rules provide the framework for an exchange's brokers to work within, from the actual entry of an order to its execution in a trading pit or ring and then the report back to the customer. The rules, regulations and by-laws prohibit a broker from trading ahead of his customer, 19 improperly crossing trades, 20 mak-

14 17 C.F.R. § 1.51(a)(1)-(6) (1982).
15 Id. § 1.51(a)(7).
17 17 C.F.R. § 1.51(7) (1982).
18 Id. § 8.01.
19 Id. § 155.2.
20 Id. § 1.39.
ing improper or disruptive bids or offers, fictitious transactions, wash trades and bucketing, among others. In addition to specific prohibited conduct, broader rules have been enacted by the exchanges which make it an offense, subject to disciplinary action, to engage in conduct detrimental to the best interests of the exchange or to engage in conduct inconsistent with just and equitable principles of trade.

As previously noted, the CFTC issued Guideline 2 to advise contract markets of exactly what is expected of them in their enforcement activities. Guideline 2 explains that the "due diligence" required in regulation 1.51 is to be determined on an individual case by case basis using all the circumstances of the situation in question as factors to be considered in determining if "due diligence" has been exercised. This means that an exchange must establish procedures to carry out its enforcement program that are set and uniform as well as flexible enough to adapt to the varied situations which occur in the course of trading on an exchange.

Realizing that no contract market enforcement program can be airtight, the Commission has stated that it does not expect all instances of rule violations to be detected but that it does expect compliance programs to be reasonably calculated to enforce exchange rules. It is thus mandatory that a reasonable program exist. Guideline 2 sets forth that the excuse of insufficient financial resources to fund an adequate enforcement program is completely unacceptable. As a consequence, the Commission permits an exchange to hire non-exchange employees for surveillance and enforcement duties. Guideline 2 provides, however, that an exchange cannot escape responsibility for inadequate surveillance and enforcement where such activities were contracted out to non-employees. Moreover, the Commission has explicitly directed that all contract personnel must come under the control of the exchange at all times.

The order for a continuing affirmative action program of rule enforcement has resulted in exchanges' establishing complex schedules for trading

---

21 Id. § 1.38.
23 Id.
24 Id. § 6(b)(D).
25 CHICAGO BOARD OF TRADE RULES 500 and 504 (1981); CHICAGO MERCANTILE EXCHANGE RULE 432(q) (1979); COMMODITY EXCHANGE, INC. BY-LAW § 210(a)(vi), (vii) (1975); MINNEAPOLIS GRAIN EXCHANGE RULE 801(d) (1979); NEW YORK COTTON EXCHANGE RULE 9.01(c)(d) (1981); NEW YORK FUTURES EXCHANGE RULE 501(iv) (1980); NEW YORK MERCANTILE EXCHANGE RULE 57.01(e)(f) (1980).
26 Contract Market Rule Enforcement Program, supra note 8.
27 Id.
28 Id.
29 Id.
30 Id.
floor surveillance, as well as regular reviews of computer records to investigate members’ trading practices and financial conditions. These activities are calculated to discover rule violations and to prevent them where possible.

This surveillance and enforcement activity stems from the requirements of regulation section 1.51. Guideline 2 describes some of the activities for which an adequate enforcement program is expected to provide surveillance. Guideline 2 includes:

1. Price movements;
2. Changes in price relationships—among futures, between markets, futures vs. cash;
3. Open interest and changes in open interest;
4. Concentration of positions among clearing members;
5. Volume of trading and changes therein;
6. Trading liquidity and the magnitude of successive price changes;
7. Deliverable supplies;
8. Deliveries—is there any apparent concentration in the making or taking of deliveries?

These Guideline 2 requirements have led exchanges to create specific computer programs to investigate and detect abnormalities of trading. Each computer program which is created to assist market surveillance produces additional specialized trading records. These records must be maintained for a period of five years and have become a part of self-regulation by record-making and retention.

Market news and gossip are recognized as factors that will move a market as surely as supply and demand and very often much more dramatically. News service tickers are maintained on exchange trading floors to disseminate what is hoped to be accurate information about national and international events. In the agricultural commodities area, for instance, information may be as varied as reports of a Russian grain failure, a forecasting of a bumper grain crop for American farmers or a United States Weather Service prediction of a longer and colder winter than usual. Because of the extreme sensitivity of the marketplace to external events, great emphasis is placed upon the detection and prevention of rumors before they affect the marketplace.

While computer-assisted trading analysis is important, so too is actual physical observation of trading in the pits or rings. Guideline 2 provides that the purpose of this activity “is to deter or eliminate practices which tend to lessen the competitiveness of floor trading or by which member

---

31 17 C.F.R. § 1.51 (1982).
32 Contract Market Rule Enforcement Program, supra note 8, at 6211.
33 17 C.F.R. § 1.31(a)(1) (1982).
floor brokers or futures commission merchants take advantage of customers.\textsuperscript{34}

These observations of trading activities are carried out at various times during each business day, including every opening and closing period of every commodity traded on any contract market. The openings and closings are extremely sensitive trading periods. Surveillance of them is crucial to a proper enforcement program under the Act.

To the uninitiated, the observation of a trading pit may strike up images of chaos. However, to a trained observer who knows what to listen for, how to read the hand signs which are a trader's shorthand, and what actions to look for while keeping an eye on the electronic price reporting board, there is a form of orderliness that makes such personal surveillance useful in a regulatory scheme. As previously indicated, personal surveillance and review of trade registers or computer-generated documents come together in a twofold activity. Guideline 2 notes this and describes what the surveillance activity should be attempting to discover. These activities are:

(1) Any floor broker or futures commission merchant taking the opposite side of customers' orders in a manner in violation of the exchange rules, whether directly, via an accommodation trade, or as a customer of the opposite broker.

