

ADMINISTRATIVE ENFORCEMENT OF THE FEDERAL COMMODITIES LAWS BY THE COMMODITY FUTURES TRADING COMMISSION

Michael S. Sackheim *

I. INTRODUCTION

On October 23, 1974, the Ninety-Third Congress enacted the Commodity Futures Trading Commission Act of 1974¹ which greatly amended the 1936 Commodity Exchange Act² and hence revolutionized the regulation of commodities trading in the United States. In 1978, Congress further amended the federal commodities laws by enacting the Futures Trading Act of 1978.³ The most significant aspect of these developments was the creation of the Commodity Futures Trading Commission (hereinafter referred to as the Commission or the CFTC),⁴ an independent federal regulatory agency modeled in the image of the Securities and Exchange Commission (SEC).

* Assistant Professor of Law, The Delaware Law School of Widener University. B.A., 1969, Queens College; M.A., 1972, New School for Social Research; J.D., 1974, Brooklyn Law School; LL.M., 1979, New York University. Professor Sackheim is a member of the American Bar Association's Subcommittee to Study the Structure and Function of the Commodities Futures Trading Commission.

¹ Pub. L. No. 93-463, 88 Stat. 1389, 93rd Cong., 2d Sess. (1974) (codified in various sections of 7 U.S.C.). For an excellent discussion of the legislative background surrounding the passage of the Commodity Futures Trading Commission Act of 1974, see Johnson, *The Commodity Futures Trading Commission Act: Preemption as Public Policy*, 29 VAND. L. REV. 1, 1-20 (1976). See generally Rainbolt, *Regulating the Grain Gambler and His Successor*, 6 HOFSTRA L. REV. 1 (1977).

² 7 U.S.C. §§ 1-22 (1976). The Commodity Exchange Act amended the Grain Futures Act of 1922, ch. 369, 42 Stat. 998, 67th Cong., 2d Sess. (current version at 7 U.S.C. §§ 1-22 (1976)).

The Commodity Exchange Act was limited in its coverage due to a narrow definition of the term commodity. 7 U.S.C. § 2 (1976). With expanding futures markets, products falling outside of the strict statutory definition of a commodity were being traded free from regulatory coverage. Moreover, fluctuating economies of food production and sale gave rise to a belief that regulation of commodity futures could stabilize distribution and prices. Johnson, *supra*, note 1, at 3-4.

³ Pub. L. No 95-405, 92 Stat. 865, 95th Cong., 2d Sess. (1978) (codified in various sections of 7 U.S.C.). The 1974 Act and 1978 amendments will collectively be referred to as the Act. For a good general discussion of the 1978 legislation, see Schneider & Santo, *Commodity Futures Trading Commission: A Review of the 1978 Legislation*, 34 BUS. LAW. 1755 (1979).

⁴ See 7 U.S.C. § 4a(a) (1976). The Commodity Futures Trading Commission Act of 1974 contained a "sunset" provision whereby CFTC funding was only authorized for the period through fiscal 1978. One amendment contained in the Futures Trading Act of 1978 extended authorized funding through September 30, 1982. See 7 U.S.C. § 16(d) (Supp. II 1978); Young, *A Test of Federal Sunset: Congressional Reauthorization of the Commodity Futures Trading Commission*, 27 EMORY L.J. 853 (1978).

The CFTC was mandated by Congress to administer and enforce the commodities laws in order to improve the regulation of commodity futures trading⁵ and to protect the investing public and commercial users of the commodities markets from abusive and criminal practices in an industry which has witnessed substantial growth over the last twenty years.⁶

The CFTC has been granted extensive enforcement jurisdiction to insure that Commission registrants and those whose acts render them subject to the purview of the Act comply with the federal commodities laws.⁷ For violations of the laws within its regulatory jurisdiction, the CFTC is empowered to seek appropriate federal court injunctive relief.⁸ Furthermore, through administrative disciplinary proceedings, the Commission is authorized to suspend or revoke the registration of persons registered with it, to prohibit persons and entities from trading over contract markets, and to impose significant civil monetary penalties for each violation of the law.⁹ The

⁵ A "commodity futures" contract is a standardized contractual obligation to buy or sell a fixed amount and grade of a certain commodity to be delivered by a designated date in the future. See generally TEWELES, HARLOW & STONE, *THE COMMODITY FUTURES GAME* 22-24 (1974); Russo & Lyon, *The Exclusive Jurisdiction of the Commodity Futures Trading Commission*, 6 HOFSTRA L. REV. 57-58 n.3 (1977). Commodity futures contracts must be distinguished from physical commodities purchased or sold over cash markets for future delivery. Section 2(a)(1) of the Act, 7 U.S.C. § 2 (1976), provides in part that "[t]he term 'future delivery,' as used in this chapter, shall not include any sale of any cash commodity for deferred shipment or delivery." See generally G. HOFFMAN, *FUTURES TRADING UPON ORGANIZED COMMODITY MARKETS IN THE UNITED STATES* 104-10 (1932).

⁶ In the 10 years between 1964 and 1974, the volume of commodity futures trading increased 400 per cent. H.R. REP. NO. 93-975, 93rd Cong., 2d Sess. 156 (1974). Similarly, futures trading volume grew from 27.7 million contracts in 1974 to 41.5 million contracts for July 1, 1976 through June 30, 1977. Trading value over these same periods witnessed an increased from \$571.6 billion to \$1.1 trillion respectively. See Rainbolt, *supra* note 1, at 2 n.4. In 1980, 82.7 million commodity futures contracts were traded over all domestic commodity exchanges. 1980 CFTC ANN. REP. 87 (1981).

For a discussion of the prevalence of violative and criminal activities in the sale of commodity futures and other commodity transactions, see Johnson, *The First and Fastest Felony: Trading Futures Off the Exchanges*, 35 BUS. LAW. 711 (1980); Comment, *Abuses in the Commodity Markets: Some Suggestions for Control*, 25 SYRACUSE L. REV. 788 (1974); Note, *Abuses in the Commodity Markets: The Need for Change in the Regulatory Structure*, 63 GEO. L.J. 751 (1975); Maidenberg, *When the Commodity Pitchman Calls*, *Hang Up*, N.Y. TIMES, May 22, 1977, § 3, at 3, col. 1.

⁷ Aside from those who are registered with the Commission, individuals involved in the interstate offer or sale of commodity futures contracts also fall within the purview of the commodity laws. See, e.g., 7 U.S.C. §§ 6, 6b, 6c, 13b (1976).

⁸ See, e.g., CFTC v. Muller, 570 F.2d 1296 (5th Cir. 1978); CFTC v. British Am. Commodity Options Corp., 560 F.2d 135 (2d Cir. 1977); CFTC v. U.S. Metals Depository Corp., 468 F. Supp. 1149 (S.D.N.Y. 1979); see section 6c of the Act, 7 U.S.C. § 13a-1 (1976).

