Rein In the CFTC

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A recent enforcement action by the Commodity Futures Trading Commission against MG Refining & Marketing Inc. and MG Futures Inc. renders uncertain the enforceability of an important class of commercial derivatives transactions. Based on the ruling, which held certain MG Refining & Marketing contracts to be "illegal off-exchange futures," losing counterparties on numerous similar contracts—and remember, every derivatives contract must have a loser—may have a choice: pay up and eat the loss, or refuse to pay, claiming their contracts are illegal, too.

In calling attention to the CFTC's July 27 action, our purpose is not to defend or attack MG Refining & Marketing itself. Our concern, rather, is with the egregious overreaching that the ruling represents. The time has come for Congress to rein in an agency seemingly more concerned with establishing turf than with the damage it may be doing to the markets.

A Doomed Quest

Because futures contracts have no specific economic attributes of their own other than exchange trading to distinguish them from ordinary forward contracts or swaps (a forward contract is any contract for the future purchase of a commodity at a fixed price, and a "swap" is merely a package of forwards), the quest for any objective definition of "off-exchange futures" among contracts not already exchange-traded is doomed from the start. An overzealous regulator fishing for "illegal off-exchange futures" thus confronts a virtually unlimited supply of possibilities.

To lawyers, the seeming oxymoron of "off-exchange futures" has legal meaning thanks to the Commodity Exchange Act of 1936. That law, designed in the main to protect exchanges from competition by free-riding "bucket shops," requires all "futures" to trade on an organized and regulat[illegible] exchange. The term "futures contr[illegible] [illegible]eedless to say, is not explicitly defined in statute law. Nevertheless, a determination by the CFTC that a financial contract *is* a "futures contract" immediately renders that contract illegal unless it is traded on a regulated exchange or specifically exempted.

Congress has attempted several times to remedy the inevitable legal uncertainties in the act over what is a "futures contract" by limiting the jurisdiction of the CFTC. Ordinary commercial forward contracts, for example, are specifically excluded from the act. In 1992, Congress also urged the CFTC promptly to exempt certain off-exchange transactions, including some swaps, from most regulation under the act. The agency did so in 1993.

The action against MG Refining & Marketing by the CFTC ruled some of the firm's privately negotiated oil derivatives contracts—called "firm-flexible" contracts—illegal futures. In support of its position, the CFTC argued that those commercial marketing contracts met "all the essential elements of a futures contract." In almost total disregard of its previous rulings and statements, the CFTC defines a future as any financial contract that: (1) calls for future delivery at a price or formula set at the contract's inception, (2) can be satisfied either by physical delivery or an offsetting transaction, and (3) is used either to speculate or hedge rather than to take delivery.

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The CFTC's extremely broad definition of "all the essential elements" of futures inevitably calls into question the legality of numerous financial transactions. After all, every derivatives contract contains some reference price or formula. Because the terms of many derivatives allow some form of cash settlement, they may also meet the second part of the test. And if derivatives are *not* used either to speculate or hedge, what are they used for?

Exclusions and exemptions from the act may ensure the continued legality of some existing products. But the applicability of such exemptions—covering certain forward, swap, hybrid, energy and trade option contracts—was not analyzed by the CFTC in its written ruling, suggesting that it may be signaling its intention to narrow some exemptions.

For other products not clearly covered by an exemption, of course, the consequences of the MG Refining & Marketing settlement may be even worse. Swaps on equities and certain swaps on securities, for example, are not covered by the swaps exemption and hence are not protected from the CFTC's new three-point acid test. MG Refining & Marketing's firm-flexible contracts, moreover, are essentially the same as many other agreements commonly negotiated by oil and gas companies, sometimes called "take-or-pay" contracts. Are these, too, now illegal?

The CFTC denies that the settlement sets any sweeping precedents for the regulation and legality of swaps—what else would you expect it to say?—but "in-the-money" counterparties everywhere are, and should be, worried that some losers will now refuse to pay up. The CFTC's repeated public denials of wider applicability, after all, carry no probative weight when a private lawsuit is filed on the basis of a ruling already on the record for all to see (and cite).

In the settlement, the CFTC also raised its micromanagement of "futures commission merchants" to a new level. The CFTC required MG Futures, a futures commission merchant, to submit its risk management systems to review by a new "Special Oversight Committee" comprising company representatives. In defining that committee's responsibilities, the CFTC spelled out in some detail what might constitute an "adequate" risk management process for a futures commission merchant, including the obligations for keeping its parent informed. Despite the CFTC's pious pronouncements, few would regard this agency sufficiently qualified to pass such specific risk management judgments.

Muscling In

Nor are futures commission merchants the only companies on which the CFTC has set its micromanagement sights. The MG Refining & Marketing settlement follows the Bankers Trust settlement last fall, in which the CFTC used Bankers Trust's presumed status as a "commodity trading adviser" to get its regulatory foot in the company's door. As in the MG Refining & Marketing case, once inside, the CFTC applied its regulatory muscle to Bankers Trust's other internal management activities as well. More important, by relying in both cases on its police authority, the CFTC establishes what are, in effect, industry standards, while circumventing the usual regulatory safeguard in which comments from the public, other agencies and Congress are solicited before rules are promulgated.

Last November, Americans elected a Congress that promised to rein in regulatory agencies whose actions far exceed their public mandates. The MG Refining & Marketing ruling and the uncertainties it has caused clearly put the CFTC in this category. Congress must limit even further the jurisdiction of the CFTC before this bull in the china shop does irreparable damage to our financial markets and their participants.

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