(2) Any floor broker or futures commission merchant matching customers' orders in violation of the exchange rules, whether directly or through the medium of an accommodation trade.

(3) Wash trading by any clearing member or floor trader.

(4) "Holdouts," "unmatched" or "unsigned" trades being improperly handled, that is, whether any broker is taking such trades into his own account or whether such trades are ending up with a person other than the one with whom such trades actually were made.

(5) Any trading outside the daily price range.

(6) Any indication of noncompetitive practices such as:
   (a) Prearranged trading
   (b) Preferential trading
   (c) Unusually heavy trading involving two or more associated brokers.

(7) If the exchange has speculative trading limits—evidence that any floor trader is trading in excess of such limits . . . . . Examinations should be made to determine whether there is any indication of floor brokers trading ahead of customers' orders or failing to give customers' the proper executions of their orders.\textsuperscript{35}

\textsuperscript{34} Contract Market Rule Enforcement Program, \textit{supra} note 8, at 6211.

\textsuperscript{35} Id.
Guideline 2 also makes general statements concerning the investigation of customer complaints,\textsuperscript{36} the investigation of other alleged or apparent violations\textsuperscript{37} and other surveillance matters.\textsuperscript{38}

Guideline 2 does not attempt to describe all types of surveillance which exchanges must undertake to enforce their rules in an appropriate manner. It does grant exchanges the discretion to carry out any surveillance, record examination or investigation which they determine to be necessary for an effective enforcement program. Guideline 2 takes note of the fact that as the exchanges gain experience in enforcing their rules they will be able to adapt to novel situations with new surveillance programs as necessary.\textsuperscript{39} Conversely, it is possible that as exchanges gain experience, some programs will become unnecessary or obsolete and will be eliminated from an enforcement program.

Section 7 of Guideline 2 calls for a prompt and effective disciplinary and/or corrective procedure.\textsuperscript{40} Part 8 of the regulations provides for due process and fairness in exchange disciplinary proceedings.\textsuperscript{41}

IV. DUE PROCESS IN EXCHANGE DISCIPLINARY ACTIONS

To attempt an exact definition of due process is to attempt to catch mercury with one's bare hands. It will always slip away. At best what can be defined is the spirit of due process. In an administrative proceeding such as an exchange disciplinary action, a property right is at stake, not life or liberty. It has been stated that in an administrative proceeding there is no particular form of procedure required to constitute due process.\textsuperscript{42}

What then is due process? In a general sense, due process is a "summarized constitutional guarantee of respect for those personal immunities which . . . are 'so rooted in the traditions and conscience . . . as to be ranked as fundamental' . . . or are 'implicit in the concept of ordered liberty.' "\textsuperscript{43}

In an administrative proceeding, "it is sufficient for due process if the party affected is apprised of the nature of the hearing and afforded an opportunity to offer evidence and examine the opposition."\textsuperscript{44} In even

\textsuperscript{36} Id. at 6212.
\textsuperscript{37} Id.
\textsuperscript{38} Id. at 6213.
\textsuperscript{39} Id.
\textsuperscript{40} Id.
\textsuperscript{41} 17 C.F.R. §§ 8.01-.28 (1982).
\textsuperscript{42} FCC v. WJR, 337 U.S. 265, 275 (1949).
\textsuperscript{44} Ashbury Truck Co. v. Railroad Comm'n, 52 F.2d 263, 268 (S.D. Colo. 1931), \textit{aff'd}, 287 U.S. 570 (1932).
stronger language, notice and the opportunity for a hearing are essential to due process where a person's liberty or property rights are affected.45

The hearing must be full and fair. This means an opportunity to be present at a set time and place, to offer evidence on one's behalf, to cross examine any opposing witnesses, to be represented by counsel, to make a statement summarizing the defense position and to have this procedure take place before an impartial officer, board or other panel.46 The impartial officer, board or panel must render its decision based upon sufficient evidence.47 The decision must be founded on reason. It may not be arbitrary. The contesting parties are entitled to know the facts relied upon in deciding the case.48 In its essence, an exchange disciplinary proceeding must assure adherence to the fundamental principles of justice and fair play.49 Through the following analysis of Part 8 of the regulations50 it will be demonstrated that fundamental fairness has been adhered to and the protections of due process have been extended to members by the commodities exchanges.

The regulations which comprise Part 851 flow directly from the regulation section 1.51 requirement for prompt and effective disciplinary actions.52 Guideline 2 of the CFTC explains the regulation section 1.51 requirements by indicating that disciplinary procedures should provide that:

1. The findings are supported by the evidence,
2. the action is taken with reasonable dispatch, and
3. in cases where penalties are warranted, that the sanctions imposed are sufficient to deter future violations.53

In addition to these requirements, Guideline 2 requires that notice of all actions taken be publicized to further the general deterrent effect.54

Part 8 is a code of regulatory procedure by which a contract market is to fulfill its obligations under regulation section 1.51. It should be noted

50 17 C.F.R. §§ 8.01-.28 (1982).
51 Id.
52 17 C.F.R. § 1.51(a)(7) (1982).
53 Contract Market Enforcement Program, supra note 8, at 6213.
54 Id.
that when the CFTC proposes new regulations and when it publishes its final regulation, the Commission will publish an accompanying preamble which is, in effect, a CFTC policy statement. This policy statement traces the new regulation back to its proposal stage and comments as to why the final rule is in its particular form. Essentially, these comments form a rule-making history and an analysis of the philosophy behind each rule.