⁹ See Sections 6(b) and 6(c) of the Act, 7 U.S.C. § 9, 13b (1976). Section 6(b) provides that in the event the Commission "has reason to believe that any person (other than a contract market)" is violating the Act, it may serve upon such person a complaint containing a notice of hearing "requiring such person to show cause why an order should not be made prohibiting it

CFTC may also refer matters and accumulated evidence to the Department of Justice and recommend the initiation of criminal prosecutions by that department.¹⁰ It is within the context of its own administrative enforcement and disciplinary proceedings, however, that the Commission is able to best articulate its jurisdictional and legislative philosophy¹¹ and to exhibit to the professional community and investing public its ability to police the commodity industry.¹² This article will explore the administrative procedures by which the CFTC investigates and enforces the federal commodities laws and examine the standards which the agency applies in its "in-house" administrative proceedings as well as those which the courts apply in certain enforcement actions.

II. THE ORGANIZATION OF THE CFTC'S ENFORCEMENT TEAM

The CFTC is organized into five branches, four of which play a vital and integral role in the agency's enforcement effort.

The Division of Trading and Markets is responsible for "monitoring exchange surveillance enforcement activities, for screening applicants for registration as industry professionals, and for conducting audits and reviews of the financial condition and practices of regis-

from trading on or subject to the rules of any contract market." *Id.* § 9. Section 6(b) also authorizes the Commission to assess violators of the Act "a civil penalty of not more than \$100,000." *Id.*

Section 6(c) similarly provides that "the Commission may, upon notice and hearing . . . make and enter an order directing" that any violator of the Act "cease and desist" from such action. In the event that the recipient of the cease and desist order fails to comply with such order, that person "shall be guilty of a misdemeanor and, upon conviction thereof, shall be fined not more than \$100,000, or imprisoned for not less than 6 months nor more than one year, or both." *Id.* § 13b.

Orders issued by the Commission pursuant to section 6(b) or 6(c) are appealable to the United States circuit courts of appeal. *See id.* §§ 9, 13b.

¹⁰ The Act imposes substantial criminal penalties for certain violations of the commodities laws. *See* Section 9 of the Act, 7 U.S.C. § 13 (1978).

¹¹ Justice Holmes' declaration in *Prentis v. Atlantic Coast Line Co.*, 211 U.S. 210 (1908), is particularly illustrative of an agency's administrative role as distinguished from a court's judicial functions. In that case he stated that:

A judicial inquiry investigates, declares and enforces liabilities as they stand on present or past facts and under laws supposed already to exist. That is its purpose and end. Legislation on the other hand looks to the future and changes existing conditions by making a new rule to be applied thereafter to all or some part of those subject to its power.

Id. at 226.

¹² *See generally* Schief & Morkham, *The Nation's "Commodity Cops"—Efforts by the Commodity Futures Trading Commission to Enforce the Commodity Exchange Act*, 34 Bus. Law. 19 (1978).

trants.”¹³ Substantial work is conducted in the surveillance of trade practices and in the investigation of contract markets activity. This Division also plays a vital role in the administrative rule-making functions of the agency. Inquiries conducted by the Trading and Markets Division are often conducted with a view toward promulgating new regulations rather than uncovering wrong-doing.

The Division of Economics and Education “monitors the operation of all active futures contract markets each day to head off any developing threats of corners, manipulation, or other market disturbance.”¹⁴ When appropriate, its findings are referred to the CFTC’s Division of Enforcement for appropriate enforcement action.

The Division of Enforcement investigates and prosecutes alleged violations of the federal commodity laws involving commodity futures contracts trading on contract markets and the trading of off-exchange commodity instruments.¹⁵ The Enforcement Division routinely cooperates with state and other federal law enforcement agencies in conducting its inquiries. As previously noted,¹⁶ the CFTC (through the Division of Enforcement) refers matters to, and cooperates with, the Justice Department in cases of alleged criminal violations of the commodity laws and various other related criminal statutes such as those concerning wire and mail fraud¹⁷ and conspiracy. Consequently, the Enforcement Division often assigns personnel to assist the Justice Department in related criminal investigations and prosecutions.¹⁸

The Enforcement Division has the primary investigative authority within the CFTC,¹⁹ and the Director of the Enforcement Division must “report to the Commission the results of his investigations and recommend to the Commission such enforcement action as he deems

¹³ 1980 CFTC ANN REP 116(1981)

¹⁴ *Id.*

¹⁵ *Id.* at 92. All domestically traded commodity futures contracts must be transacted over regulated commodity futures exchanges which are designated by the CFTC as “contract markets” pursuant to section 5 of the Act, 7 U.S.C. § 7 (1976). Section 4 of the Act, 7 U.S.C. § 6h (1976), prohibits interstate commodity futures transactions “executed or consummated otherwise than by or through a member of contract market.” See *In re Stovall Co.*, [1977-1980 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 20,941 (Dec. 6, 1979).

¹⁶ See text accompanying note 10 *supra*.

¹⁷ In *United States v. Brien*, 617 F.2d 299 (1st Cir. 1980), it was held that the exclusive jurisdiction given the CFTC by virtue of section 2(a)(1) of the Act, 7 U.S.C. § 2 (1976), does not preempt the Justice Department from prosecuting commodity law violators for mail fraud. 617 F.2d at 309-11.

¹⁸ See e.g., *In re Perlin*, 589 F.2d 260, 267-69 (7th Cir. 1978) (not inappropriate for CFTC attorney to serve as Special Assistant U.S. Attorney and appear before grand jury in criminal-commodity matter); see section 12 of the Act, 7 U.S.C. § 16 (1976).

¹⁹ See 17 C.F.R. § 11.2 (1981).

appropriate.”²⁰ The Enforcement Division is staffed with investigators comprised of futures trading specialists and investigative and trial attorneys. Its staff is located in New York, Chicago, San Francisco and Washington, D.C., with all investigations and civil prosecutions ultimately supervised by the Division’s Washington, D.C. administrative personnel.

The CFTC’s Office of General Counsel reviews CFTC staff requests for enforcement action and represents the CFTC before the United States courts of appeal and Supreme Court. The General Counsel’s Office also defends the Commission and its staff in suits brought to challenge Commission investigative or enforcement activities and is responsible for filing *amicus curiae* briefs in actions involving CFTC enforcement and investigative activities.²¹

Through close intra and inter-agency cooperation, the CFTC enforces the federal commodity laws with the goal of protecting the investing public from fraud and deceit.

III. COMMISSION INVESTIGATIONS

As a relatively new regulatory agency, the CFTC has initiated numerous formal investigations and informal inquiries, and has commenced numerous and diverse administrative and federal court injunctive proceedings against alleged violators of the federal commodity laws. The most ubiquitous exchange-related violations appear to encompass attempted or actual market manipulations, deceptive acts aimed at customers, and illegal trading practices such as wash sales and other fictitious sales of commodity futures contracts.²² Most off-exchange violations policed by the Commission involve the offer and sale of investment instruments which are actually commodity op-

²⁰ *Id.* § 11.2(a).