Subpart A of Part 85 sets forth the general scope of the rules. Regulation section 8.03 contains definitions which are pertinent to other provisions of Part 8. Of significance in this definition section is subsection (j), “Persons within the jurisdiction of the exchange.” This subsection effectively states whom the exchanges are expected to regulate. Jurisdiction under this section extends to any exchange employee, staff member or official, any member or person with membership privileges or any person employed by or affiliated with a member or person with membership privileges, including any agent or associated person, any other person under the supervision or control of the exchange or of any other member.56

Subpart B of Part 8, entitled Disciplinary Procedure, sets forth the actions an exchange must take in the interests of due process in its self-regulatory process.

Regulation section 8.05 states that each exchange is to have adequate enforcement staff to initiate and conduct investigations and to prosecute effectively alleged rule violations. As noted previously, the CFTC has stated that a lack of financial resources for an adequate enforcement program is not justification for not having such an enforcement program. Guideline 2 states simply that such an exchange must modify its financial arrangements to provide an enforcement program that protects the public.61

Regulation section 8.06, entitled Investigations, requires that the disciplinary procedures established by the exchanges in conjunction with their enforcement staffs be such that an investigation will be undertaken upon a referral from CFTC or upon receipt of information by the exchange which indicates “a possible basis for finding that a violation has occurred or will occur.”62 The CFTC in its statement of purpose explains that the broad language of the regulation is intended to include every source of

55 17 C.F.R. §§ 8.01-.03 (1982).
56 Id. § 8.03.
57 Id. § 8.03(j).
58 Id.
59 Id. §§ 8.05-.20.
60 Id. § 8.05.
61 Contract Market Rule Enforcement Program, supra note 8, at 6210.
information that may suggest the possibility of a rule violation. Therefore, the CFTC states that an investigation will be required upon receipt of a complaint from a customer, exchange member or other person. 63

Regulation section 8.06(b) states that an enforcement staff shall complete an investigation within four months unless a significant reason exists to extend this time. 64 Just what is to be a “significant reason” is not set forth. The four month time period meets the requirement of due process that a proceeding shall take place within a reasonable period of time. Based upon the CFTC remarks, it appears that this four month period is to be used as a standard upon which an enforcement staff’s performance will be judged. 65 That is, if an exchange shows a significant number of investigations lasting longer than four months, it may be reasonable to conclude that the enforcement staff is not properly discharging its duties and may prompt CFTC proceedings against the exchange for not properly meeting its obligations under the Commodity Exchange Act. In addition to this form of liability, it appears that an enforcement staff’s performance may be an area of interest in a civil suit brought against an exchange pursuant to a private right of action under the Act. 66

Section 8.07 is entitled Investigation Reports. 67 It is concerned with the substance of every investigation. As due process calls for a determining body to be aware of the facts of a disciplinary proceeding when it decides any aspect of a case, this section provides for that which must be presented to a disciplinary committee so it may act from an informed position.

A report is to be made of every investigation. It is to include the reason an investigation was initiated, a summary of a customer complaint if pertinent, any relevant facts and the staff’s conclusion and recommendation as to whether the disciplinary committee should proceed with the matter. 68 An investigation report must be prepared even if there is no reasonable basis upon which to find a violation. If this is the case, the matter may be dismissed or terminated or the staff may recommend that a warning letter be issued. 69

63 [1977-80 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 20,668, at 22,717-24. The following is a list of rules of several of the active commodity exchanges which relate to investigations and the staff authority to conduct them: CHICAGO BOARD OF TRADE RULE 170.01 (1981), CHICAGO MERCANTILE EXCHANGE RULE 401 (1979), COMMODITY EXCHANGE, INC. NEW RULES 8.21 (1981), KANSAS CITY BOARD OF TRADE RULE 1400.00 (1981), MINNEAPOLIS GRAIN EXCHANGE RULE 803 (1979), NEW YORK COTTON EXCHANGE RULE 10.04 (1981), NEW YORK FUTURES EXCHANGE RULE 503 (1980), NEW YORK MERCANTILE EXCHANGE RULE 59.04 (1980).

64 17 C.F.R. § 8.06(b) (1982).

65 [1977-80 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 20,668, at 22,726.


68 Id. § 8.07(a).

69 Id. § 8.07(b).
The warning letter in this instance is an interesting device. It may be issued by the staff if the exchange's rules so permit. It is hoped to have the effect of deterring future violations and may be used in situations where a strong suspicion of a rule violation exists but where the staff lacks the evidence to prove a violation.\(^7\) 0

The CFTC stated in its comments that an investigation report will serve two purposes. First, it "will provide the disciplinary committee with basis upon which to decide whether to issue charges of a violation. Second, it will serve as a record of the investigation and resultant conclusions by the enforcement staff which may be examined by the Commission during its periodic inspections of the exchange's rule enforcement procedures."\(^7\) 1 It is apparent from this and other Commission statements that a great deal of what is required of exchanges is done to expedite the CFTC's oversight obligations and capabilities.

Regulation section 8.08, entitled Disciplinary Committee, states that exchanges shall establish one or more disciplinary committees to determine whether violations have been committed, to accept offers of settlement and to set penalties upon a determination of guilt.\(^7\) 2 In a bifurcated committee plan the first committee may be loosely analogized to a grand jury in that the committee acts as an accusatory body. The second committee may be seen as a petit jury hearing the merits of the case and determining guilt or innocence.\(^7\) 3

The CFTC prohibits any enforcement staff member from serving on a disciplinary committee.\(^7\) 4 The enforcement staff may have its own counsel to present cases to the committee. The committee itself may have the services of other exchange employees, as counsel or otherwise, who may assist or advise the committee in matters of procedure or logistics, but will not have any part whatsoever in any deliberative proceeding. As a practical matter, it is useful for an exchange to provide a committee with counsel to advise it of its obligations. This should protect the rights of any participant in a disciplinary matter by preventing a committee from trampling an individual's due process and fair dealing guarantees. This

\(^{70}\) Id. § 8.07(c).

\(^{71}\) [1977-80 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 20,668, at 22,727.

\(^{72}\) 17 C.F.R. § 8.08 (1982).

\(^{73}\) Most commodity exchanges have organized their disciplinary committees into a bifurcated structure. See, e.g., CHICAGO BOARD OF TRADE RULES 540(A) and 542 (1981), COMMODITY EXCHANGE, INC. NEW RULES 8.22 and 8.24 (1980), MIDAMERICA COMMODITY EXCHANGE RULES 706 and 707 (1978), MINNEAPOLIS GRAIN EXCHANGE RULE 804 (1979), NEW YORK COFFEE, SUGAR & COCOA EXCHANGE RULES 515 and 518 (1980), NEW YORK COTTON EXCHANGE RULE 10.05 (1981), and NEW YORK MERCANTILE EXCHANGE RULE 59.05 (1980). Some commodity exchanges operate with a single disciplinary committee with combined functions. See, e.g., NEW YORK EXCHANGE RULES 502 and 508 (1980).

\(^{74}\) [1977-80 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 20,668, at 22,728.
is an internal policy decision for each exchange to make based upon its own needs.

Regulation section 8.09, entitled Review of Investigation Report,\(^{75}\) sets forth what actions a disciplinary committee should take in regard to the report submitted to it. First, the committee must make a prompt review of the report. Such a review will guarantee a prompt disposition of the matter and will protect the rights of the respondent by not subjecting him to a needless delay. It is basic to due process that a prompt hearing be afforded a respondent.\(^ {76}\) Contract markets would be well advised to attempt to handle their disciplinary cases in a timely manner. Respondents would, on the other hand, be well advised to note that the lack of a speedy hearing is a sound due process defense.

A review of the investigation report may result in one of three dispositions. First, the committee may send the matter back to the enforcement staff with directions to investigate further. Second, the investigation report is acceptable for review, and if the committee determines that "no reasonable basis exists for finding a violation or that prosecution is otherwise unwarranted, it may direct that no action be taken."\(^{77}\) This may be done even if it is contrary to the recommendation of the enforcement staff. Third, upon review the committee may find "that a reasonable basis exists for finding a violation which should be adjudicated."\(^ {78}\) If this is the case the committee must direct that the person to be charged be served with a written notice of charges. A formal, written notice of charges is a fundamental element of the regulatory process and is basic to the protection of the respondent's right to a fair adjudication. It is an element of due process that the accused have notice of the charge against him,\(^ {79}\) and only then may he properly defend himself. The committee may determine that the investigation report warrants charges even though the enforcement staff has recommended against such action. The integrity of the accusatory body is preserved by permitting it the independence to act contrary to any staff recommendation. This frees the committee from defense charges that it was improperly and unduly influenced by the exchange staff. The entire disciplinary process benefits from this independence.

Regulation 8.10, entitled Predetermined Penalties,\(^ {80}\) provides that an exchange may set forth specific maximum penalties for particular violations. The CFTC points out that predetermined penalties are designed to expedite the self-regulatory process and it is entirely within the discretion of the exchange to establish appropriate penalties.\(^ {81}\)

\(^{75}\) 17 C.F.R. § 8.09 (1982).
\(^{76}\) Id. § 8.09(b).
\(^{77}\) Id. § 8.09(a).
\(^{78}\) Id. § 8.09(b).
\(^{79}\) Id.
\(^{80}\) Id. § 8.10.
\(^{81}\) [1977-80 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 20,668, at 22,729.
Regulation section 8.11 is entitled Notice of Charges. The CFTC states that "it is a fundamental right of a respondent to know which rules he is charged with violating." The regulation states that the notice of charges is to:

(a) State the acts, practices, or conduct in which the person is alleged to have engaged;
(b) State the rule alleged to have been violated (or about to be violated);
(c) State the predetermined penalty, if any;
(d) Prescribe the period within which a hearing on the charges may be requested;
(e) Advise the person charged that:
   (1) He is entitled, upon request, to a hearing on the charges;
   (2) If the rules of the exchange so provide, failure to request a hearing within the period prescribed in the notice, except for good cause, shall be deemed a waiver of the right to a hearing; and
   (3) If the rules of the exchange so provide, failure in an answer to deny expressly a charge shall be deemed to be an admission of such charge.

During the public comment process regarding charges, the CFTC stated that an objection to specific charges was made by an exchange which noted that a respondent was sometimes charged with conduct detrimental to the best interests of the exchange or conduct which was inconsistent with just and equitable principles of trade. The CFTC responded that an exchange may enforce general standards of professional conduct and practices. The use of this type of charge was challenged in Crimmins v. American Stock Exchange, Inc.

In this case, the American Stock Exchange (Amex) brought a disciplinary action against Crimmins, a registered representative, for conduct inconsistent with just and equitable principles of trade and for conduct detrimental to the interest and welfare of the Amex. The charges related to Crimmins' activities in the sale of stock in Four Seasons Nursing Homes. They concerned an alleged conflict of interest between Crimmins and his customers due to his relationship with the principals of Four Seasons. The charges also alleged that Crimmins made a material misstatement as to his relationship with Four Seasons and engaged in off the board transactions in a listed security that were against Amex rules. Crimmins v. American Stock Exchange, Inc.
mins, in his action to overturn the Amex disciplinary proceeding, claimed he had received inadequate notice of the charges against him, that an unconstitutionally vague standard had been applied in judging his actions and the penalty which suspended him from the securities industry was a deprivation of property without due process. The court found the charges to be more than sufficiently clear and detailed to permit an effective defense. It found that the Amex Report of Investigation discussed the conduct upon which Crimmins was charged and gave a clear, detailed description of the charges. The court also found that he had not been deprived of a property right without due process and stated that throughout the disciplinary process he had been represented by counsel and had the right to subpoena evidence to be used in his defense. As to the defense of vagueness of the charges the court held, in a part of the decision that may be of the most interest in an analogy to regulation section 8.11, that as "an experienced registered representative plaintiff may be fairly charged with knowledge of ethical standards of his profession . . . ."87