²¹ Markham, *Investigations Under the Commodity Exchange Act*, 31 AD. L. REV. 285, 290 (1979); 1977 CFTC ANN. REP. 85-103 (1978); see 7 U.S.C. § 4a(c) (1981).

²² Section 4c of the Act, 7 U.S.C. § 6c (1976), prohibits any transaction in a commodity which “is of the character of, or is commonly known to the trade as, a ‘wash sale,’ ‘cross trade,’ or ‘accommodation trade,’ or is a fictitious sale.” “Wash sales” have been defined by many courts. *E.g.*, Ernst & Ernst v. Hochfelder, 425 U.S. 185, 205 n.25 (1976) (“‘wash sales’ are transactions involving no change in beneficial ownership”); United States v. New York Coffee & Sugar-Exchange, Inc., 263 U.S. 611 (1924) (wash sales in the commodities market are “bets upon the market in which it is understood between the parties that neither is bound to deliver or accept delivery”); People v. Kellogg, 105 A.D. 505, 514, 94 N.Y.S. 617, 622-23 (Sup. Ct. 1905) (wash sale occurred where “the broker purchased and sold for the defendant and his associates . . . [and] [t]he actual transaction was solely theirs; nothing was paid save that the broker received his commission”).

tions²³ or the alleged sale of commodity futures contracts outside the regulated commodity markets.²⁴ During 1980, the CFTC's Division of Enforcement opened 777 investigations and commenced 36 administrative enforcement proceedings and 19 federal court injunctive enforcement proceedings for alleged violations of the Act and its accompanying regulations.²⁵

Prior to the commencement of a formal adversarial enforcement action, the CFTC conducts an investigation of the unlawful conduct.²⁶ Commission investigations are begun through a variety of means, including customer complaints, referrals from other agencies, industry complaints, and inquiries initiated by the Commission based upon registration reviews. The Act imposes broad record keeping requirements upon commodity professionals and those engaged in futures transactions and mandates that such records be kept readily available for inspection by Commission representatives.²⁷

²³ A commodity option confers upon the purchaser the contractual right to buy or sell either a specified commodity or a commodity futures contract within a certain period of time at a given price. See *British Am. Commodity Options Corp. v. Bagley*, 552 F.2d 482, 484-85 (2d Cir.), cert. denied, 434 U.S. 938 (1977).

By the 1978 amendments, Congress imposed a general ban on the offer and sale of commodity options. See 7 U.S.C. § 6c(c) (Supp. II 1978). An exception to this prohibition was nonetheless provided for "dealers," that is United States domiciles "who on May 1, 1978 [were] in the business of granting . . . options on . . . physical commodities and [were] in the business of buying, selling, producing, or otherwise using that commodity." *Id.* § 6c(d). These dealers were permitted to "continue to grant or issue options on that commodity in accordance with Commission regulations." *Id.* This general prohibition on commodity option transactions shall continue until the CFTC submits to Congress evidence of its ability to properly regulate such transactions. See *id.* § 6c(c). For an excellent discussion of commodity options regulation in the United States, see Lower, *The Regulation of Commodity Options*, 1978 DUKE L.J. 1095.

²⁴ See note 15 *supra* and accompanying text.

²⁵ 1980 CFTC ANN. REP. 94 (1981).

²⁶ See Rules Relating to Investigations, 17 C.F.R. §§ 11.1-.8 (1981). For an extensive discussion of Commission investigations, see Markham *supra* note 21.

²⁷ Sections 4g and 4i of the Act, 7 U.S.C. §§ 6g, 6i (1976), present the record-keeping duties of futures commission merchants and floor brokers. Section 4n of the Act, 7 U.S.C. § 6n (1976), delineates what records are required to be kept by commodity trading advisors and commodity pool operators.

Records "required to be kept by the Act" or by any regulations promulgated thereunder must "be kept for a period of five years from the date thereof and shall be readily accessible during the first 2 years of the 5 year period." 17 C.F.R. § 1.31(a)(1) (1976). Moreover, these books and records are "open to inspection by any representative of the Commission or the U.S. Department of Justice." *Id.* It should be noted, however, that a district court recently held that the "required records" doctrine will not preclude the claim of fifth amendment privileges by an unregistered ostensible commodity pool operator against required production of the records where the nature of the records indicated by their mere existence that they were evidence of criminal activity. *CFTC v. Buterin*, 2 COMM. FUT. L. REP. (CCH) ¶ 21,133, at 24,606-07 (D. Kan. Dec. 29, 1980).

Section 6(b) of the Act²⁸ provides that the Commission may institute formal administrative adversarial proceedings against certain classes²⁹ of alleged commodities law violators, requiring the recipient of the complaint and notice of hearing to show cause why specified remedial sanctions should not be imposed upon him. These remedial sanctions may include a possible prohibition from trading on any contract market, a possible suspension or revocation of CFTC registration status, and the imposition of a civil monetary penalty.³⁰

In preparing for possible adversarial enforcement proceedings the Commission may conduct an informal inquiry into alleged violative activity or it may issue a formal written order of investigation setting forth a general description of the scope of the formal investigation. This order would also set forth the authority pursuant to which the formal investigation is being conducted, and may authorize the staff to issue subpoenae *ad testificandum* and subpoenae *duces tecum* pursuant to the formal order of investigation.³¹

Commission subpoenae are generally prepared by the staff subject to the authority of the Commission's formal order of investigation and may require the recipient to testify and/or produce documents relating to any matter under investigation.³² Because of the quasi-criminal nature of the investigation, the subpoenaed witness has certain rights. Among them are the right to be advised and represented by counsel³³ and the right to refuse to answer questions on the basis of the witness's fifth amendment right against self-incrimination.³⁴ There are, however, criminal penalties imposed on a witness who makes false statements under oath during the course of a Commission investigation³⁵ or who makes willful misrepresentations to Commission staff, whether or not made under oath.³⁶

²⁸ 7 U.S.C. § 9 (1976).

²⁹ Section 6(b) of the Act, 7 U.S.C. § 9 (1976), covers "any person (other than a contract market)" who is allegedly "manipulating or attempting to manipulate . . . the market price of any commodity." The provision then discusses the Commission's authority to require that suspected futures commission merchants, commodity trading advisors, commodity pool operators, and floor brokers show cause why such individuals' registration with the Commission "should not be suspended or revoked." *Id.*

³⁰ See 7 U.S.C. §§ 9, 13b (1976); note 9 *supra* and accompanying text.

³¹ 17 C.F.R. § 11.4 (1981).

³² See *id.*

³³ See *id.* § 11.7(c).

³⁴ See *id.* § 11.7(d)(1).