Thus, while the CFTC states that exchanges which desire to enforce professional standards should adopt rules setting those standards,88 in view of Crimmins, such action may not be necessary. Arguably, it should be found that a commodities broker or trader will be held to the same knowledge of this profession's standards as Crimmins was held to in the securities industry. The CFTC has taken this matter further with the enactment of regulation section 155.2 which calls for contract markets to establish standards of conduct in regard to certain trading practices.89

87 Id. at 277.
88 17 C.F.R. § 155.2 (1982). Regulation 155.2 states that a contract market shall adopt rules to:

(a) Prohibit such member from purchasing any commodity for future delivery or any commodity option for his own account, or for any account in which he has an interest, while holding an order of another person for the purchase of the same commodity or commodity option which is executable at the market price or at the price at which such purchase can be made for the member's own account or any account in which he has an interest.

(b) Prohibit such member from selling any commodity for future delivery or any commodity option for his own account, or for any account in which he has an interest, while holding an order of another person for the sale of the same commodity or commodity option which is executable at the market price or at the price at which such sale can be made for the member's own account or any account in which he has an interest.

(c) Prohibit such member from executing any transaction for any account of another person for which buying and/or selling orders can be placed or originated, or for which transactions can be executed, by such member without the prior specific consent of the account owner, regardless of whether the general authorization for such orders or tran-
Regulation section 8.12, entitled Right to Representation, is concerned with the right to counsel. Regulation section 8.12 states that upon being served with a notice of charges the respondent has the right to be represented by counsel or any other representative of his choosing. This section specifically omits counsel at the investigatory stages. The CFTC transactions is pursuant to a written agreement, except that orders for such an account may be placed with another member for execution.

(d) Prohibit such member from disclosing at any time that he is holding an order of another person or from divulging any order revealed to him by reason of his relationship to such other person, except pursuant to paragraph (c) of this section or at the request of an authorized representative of the Commission or the contract market.

(e) Prohibit such member from taking, directly or indirectly, the other side of any order of another person revealed to him by reason of his relationship to such other person, except with such other person's prior consent and in conformity with contract market rules approved by the Commission.

(f) Prohibit such member from making any purchase or sale which has been directly or indirectly prearranged.

(g) Prohibit such member from allocating trades among accounts except in accordance with rules of the contract market which have been approved by the Commission.

(h) Prohibit such member from withholding or withdrawing from the market any order or part of an order of another person for the convenience of another member.

(i) Require that every execution of a transaction on the floor by such member be confirmed promptly with the opposite floor broker or floor trader; such confirmation shall identify price, quantity, future and respective clearing members. In the event a contract market cannot require prompt identification of respective clearing members without seriously disrupting the functions of its marketplace, the contract market may petition the Commission for exemption from this requirement. Such petition shall include:

(1) An explanation of why the contract market cannot require the prompt identification of respective clearing members without seriously disrupting the functions of its marketplace, and

(2) A proposed contract market 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.

The Commission may, in its discretion and upon such terms and conditions as it deems appropriate, grant such petition for exemption upon finding that the functions of the contract market may be seriously disrupted by requiring the prompt identification of respective clearing members and that the contract market appears to have adequately insured that every trade executed thereon can be effectively matched and will be accepted by a clearing member for clearance or will be otherwise sufficiently guaranteed.

Id.

90 Id. § 8.12.

91 Id.
remarked in the comments accompanying this regulation that there was some merit in not providing a right to counsel during the investigatory process because such representation could impede the progress of an investigation and result in more protracted and costlier proceedings.\textsuperscript{2}

This position is not the best possible reasoning. It could put an individual's livelihood and exchange membership in jeopardy and deny him an effective defense of that property right. The CFTC fails to note that many of the exchanges provide in their rules that a member must cooperate with any investigation through giving oral testimony or documentary evidence upon the request of the exchange.\textsuperscript{3} It is a condition of membership that a person agree to abide by the rules of the exchange, which call for cooperation in an investigation. Failure to cooperate is a separate chargeable offense and will subject an exchange member to punitive action. Surely the members' obligation to cooperate should be enough to move an investigation forward. A better course for the CFTC to have taken would have been that which was originally proposed: representation by counsel at every stage of the disciplinary proceeding. The CFTC did state that this regulation did not preclude an exchange from providing a right to counsel at every stage of the disciplinary process.\textsuperscript{4} This particular comment is noteworthy for its lack of forcefulness as compared to other CFTC comments.

A question may be raised as to why the right to counsel had to be specified at all. A plausible explanation may be that the futures trading industry has a long history of effective self-regulation with little or no governmental oversight.\textsuperscript{5} The industry has been accustomed to its own methods, however peculiar they may appear to a prosecutor or defense counsel. For example, the Chicago Board of Trade once had a rule which stated that in hearings or investigations no person was entitled to representation by professional counsel. With this type of rule in the industry's self-regulatory history it is understandable why an express regulation granting the right to representation by counsel was adopted. Regulation section 8.13, entitled Answer to Charges,\textsuperscript{6} provides that a respondent be given a reasonable period of time to file an answer to the charges. It does not make an answer mandatory but does permit an exchange to enact rules which establish procedures regarding a failure to answer or to deny a specific charge. Exchanges are permitted to enact

\textsuperscript{5} Chicago Board of Trade Manual, 1, 15 (1980).
\textsuperscript{6} Chicago Board of Trade Rule 160 (1969).
\textsuperscript{6} 17 C.F.R. § 8.13 (1982).
rules which, in effect, state that a failure to answer will be deemed an admission of the facts alleged. The regulation also requires that the answer be in writing and "include a statement that the respondent admits, denies or does not have and is unable to obtain sufficient information to admit or deny each allegation. A statement of a lack of sufficient information shall have the effect of a denial of an allegation." The regulation further states that a failure to file a timely answer is to be deemed an admission of all charges in the complaint and, if an answer is made which fails to deny a charge, such failure is deemed an admission of that charge. Thus, to protect the rights of a respondent, the best course is to make some answer to the charge. In some instances a general denial will be appropriate. It must be noted here that sections 8.13(a), (b) and (c) are prefaced by the phrase, "the rules of an exchange may provide that . . . ." Therefore, it would be well to note each particular contract market's rule concerning answers.

Regulation section 8.14, entitled Admission or Failure to Deny Charges, is concerned with the effect an admission or a failure to deny has on the respondent in a disciplinary proceeding. The regulation provides that exchange rules may state that if a respondent admits or fails to deny charges against him, the disciplinary committee may find that the rules which the complaint alleged to have been violated have in fact been violated and may impose a penalty for each violation. Regulation sections 8.13 and 8.14 taken together form the basis of any default procedure an exchange may institute.

Section 8.14 provides that where a default is taken the contract market must notify the respondent promptly in writing of any action taken against him and advise him that he may request a hearing on the penalty. This hearing is not a matter of right. Section 8.14(b) states that "except for good cause shown no hearing shall be permitted on a penalty imposed." The default procedure provides that if a respondent fails to request a hearing on the penalty within a reasonable time, he is deemed to have accepted the penalty. In each instance a respondent must determine

---

98 Id. § 8.13(a).
99 Id. § 8.13(b).
100 Id. § 8.13(c).
101 Id. § 8.13.
104 Id. § 8.14(b).
105 Id.
106 Id. § 8.14(c).
whether defaulting on the merits and attempting to challenge a penalty is a better strategy than standing up to a hearing on the merits. Counsel of respondent would be well advised to check the time constraints of each contract market as they regard as answer to charges, as they do differ.

Regulation section 8.15, entitled Denial of Charges and Right to Hearing,107 sets forth a most basic aspect of due process, that of a hearing on the merits. The charges to be heard may be all the charges or just those denied in the respondent's answer. Discretion is granted the exchange in enacting rules to determine which charges will be heard. This section also provides for a hearing on the penalty. Regulation section 8.15 will be discussed further in conjunction with regulation section 8.17.108

In the interim is regulation section 8.16, entitled Settlement Offer,109 which was commented on extensively by the CFTC in its remarks upon the adoption of Part 8. Regulation section 8.16 permits an exchange to enact a rule allowing a respondent to submit a written offer of settlement.110 This may be submitted at any time after the investigation staff report is completed. The exchange may provide that respondent in his offer of settlement accept a penalty without admitting or denying the charges against him. The offer of settlement is an effective device for successfully terminating disciplinary actions with a considerable saving of time and costs to all parties. Regulation section 8.16 states that a written decision accepting the offer of settlement must be made and shall specify rule violations, any penalties imposed and whether the respondent is admitting or denying the charges.111 The regulation further stipulates that if the offer is withdrawn or rejected, it is not to be construed as an admission against the respondent.112 In addition, the regulation states that the respondent shall not in any way be prejudiced if an offer he submits is withdrawn or rejected.113 This permits a respondent to negotiate an offer with the knowledge that he may still defend himself to the fullest extent if the offer is rejected.

On the issue of penalties, the CFTC commentary noted the removal from the proposed regulation of the requirement that any penalty imposed be sufficient to deter future violations. However, the Commission did state that an inadequate penalty would not be appropriate. The CFTC also stated that in agreeing to the penalty provided in the settlement offer the disciplinary committee must consider the same factors that it would use in setting a penalty after a hearing.114 There is no direction as to what

---

107 Id. § 8.15.
108 Id. § 8.17.
109 Id. § 8.16.
110 Id.
111 Id.
112 Id. § 8.16(d).
113 Id.
an appropriate penalty would be, nor is there any direction as to what factors are to be considered prior to accepting a settlement. The CFTC removal of the deterrent requirement appears to be merely cosmetic. Any appropriate penalty should have a deterrent effect, no matter how unstated such effect is by the CFTC.

It is important to note that even though an offer of settlement is made which neither admits nor denies guilt, the acceptance of such an offer does constitute a penalty, just as any action taken after a hearing which finds guilt would also be a penalty. The simple difference is that there is no finding of guilt or liability in an acceptance of an offer of settlement. The importance of an accepted offer as a penalty is in the area of registration with the Commission and with membership applications to other exchanges. In both there is the requirement that the individual state if he has ever been penalized by an exchange or by the CFTC or another self-regulatory organization. This simple fact may work a deterrent effect on floor brokers or traders. It may also be one reason why an individual will go to a hearing to attempt to exonerate himself completely rather than take the easy way out by offering to accept a penalty to settle the case. Of course the decision of hearing or offer of settlement should be made based upon the strength of the evidence presented against the respondent and the validity of his defense.

As previously noted, regulation section 8.17 deals specifically with hearings. This regulation is concerned with providing a fair hearing, a basic element of due process. It states that "the hearing shall be fair and shall be conducted before members of the disciplinary committee." In order to assure an unbiased hearing panel, the regulation states that "no member of the disciplinary committee may serve on the committee or panel if he or any person or firm with which he is affiliated has a financial, personal, or other direct interest in the matter under consideration." The question of indirect interest must arise as a consequence of the use of the word "direct." It must be determined at what point an indirect interest becomes "direct."