³⁵ See 18 U.S.C. § 1621 (1976); 17 C.F.R. § 11.6(6) (1976).

³⁶ See 18 U.S.C. § 1001 (1976); 17 C.F.R. § 11.6(b) (1981).

Unlike subpoenae issued by the SEC, non-compliance with CFTC subpoenae is not per se illegal.³⁷ The Commission must enforce compliance with its subpoenae by obtaining an enforcement order from a federal district court.³⁸ The Commission is not, however, required to make an express showing in its application that the recipient of the subpoena is a person or entity subject to the provisions of the Act.³⁹ Moreover, in the absence of a showing by the recipient of a CFTC subpoena that the documents are irrelevant to the agency investigation, subpoenaed records are considered prima facie relevant to the CFTC investigation and the district court will insist upon compliance.⁴⁰ Courts will also presume regularity in the issuance of the subpoena, the burden of showing irregularity resting squarely upon the recipient of the subpoena.⁴¹ This burden is difficult to overcome because the CFTC, like all independent federal agencies, may formally "investigate [a subject] merely on suspicion that the law is being violated, or even because it wants assurance that it is not."⁴²

Based on the evidence and information gathered through its investigation, the Enforcement Division will determine whether an enforcement action should be initiated. If some action is recom-

³⁷ 15 U.S.C. § 78u (c) (1976) makes it a misdemeanor for a person without "just cause" to fail to respond to a subpoena issued pursuant to an SEC formal order of investigation. *Id.* No comparable provision exists under the commodity laws.

³⁸ Section 13(3) of the 1978 Act, 7 U.S.C. § 15 (Supp. II 1978) (amending 7 U.S.C. § 15 (1976)), expressly provides:

the Commission may invoke the aid of any court of the United States within the jurisdiction in which the investigation or proceeding is conducted, or where such person resides or transacts business, in requiring the attendance and testimony of witnesses and the production of books, papers, correspondence, memoranda and other records.

Id.

³⁹ *Id.*; see *CFTC v. First Nat'l Bullion Corp.*, 461 F. Supp. 659, 661 (S.D.N.Y. 1978), *aff'd*, 598 F.2d 609 (2d Cir. 1979).

⁴⁰ *Id.* at 661-62.

⁴¹ See *Siegel Trading Co., Inc. v. CFTC*, [1975-1977 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 20,212 (N.D. Ill. Sept. 27, 1976), *aff'd*, Civ. No. 76-2233 (7th Cir. 1977). But see *CFTC v. Rosenthal & Co.*, 2 COMM. FUT. L. REP. (CCH) ¶ 21,012 (N.D. Ill. March 18, 1980) (respondent granted limited discovery in subpoena enforcement proceeding regarding purpose and scope of Commission's investigation and degree of cooperation with Justice Department).

⁴² *United States v. Morton Salt Co.*, 338 U.S. 632, 642-43 (1950). As the Court of Appeals for the Second Circuit observed in *SEC v. Brigadoon Scotch Distrib. Co.*, 480 F.2d 1047 (2d Cir. 1973), *cert. denied*, 415 U.S. 915 (1974):

Every person doing business and every investor knows that government agencies conduct investigations for a variety of reasons, and most of them feel the duty to respond to a proper inquiry. As for those whose practices are investigated, it is a necessary hazard of doing business to be the subject of inquiry by a government regulatory agency.

Id. at 1056 (emphasis added).

mended, specific advice will also be made as to the persons and entities against whom the action should be taken, the appropriate forum for the commencement of the action, and the nature and types of remedies which should be sought to protect the public and further the goals of the Commission.⁴³ The Commission will consider the recommendations of the Enforcement Division at a non-public Commission meeting.⁴⁴ Defense counsel who is aware of the Enforcement Division's recommendations may submit arguments to the Commission concerning reasons why the Enforcement Division's recommendations should be modified or why the Commission should refrain from commencing an enforcement action. Unlike the SEC,⁴⁵ the CFTC has not adopted a formal procedure for the submission of such arguments, and consequently submissions may be of limited value.⁴⁶ Nevertheless, upon learning of the CFTC's investigation, defense counsel should seek to communicate with the CFTC staff in the expectation of expeditiously settling the dispute, informally discovering the thrust of the CFTC's inquiry and intentions, suggesting to the staff the appropriate wording of the charges and/or settlement order, and arranging for a grant of "use" immunity for his or her client.⁴⁷ Frequently, the subject of a CFTC investigation is either simultaneously the subject of a parallel criminal investigation, or will be referred to the Department of Justice for criminal prosecution upon the completion of the Commission's investigation and civil prosecution.⁴⁸ As such, communication should be aimed at preparing counsel for client representation before the CFTC as well as before other investigative authorities.

⁴³ See generally Markham, *supra* note 21.

⁴⁴ See 17 C.F.R. § 147.3(b) (1981).

⁴⁵ The SEC has adopted a procedure whereby "involved" persons may "on their own initiative" submit statements to the Commission expressing their positions regarding the investigation. The SEC staff may then "in its discretion" provide such persons with general information relating to the investigation and establish a time framework for the submission of additional statements by the interested persons which will be forwarded to the Commission for consideration. *Id.* § 202.5(c).

⁴⁶ See Markham, *supra* note 21, at 312-13.

⁴⁷ Pursuant to 17 C.F.R. § 11.7(d)(2) (1981), the Commission, with the approval of the Attorney General of the United States, may confer "use" immunity upon a witness. See 18 U.S.C. § 6001 (1976). See generally Smaltz, *Tactical Considerations for Effective Representation During a Government Investigation*, 16 AM. CRIM. L. REV. 383 (1979).

⁴⁸ For discussions of issues which arise when a regulatory agency and the Department of Justice are conducting parallel investigations of the same subject, see Pickholz, *Parallel Enforcement Proceedings: Guidelines for the Corporate Lawyer*, 7 SEC. REG. L.J. 99 (1979).

IV. THE ADMINISTRATIVE PROCEEDING BEFORE THE CFTC

A. *Discovery in the Administrative Proceeding*

Pre-hearing discovery in the context of a CFTC administrative proceeding is less structured and less broad than the discovery provisions of the Federal Rules of Civil Procedure.⁴⁹ Regulations 10.42 and 10.44 of the CFTC's Rules of Practice⁵⁰ generally govern the scope of discovery in CFTC proceedings and vest with the presiding administrative law judge broad discretion. Pursuant to the rules, the judge may, in his discretion, order the Commission staff and the respondent to outline their cases setting forth the legal theories upon which each party will rely.⁵¹ In addition, the judge may require the parties to identify the witnesses who will testify in their behalf and to furnish copies of or a list of documents to be introduced at the hearing.⁵²

Both the Commission staff and the respondent have the right to serve the other side with a written request for admissions⁵³ which must be responded to either in the form of a good faith objection, or good faith denial; however, lack of information or knowledge may not be invoked as a reason for failure of a party to admit or deny the requested admission "unless he states that he has made reasonable inquiry and that the information known or reasonably available to him is insufficient to enable him to admit or deny."⁵⁴ The administrative law judge may then enter appropriate orders assessing the sufficiency of the responses.⁵⁵ Depositions and interrogatories may be permitted, at the discretion of the administrative law judge and upon the written application of a party, when a prospective material witness for good cause will be unable to attend the hearing.⁵⁶ As such, the deposition and interrogatory tools provided for in the regulations are not really intended to be a discovery device, but are basically to be

⁴⁹ See generally Kaufman, *Have Administrative Agencies Kept Pace with Modern Court Developed Techniques Against Delay?—A Judge's View*, 12 AD. L. BULL. 103, 114 (1959); *Discovery in Agency Adjudication, Recommendations and Report of the Administrative Conference of the United States*, Jan. 8, 1968-June 30, 1970, Recommendation No. 21 (1971).