The CFTC's commentary does not refer to any indirect interest and merely states that the term "direct interest" took the place of the word "disinterested" in the proposed rules. Theoretically, on a panel of exchange members all would be interested in the case, if only as it reflects upon the exchange as an entity, an entity in which they have a proprietary interest. More specifically, indirect interest questions may have to do with any common type of business done by the respondent and a member of

117 Id. § 8.17(a)(1).
118 Id.
119 Id.
the panel, any business actually transacted between the respondent and a panel member apart from the transaction in question, and any prior relationship between a panel member and the respondent. A strong indirect interest would appear to be reasonable grounds upon which a respondent could move for the panel member in question to disqualify himself, or, failing to obtain a disqualification, for an appeal.

A simple fact should be noted here: exchanges are small communities. It is in their nature that members know each other and do business with each other. There is nearly no chance of getting a panel where the members do not know the respondent at all. Perhaps by this regulation, and by its commentary, the CFTC in its use of the term "indirect interest" has taken note of the closeness of exchange communities and of what may be an impossible task, that of being thoroughly disinterested.

The due process requirement of a fair hearing is advanced by regulation section 8.17(a)(2), which is concerned with the respondent's discovery rights. It states that:

The respondent shall be entitled in advance of the hearing to examine all books, documents, or other tangible evidence in the possession or under the control of the exchange which are to be relied upon by the enforcement staff in presenting the charges contained in the notice of charges or which are relevant to these charges. 121

It should be noted that this does not provide a respondent with a right to depose a member of the enforcement staff prior to a hearing even if the case is based upon a personal observation, but it does make any relevant notes, papers or recommendation of the enforcement staff subject to discovery.

In regard to the possible use of interrogatories, the CFTC commented that it did not believe their use necessary for a fair proceeding. The Commission stated that "a respondent is adequately protected if he is entitled to discover from the exchange all books, documents, or other tangible evidence which are relevant to his case." 122 Given the nature of exchange investigations, the type of violations pursued, and the excellent record or audit trail which is required by regulation 1.35, 123 this position by the Commission is accurate. It does not result in a diminution of a respondent's right to due process. Regulation section 8.17(a)(3) further advances due process rights by providing that a hearing shall be held promptly after reasonable notice to the respondent. 124 Regulation section 8.17(a)(4)

123 17 C.F.R. § 1.35 (1982).
124 Id. § 8.17(a)(3). See the following for the notice afforded respondents under the rules of the various exchanges. CHICAGO BOARD OF TRADE RULE 540.02 (1981), COMMODITY EXCHANGE, INC. RULE 8.27 OF THE NEW RULES OF COMEX (1980), MIDAMERICA COMMODITY EXCHANGE RULE 708 (1978), and NEW YORK FUTURES EXCHANGE RULE 510 (1978).
states that formal rules of evidence need not apply but cautions that evidentiary procedures are not to be so informal as to deny a fair hearing.\textsuperscript{125} This regulation takes note of the fact that exchange disciplinary proceedings are not held before lawyers in most instances. These panels are most likely not schooled in the rules of evidence.

Regulation section 8.17(a)(5) provides that the enforcement staff of the exchange shall present the case on the charges.\textsuperscript{126} The enforcement staff is therefore the investigator and the prosecutor.

Regulation section 8.17(a)(6)\textsuperscript{127} and (7)\textsuperscript{128} state, respectively, that the respondent is entitled to appear personally at the hearing and shall be entitled to cross examine any persons appearing as witnesses for the exchange. A respondent may call witnesses to testify in his behalf as provided by regulation section 8.17(a)(8)\textsuperscript{129} These three subsections taken together give strength to the basic protections of due process in an exchange disciplinary proceeding.

Regulation section 8.17(a)(9) empowers exchanges to "require persons within its jurisdiction who are called on as witnesses to appear at the hearing and to produce evidence. It shall make reasonable efforts to secure the presence of all persons called as witnesses whose testimony would be relevant."\textsuperscript{130} The Commission, in its commentary, stated that this provision assures that a respondent will be able to call witnesses whose testimony is material to his defense, and conversely enables the enforcement staff, which lacks other than exchange subpoena power, to call hostile witnesses who might otherwise be unwilling to testify.\textsuperscript{131}

While this comment is admirable in what it hopes to accomplish, it is, at the same time, somewhat unrealistic. The Commission fails to inform an exchange how it is to get someone outside of its jurisdiction to appear, be sworn, give testimony, and be subject to the unpleasant experience of cross examination.

In addition, what constitutes a reasonable effort to secure witnesses not subject to exchange jurisdiction? There is no hint as to what methods are reasonable. Having embarked on such a regulation, it would have been more appropriate to have given some guidance rather than a simple pronouncement. Instead, the Commission goes on to comment on the type and costs of a record of the hearing, leaving the question of witnesses outside exchange jurisdiction unanswered. Fortunately, the realities of exchange disciplinary proceedings are such that they usually involve persons who are either members of the exchange or employees of such

\textsuperscript{125} 17 C.F.R. § 8.17(a)(4) (1982).
\textsuperscript{126} Id. § 8.17(a)(5).
\textsuperscript{127} Id. § 8.17(a)(6).
\textsuperscript{128} Id. § 8.17(a)(7).
\textsuperscript{129} Id. § 8.17(a)(8).
\textsuperscript{130} Id. § 8.17(a)(9).
\textsuperscript{131} [1977-80 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 20,668, at 22,733.
members who are subject to jurisdiction through the employer-employee relationship.

Regulation section 8.17(b) provides that an exchange may establish summary penalties to be imposed upon a person who fails to appear at a hearing after proper notice or who, upon appearing, engages in conduct which disrupts the proceeding. It is possible that contumacious testimony may be included in this disruptive conduct.