⁵⁰ 17 C.F.R. §§ 10.42, 10.44 (1981).

⁵¹ *Id.* §§ 10.42(a)(1)-42(a)(2).

⁵² *Id.* §§ 10.42(a)(3)-42(a)(4). Unless ordered otherwise, the Commission staff must also make available to the respondent prior to the hearing date copies of documents obtained during the Commission's pre-complaint investigation, including "transcripts of testimony, signed statements and substantially verbatim reports of interviews which were obtained during the investigation . . . and all exhibits to those transcripts, statements and reports." *Id.* § 10.42(b).

⁵³ *Id.* § 10.42(c)(1).

⁵⁴ *Id.* § 10.42(c)(2).

⁵⁵ *Id.* § 10.42(c)(3).

⁵⁶ *Id.* § 10.44(a).

utilized for the purpose of preserving the testimony of a witness who would otherwise be unable to testify at the hearing.⁵⁷

In a recent disciplinary proceeding,⁵⁸ the Commission ordered the Division of Enforcement to produce "as a matter of due process . . . any material of which it is aware that is arguably exculpatory as to either guilt or punishment."⁵⁹ The Commission further ordered that such exculpatory evidence be turned over to the respondent prior to the hearing pursuant to the criminal law doctrine established in *Brady v. Maryland*.⁶⁰ The Commission's ruling, which may be invoked as precedent in disciplinary matters adjudicated before the CFTC, represents an innovative application of common rules of fair play which have heretofore been denied respondents in SEC administrative proceedings.⁶¹

B. *The Commencement of the Proceeding and Administrative Remedies*

The administrative proceeding is an important disciplinary and enforcement weapon for the implementation of the federal commodity laws. Section 6(b) of the Act⁶² is the principal statute under which the Commission may commence a public administrative proceeding.⁶³

⁵⁷ *Id.* § 10.44(g); cf. SEC Rule of Practice 15(f)(1), *id.* § 201(f) (depositions may be used at SEC hearings only when witness is unavailable for designated reasons).

⁵⁸ *In re First Guar. Metals Co.*, 2 COMM. FUT. L. REP. (CCH) ¶ 21,074 (July 2, 1980).

⁵⁹ *Id.* at 24,340.

⁶⁰ 373 U.S. 83 (1963). In *Brady*, the Supreme Court determined that suppression by the prosecution of a confession given by an accused murderer was a denial of the due process rights of a co-defendant who was being tried separately. *Id.* at 87.

⁶¹ Codified procedures followed by the SEC concerning the production of government witnesses' statements and reports provide that exculpatory statements are made available for inspection only after the witness has testified on direct examination at the SEC administrative hearing. See rule 11.1 of the SEC's Rules of Practice, 17 C.F.R. § 201.11.1 (1981).

Other important CFTC Rules of Practice concerning administrative hearings provide for, *inter alia*, the scheduling of a pre-hearing conference, *id.* § 10.41; the requirement that all hearings be publicly held, *id.* § 10.64; the right to call expert witnesses at the hearing, *id.* § 10.66(d); the requirement that only relevant, material, and reliable evidence shall be admitted at the hearing, *id.* § 10.67(a); the requirement that subpoenae may only be issued upon application to an administrative law judge, *id.* § 10.68; the fact that full or partial summary judgments denominated summary dispositions may be applied for by either party, *id.* § 10.91; the procedure for review of the administrative law judge's initial decision by the Commission, *id.* § 10.102; and the manner in which settlements may be reached between respondents and the Commission, *id.* § 10.108.

⁶² 7 U.S.C. § 9 (1976).

⁶³ Pursuant to section 6b of the Act, 7 U.S.C. § 13a (1976), the Commission may also commence appropriate administrative proceedings against a contract market and certain persons affiliated to a contract market for violations of the federal commodity laws and for failure to enforce "its rules of government made a condition of its designation." *Id.*

Pursuant to section 6(b), the administrative proceeding is commenced by the service of a complaint and notice of hearing⁶⁴ requiring the recipient to appear and to "show cause" why specific sanctions should not be taken by the Commission.⁶⁵

Section 6(c) of the Act⁶⁶ provides that after evidence is heard by the administrative law judge, the Commission may enter a cease and desist order preventing further violations of the Act. Section 6(b) additionally provides that after the evidentiary hearing the Commission may, if appropriate, (1) enter an order prohibiting the violator from trading on or subject to the rules of any contract market; (2) suspend or revoke the registration of CFTC registrants; and/or (3) assess the violator a civil penalty of not more than \$100,000 for each violation of the federal commodity laws found to have occurred.⁶⁷

A recipient's failure to comply with an administrative cease and desist order is a misdemeanor under the Act and "upon conviction thereof," the violator may be fined up to \$100,000, "or imprisoned for not less than six months nor more than one year, or both."⁶⁸ It is clear from these provisions that the willful violation of a Commission order may result in a criminal prosecution with attendant penal sanctions.

C. *The Burden of Proof in CFTC Administrative Proceedings*

In the 1977 securities law decision of *Collins Securities Corp v. SEC*,⁶⁹ an appeal involving a review of an SEC administrative disciplinary proceeding, the United States Court of Appeals for the District of Columbia held that in administrative enforcement proceedings, where severe remedial and punitive sanctions may be imposed by the SEC for violations of the anti-fraud provisions of the federal securities

⁶⁴ The complaint sets forth the named respondents and the alleged statutory violations; generally describes the substance of the alleged facts which gave rise to the statutory violations; designates the time and place for an evidentiary hearing before an administrative law judge; and designates the date by which an answer or response must be interposed by the respondents. See *id.* § 9. The conduct of the administrative proceeding is governed by the Commission's Rules of Practice, as set forth in Part 10 of the regulations promulgated under the Act. 17 C.F.R. §§ 10.1-.108 (1981). The Rules of Practice governing CFTC reparation proceedings are contained within Part 12 of the regulations. *Id.* §§ 12.1-.102.