Following the hearing, a decision must be rendered based upon the evidence which was introduced at the hearing. Regulation section 8.18 sets forth what the decision shall include. It must be in writing and include a notice of the charges or a summary thereof and contain the respondent's answer and a summary of the evidence produced at the hearing. The decision must also include a statement of the findings of the hearing panel pertaining to each charge and refer to each rule found to have been violated. Finally, the decision must state the penalty, if any, and its effective date.

The Commission commented that a written decision serves two functions. First, it advises the respondent of the determination of the disciplinary panel. Second, it provides a record for the Commission to review pursuant to its oversight of exchange rule enforcement programs.

The Commission stated that for these purposes it was essential that the decision be based upon the evidence introduced and include the reasons for the decision. Decisions should not be made just to expedite the CFTC's oversight activities but rather to inform a respondent why a finding has been made in such a manner to enable the respondent to make an informed determination whether he should accept the decision or appeal it to a higher panel at the exchange or petition the CFTC for review. This should be an integral part of due process in any disciplinary proceeding. It appears that the CFTC has given weight to the respondent's right to due process and to a means of facilitating its oversight obligation.

A respondent has a right to appeal a decision. Regulation section 8.19 permits an exchange to establish an appeal procedure. This procedure must provide for a review board to hear appeals brought by respondents and to review decisions on the board's initiative. As in the case of the hearing panel, provision has been made to exclude any person from the appeals panel who had any direct interest in the proceeding. In addition, no person involved in the case at any prior stage may hear an appeal. As committee memberships in contract markets are changed

132 17 C.F.R. § 8.17(b) (1982).
133 Id. § 8.18.
134 Id. § 8.18(a)-(e).
137 Id. § 8.19(b).
138 Id.
on a regular basis it is useful to determine, prior to processing an appeal, who has been named to sit on the appeal panel. A knowledge of the workings of the investigation and enforcement staff's operations, together with such knowledge of the accusatory panel and the hearing panel's operations and membership, is necessary to challenge successfully any panel member's attendance on the appeal board. The appeal must consist of a review of the hearing record together with written briefs submitted by the parties and oral or written arguments. Thus, the appeals panel cannot consider new evidence; instead, it is limited to the record evidence produced at the hearing.

Following the hearing on the appeal, the board must issue a written decision. It is inherent in a respondent's right to due process that he be aware of the grounds for the decision and therefore, the decision is to "include a statement of the findings and conclusions with respect to each charge or penalty reviewed, including the specific rules which the respondent was found to have violated by the disciplinary committee, and a declaration of any penalty imposed and the effective date of such penalty."

To summarize Part 8, it is appropriate to state that due process is present in all of its various sections. Throughout the regulations, the CFTC was concerned with fundamental fairness which comprises due process. The regulations have provided for notice to be given, a right to representation by counsel, an efficient evidentiary and adversarial procedure where a respondent may confront and cross examine his accusers, and an impartial deliberative and appeals process. Since contract markets must meet the requirements of Part 8 it is expected that, with subtle variations, all contract markets will afford their members due process in disciplinary proceedings.

VI. CONCLUSION

On May 3, 1982, the Supreme Court decided *Curran v. Merrill Lynch, Pierce, Fenner & Smith, Inc.* The Court answered the question of whether there was a private right of action for violations of the Commodity Exchange Act by holding that there was an implied right of action. In *Curran*, the CFTC had argued that a private right of action strengthens the enforcement and regulatory mechanisms already in place. The Court apparently found this to be a persuasive argument. Whether a private right of action will have the desired effect remains to be seen.

129 Id.
130 Id. § 8.19(c).
142 456 U.S. at 382-88.
143 Id. at 387.
In the 1982 reauthorization of the CFTC, Congress amended the CEA to specifically include a private right of action. As it pertains to contract markets the new statute provides:

(A) A contract market or clearing organization of a contract market that fails to enforce any bylaw, rule, regulation, or resolution it is required to enforce by section 7a(8) and (9) of this title,

(B) a licensed board of trade that fails to enforce any bylaw, rule, regulation or resolution that it is required to enforce by the Commission, or

(C) any contract market, clearing organization of a contract market, or licensed board of trade that in enforcing any such bylaw, rule, regulation or resolution violates this chapter or any Commission rule, regulation, or order, shall be liable for actual damages sustained by a person who engaged in any transaction on or subject to the rules of such contract market or licensed board of trade to the extent of such person's actual losses that resulted from such transaction and were caused by such failure to enforce or enforcement of such bylaws, rules, regulations, or resolutions. 4

The amendment further provides that:

A person seeking to enforce liability under this section must establish that the contract market, licensed board of trade, clearing organization . . . officer, director, governor, committee member, or employee acted in bad faith in failing to take action or in taking such action as was taken, and that such failure or action caused the loss. 4

It is too early to determine what effect the amendments to the Act will have on contract market self-regulation. In concluding this Article, however, it is appropriate to note that regulation 1.35 among other record-keeping requirements may have provided the source of evidence for private actions under the Act. It may be the realization by a contract market that its own records and the specificity of them, as required by the Act, may serve as the means to a successful lawsuit against it that will be the moving factor in an enhancement of contract market self-regulation.

144 Futures Trading Act of 1982, Pub. L. No. 97-444, 96 Stat. 2294, enacting 7 U.S.C.A. §§ 2a, 12d, 25 and 26, amending 7 U.S.C.A. §§ 4a, 5, 6, 6a, 6c, 6d, 6f-i, 6k, 6m-p, 7a, 8, 9, 12, 12a, 13, 13a-1, 13a-2, 13c, 16a, 18, 20, 21, 23 and 612-3 (West Supp. 1983).


146 Id. § 25(b)(4).

147 17 C.F.R. § 1.35 (1982).