⁶⁵ See 7 U.S.C. § 9 (1976).

⁶⁶ *Id.* § 13b.

⁶⁷ *Id.* § 9.

⁶⁸ *Id.* § 13b.

⁶⁹ 562 F.2d 820 (D.C. Cir. 1977). In *Collins*, a broker-dealer and its president were accused of manipulating the market price of a certain stock, the purchase of which could be achieved through exercising stock purchase warrants. *Id.* at 822.

laws, the SEC staff must prove by "clear and convincing evidence" the culpability of the alleged violator.⁷⁰ In *Collins*, the court considered the serious punitive sanctions that may be imposed by an agency such as the SEC and concluded that due to the quasi-penal nature and effect of the sanctions, the quantitative "preponderance of the evidence" standard previously invoked by the SEC in such proceedings was inadequate.⁷¹ Instead, a "clear and convincing evidence" standard should be required in administrative proceedings involving allegations of fraud where very serious and punitive-type sanctions may be imposed.⁷² In a recent CFTC administrative decision,⁷³ a CFTC administrative law judge adopted the *Collins* standard of "clear and convincing evidence" in the context of a disciplinary proceeding involving allegations of fraud.⁷⁴

On February 25, 1981, however, the Supreme Court in *Steadman v. SEC*,⁷⁵ rejected the "clear and convincing evidence" test and upheld the use of a "preponderance of the evidence" burden of proof in SEC administrative disciplinary proceedings.⁷⁶ In reaching its

⁷⁰ *Id.* at 824-26.

⁷¹ *Id.* In discussing the necessity of a fair and just means of assessing proof in administrative proceedings, the court stated that "we discern a need to subject such evidence (inferences) to a standard which will ensure that any remedial sanctions are imposed only in those circumstances where the evidence is of such a quality as to make the sanctions appear just and reasonable." *Id.* at 823.

⁷² *Id.* at 824-26. Under the "preponderance of the evidence" standard, the trier of fact "must believe that it is more probable that the facts are true or exist than it is that they are false or do not exist," McBaine, *Burden of Proof: Degrees of Belief*, 32 CAL. L. REV. 242, 261 (1944), whereas under the "clear and convincing evidence" standard, the trier of fact "must believe that it is highly probable that the facts are true or exist . . . yet it is not sufficient to believe that it is merely more probable that they are true or exist than it is that they are false or do not exist." *Id.* at 262-63.

⁷³ Harold Collins, [1977-1980 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 20,910 (Aug. 30, 1979).

⁷⁴ *Id.* at 23,690. The raising of the standard of proof by *Collins* in administrative proceedings involving allegations of fraudulent conduct, where the subject of the proceeding may receive severe personal and economic sanction, appears to protect the rights of the individual from being penalized erroneously based upon inaccurate evidentiary inferences. *Collins*, 562 F.2d at 823. See e.g., *Woodby v. Immigration & Naturalization Serv.*, 385 U.S. 276 (1966) (deportation); *Chaut v. United States*, 364 U.S. 350 (1960) (loss of citizenship); *Gonzalez v. Landon*, 350 U.S. 920 (1955) (per curiam) (expatriation); *Schneiderman v. United States*, 320 U.S. 118 (1943) (denaturalization) (cited in Comment, *Scope of Review or Standard of Proof—Judicial Control of SEC Sanctions: Steadman v. SEC*, 93 HARV. L. REV. 1845, 1852 n.67 (1980)).

⁷⁵ 101 S. Ct. 999 (1981). See generally Steinberg, *Steadman v. SEC—Its Implications and Significance*, 6 DEL. J. CORP. L. 1 (1981).

⁷⁶ 101 S.Ct. at 1004. *Steadman* involved a disciplinary proceeding brought by the SEC pursuant to alleged violations of the Investment Company Act of 1940, 15 U.S.C. §§ 80 a-1 to 80b-52 (1976), and the Investment Advisers Act of 1940, 15 U.S.C. §§ 80b-1 to 80b-21 (1976). Employing a "preponderance of the evidence" standard, the SEC found the existence of statutory violations and consequently suspended the defendant "for 1 year from associating with any

decision, the Court focused on the language of section 7(c) of the Administrative Procedure Act (APA),⁷⁷ which the Court deemed to establish a quantitative test applicable to all administrative agency disciplinary proceedings.⁷⁸ The commodities laws contain no prescribed standard regarding the burden of proof to be applied in administrative proceedings before it. On the other hand, section 7(c) of the APA allows sanctions to be imposed in administrative disciplinary proceedings when they are "in accordance with . . . substantial evidence."⁷⁹ The Court in *Steadman* found that "[t]he word 'substantial' denotes quantity" (preponderance) rather than quality (clear and convincing).⁸⁰

If *Steadman* is to be applied to CFTC administrative proceedings as *Collins* was initially, it now appears that in administrative proceedings conducted before the CFTC the Commission need only prove statutory violations by a quantitative "preponderance of the evidence" in order to impose remedial and punitive sanctions upon violators of the Act and its accompanying regulations.

V. STANDARDS FOR LIABILITY UNDER THE ACT'S ANTI-FRAUD PROVISIONS

A. *Scienter*

The general anti-fraud provision of the Act is section 4b.⁸¹ Essentially, this provision makes it unlawful to perpetrate any fraudulent or deceptive practices in connection with the making or sale of commodity futures contracts. The overwhelming majority of administrative enforcement actions involve alleged violations of this provision. Section 4b itself is similar, but not identical, to the often-invoked anti-fraud provisions of the federal securities laws—section 10(b) of

broker or dealer in securities." 101 S.Ct. at 1004. On appeal, the Court of Appeals for the Fifth Circuit affirmed the use of a preponderance of the evidence test. *Steadman v. SEC*, 603 F.2d 1126, 1143 (5th Cir. 1979).

⁷⁷ 5 U.S.C. § 556(d) (1976).

⁷⁸ 101 S.Ct. at 1005.

⁷⁹ 5 U.S.C. § 556(d) (1976).

⁸⁰ 101 S.Ct. at 1006. In support of its conclusion, the Court examined the legislative history of section 7(c) of the Administrative Procedure Act, 5 U.S.C. § 556(d) (1976), and found legislative intent to be such that "[w]here there is evidence pro and con, the agency must weigh it and decide in accordance with the preponderance." 101 S.Ct. at 1007 (quoting H.R. REP. NO. 1980, 79th Cong., 2d Sess. 37 (1946)) (emphasis omitted).

⁸¹ 7 U.S.C. § 6 b (1976). This provision states in pertinent part:

It shall be unlawful (1) for any member of a contract market, or for any correspondent, agent, or employee of any member, in or in connection with any order to make, or the making of any contract of sale of any commodity in interstate commerce, made, or to be made, on or subject to the rules of any contract market, for or

the Securities Exchange Act⁸² and rule 10b-5,⁸³ promulgated thereunder. Actions brought under these anti-fraud provisions generally share the common proof requirement of "scienter." In other words, some element of intent to defraud or willful misconduct on the part of the defendant must be established by the suing party.⁸⁴ Recent decisions construing section 4b, however, suggest a departure from the strict scienter requirement and a possible shift toward examining the effect of a particular course of conduct upon the commodity investor rather than the presence of some affirmative intent on the part of the actor.⁸⁵

Early cases brought under section 4b rejected the notion that liability could be imposed on a finding of mere negligence. For example, in *McCurnin v. Kohlmeyer & Co.*,⁸⁶ a private suit was brought by a customer to recover losses for alleged unauthorized cotton commodity futures transactions entered into on his behalf by his commodity broker.⁸⁷ The District Court for the Eastern District of Louisiana found that the verbiage utilized in section 4b of the Act ("cheat,"

on behalf of any other person, or (2) for any person, in or in connection with any order to make, or the making of, any contract of sale of any commodity for future delivery, made, or to be made, on or subject to the rules of any contract market, for or on behalf of any other person if such contract for future delivery is or may be used for (a) hedging any transaction in interstate commerce in such commodity or the products or by-products thereof, or (b) determining the price basis of any transaction in interstate commerce in such commodity, or (c) delivering any such commodity sold, shipped, or received in interstate commerce for the fulfillment thereof—

(A) to cheat or defraud or attempt to cheat or defraud such other person;

(B) willfully to make or cause to be made to such other person any false report or statement thereof, or willfully to enter or cause to be entered for such person any false record thereof;

(C) willfully to deceive or attempt to deceive such other person by any means whatsoever in regard to any such order or contract or the disposition or execution of any such order or contract, or in regard to any act of agency performed with respect to such order or contract for such person; or

(D) to bucket such order, or to fill such order by offset against the order or orders of any other person, or willfully and knowingly and without the prior consent of such person to become the buyer in respect to any selling order of such person, or become the seller in respect to any buying order of such person.

Id.

⁸² 15 U.S.C. § 78j(b) (1976).

⁸³ 17 C.F.R. § 240.10b-5 (1981). See generally Note, *Reflections of 10b-5 in the "Pool" of Commodity Futures Fraud*, 14 Hous. L. Rev. 899 (1977).

⁸⁴ E.g., *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976) (damages held not to be recoverable under section 10b and rule 10b-5 in absence of "intent to deceive, manipulate or defraud"); *McCurnin v. Kohlmeyer & Co.*, 347 F. Supp. 573, 575-76 (E.D. La. 1972), *aff'd*, 477 F.2d 113 (5th Cir. 1973) (finding of mere negligence held not actionable under section 4b of Commodities Exchange Act).

⁸⁵ See notes 94-98 *infra* and accompanying text.

⁸⁶ 347 F. Supp. 573 (E.D. La. 1972), *aff'd*, 477 F.2d 113 (5th Cir. 1973).

⁸⁷ *Id.* at 575.

"defraud," and "willfully") connotes deliberate acts or a degree of negligence that is so gross as to approach wilfulness,⁸⁸ and held that the statute was meant to prohibit only intentionally deceptive conduct.⁸⁹ As such, the court found that section 4b was clearly not intended to impose liability for "good faith actions merely because they are negligent or uninformed."⁹⁰

Similarly, in *Haltmier v. CFTC*,⁹¹ the Court of Appeals for the Second Circuit found that for a section 4b violation, "[i]t is enough that the commodities broker acted deliberately, knowing that his acts were unauthorized and contrary to instruction. Such knowing, intentional conduct made his acts willful, and therefore his violations of the statutory prohibition against cheating or defrauding the customers were wilful"⁹² Thus, by emphasizing the deliberate and willful nature of the misconduct, the court preserved intact the traditional view that liability cannot be founded upon negligent conduct alone.

In contrast to the prevailing view that section 4b imposes a scienter requirement, in a recent reparation proceeding⁹³ between private litigants⁹⁴ the Commission affirmed an administrative law judge's ruling that section 4b liability may be imposed for certain

⁸⁸ *Id.* at 576. *Accord*, *Master Commodities, Inc. v. Texas Cattle Management Co.*, 586 F.2d 1352 (10th Cir. 1978).

⁸⁹ 347 F. Supp. at 575-76.

⁹⁰ *Id.* at 576.

⁹¹ 554 F.2d 556 (2d Cir. 1977). *Haltmier* involved a judicial review of a CFTC administrative order, wherein the CFTC issued an order after an administrative proceeding prohibiting the petitioner from trading commodity futures for a period of 18 months, pursuant to section 6(b) of the Act, 7 U.S.C. § 9 (1976), and ordering the petitioner to cease and desist from engaging in unauthorized commodity futures transactions for customer accounts, pursuant to section 6(c) of the Act, *Id.* § 13b. 554 F.2d at 559.

⁹² 554 F.2d at 562 (citing *Silverman v. CFTC*, 549 F.2d 28 (7th Cir. 1977); *George Steinberg & Son, Inc. v. Butz*, 491 F.2d 988 (2d Cir.), *cert. denied*, 419 U.S. 830 (1974); *Goodman v. Benson*, 286 F.2d 896 (7th Cir. 1961); *Eastern Produce Co. v. Benson*, 278 F.2d 606 (3rd Cir. 1960)).

To avoid the problems inherent in proving and defending claims predicated upon alleged unauthorized trading, such as in the *Haltmier* case, the Commission promulgated regulation 166.2, 17 C.F.R. § 166.2 (1981), which requires specific authorization by the customer for each distinct transaction, or alternatively mandates discretionary authorization by the customer.

⁹³ Pursuant to section 14 of the Act, 7 U.S.C. § 18(a) (1976), any person may commence an administrative reparations proceeding before the CFTC by alleging that he or she has suffered damages as a consequence of "any violation of any provision of the Act or any rule, regulation or order thereunder by any person who is registered or required to be registered under section 4d, 4e, 4k or 4m of the Act."

⁹⁴ *Gordon v. Shearson Hayden Stone, Inc.*, [1977-1980 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶20,427 (June 14, 1977), *aff'd*, No. 80-7212 (9th Cir. 1982).

reckless, although unintentional, good faith failures on the part of a broker to disclose certain risks involved in trading to a commodity investor.⁹⁵ In *Gordon v. Shearson Hayden Stone, Inc.*,⁹⁶ the CFTC found that the concept of constructive, as opposed to intentional fraud, was the intended prohibition of section 4b(A) of the Act, and held that such constructive fraud does not envision a showing of an intentional breach of a fiduciary obligation, but encompasses the effects of acts and omissions which are not in accordance with the historical standards to which an investment fiduciary may be held.⁹⁷ Thus, in applying the prohibitions of section 4b of the Act the CFTC itself has focused upon the effect which particular reckless conduct may have upon an investment, rather than upon the intent of the party engaging in the particular conduct.⁹⁸

Willful misconduct has also been held not to be a necessary element to an enforcement action brought by the CFTC seeking to enjoin the fraudulent sale of commodity options in violation of rule 30.01⁹⁹—a regulation promulgated by the Commission proscribing deceitful practices in connection with the offering of commodity options. In *Commodity Futures Trading Commission v. J.S. Love & Associates Options*,¹⁰⁰ the District Court for the Southern District of New York held that in view of the general language of the regulation and the “purposeful omission of the word ‘willful’” in the rule, the Commission could establish a violation absent evidence of willful misconduct.¹⁰¹

In addition to the section 4b anti-fraud provision, the Act contains section 4o(1),¹⁰² a more specific anti-fraud section which prohibits any commodity trading advisor¹⁰³ or commodity pool opera-

⁹⁵ *Id.* at 21,734.

⁹⁶ [1977-1980 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶20,427 (June 14, 1977), *aff'd*, No. 80-7212 (9th Cir. 1982).

⁹⁷ *Id.* at 21,734.

⁹⁸ See notes 94-97 *supra* and accompanying text.

⁹⁹ 17 C.F.R. § 30.01 (1981). This rule generally prohibits the use of any instrumentality of interstate commerce “(a) to cheat or defraud or attempt to cheat or defraud any other person; (b) to make or cause to be made . . . any false report . . . ; (c) to deceive or attempt to deceive any other person by any means whatsoever,” in connection with the purchase or sale of commodity options. *Id.*

¹⁰⁰ 422 F. Supp. 652 (S.D.N.Y. 1976).

¹⁰¹ *Id.* at 657-60.

¹⁰² 7 U.S.C. § 6o (1976). For an in-depth discussion of section 4o(1) liability standards, see Mitchell, *The Regulation of Commodity Trading Advisors*, 27 EMORY L.J. 957, 990-94 (1978).

¹⁰³ Section 2(a)(1) of the Act, 7 U.S.C. § 2 (1976), defines a commodity trading advisor as: [A]ny person who, for compensation or profit, engages in the business of advising others, either directly or through publications or writings, as to the value of commodities or as to the advisability of trading in any commodity for future delivery on

tor¹⁰⁴ from employing "any device, scheme, or artifice to defraud any client or . . . prospective client"¹⁰⁵ and from engaging in "any transaction, practice, or course of business which operates as a fraud or deceit upon any client or . . . prospective client."¹⁰⁶ Under the 1978 amendments to the Act, section 4o(1) now applies both to CFTC registrants, and to those commodity trading advisors and commodity pool operators not registered under the Act but whose activities bring them within the purview of the Act.¹⁰⁷ This anti-fraud provision, which is unique to commodity pool operators and commodity trading advisors, appears to evidence an intent by Congress to subject this class of professionals to broader standards of liability than other CFTC registrants,¹⁰⁸ such as the futures commission merchant or his associates.¹⁰⁹

or subject to the rules of any contract market, or who for compensation or profit, and as part of a regular business, issues or promulgates analyses or reports concerning commodities; but does not include (i) any bank or trust company, (ii) any newspaper reporter, newspaper columnist, newspaper editor, lawyer, accountant, or teacher, (iii) any floor broker or futures commission merchant, (vi) the publisher of any bona fide newspaper, news magazine, or business or financial publication of general and regular circulation including their employees, (v) any contract market, and (vi) such other persons not within the intent of this definition as the Commission may specify by rule, regulation, or order: Provided, that the furnishing of such services by the foregoing persons is solely incidental to the conduct of their business or profession.

Id.

¹⁰⁴ Section 2(a)(1) of the Act, 7 U.S.C. § 2 (1976), defines a commodity pool operator as: [A]ny person engaged in a business which is of the nature of an investment, trust, syndicate, or similar form of enterprise, and who, in connection therewith, solicits, accepts or receives from others, funds, securities, or property, either directly or through capital contributions, the sale of stock or other forms of securities, or otherwise, for the purpose of trading in any commodity for future delivery on or subject to the rules of any contract market, but does not include such persons not within the intent of this definition as the Commission may specify by rule or regulation or by order.

Id.

¹⁰⁵ 7 U.S.C. § 6o(1)(A) (1976).

¹⁰⁶ *Id.* § 6o(1)(B).

¹⁰⁷ Section 10 of the Futures Trading Act of 1978, Pub. L. No. 95-405, § 10, 92 Stat. 870, 97th Cong., 2d sess., deleted "registered under this chapter" following "pool operator." See note 7 *supra*.

¹⁰⁸ See Mitchell, *supra* note 102, at 991.

¹⁰⁹ Section 2(a)(1) of the Act, 7 U.S.C. § 2 (1976), defines a futures commission merchant as: [I]ndividuals, 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 or 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.

Id.

The thrust of section 4o(1) is to impose liability based upon the effect which particular acts or practices may have upon a client rather than to impose liability predicated upon the intent or evil motive of the commodity trading advisor or pool operator. Thus, section 4o(1) prohibits conduct which "operates as a fraud or deceit" upon a client or prospective client.¹¹⁰ Indeed, legislative history does not evidence any congressional intent to impose a scienter requirement as a predicate for liability upon trading advisors or post operators.¹¹¹ This broad basis for liability has been justified by the Commission's view of the advisor as a fiduciary to his client.¹¹² It is clear that but for commodity trading advisors, many investors would not enter into commodity transactions at all. Furthermore, commodity pool operators for their part are generally vested by their clients with a large degree of discretion over client funds.

In summary, the Act tends to impose on those persons who fall within the purview of section 4o a broader standard of care, predicating liability or breach of fiduciary duty on what, in some cases, amounts to mere negligence. The more limited language of section 4b of the Act, on the other hand, predicates liability on the basis of deliberate, intentional and willful misconduct, with a showing of mere negligence being insufficient to satisfy its scienter requirement.

B. *Respondeat Superior*

Regulation 166.3,¹¹³ promulgated under the Act, sets forth the Commission's standards for the supervisory obligation of commodity professionals as follows:

Each Commission registrant, except an associated person who has no supervisory duties, *must diligently supervise* the handling of all commodity interest accounts carried, operated, or advised by the registrant and all other activities, of its partners, officers, employees and agents (or persons occupying a similar status or performing a similar function) relating to its business as a Commission registrant.¹¹⁴

The phrase "must diligently supervise" contained in regulation 166.3 would appear to imply that there is a statutory limit upon the

¹¹⁰ *Id.* § 6.(1).

¹¹¹ See Mitchell, *supra* note 102, at 994 (citing S. REP. No. 1131, 93d Cong., 2d Sess. 35, reprinted in [1974] U.S. CODE CONG. & AD. NEWS 5843, 5874).

¹¹² See Mitchell, *supra* note 102, at 993.

¹¹³ 17 C.F.R. § 166.3 (1978); see *id.* § 1.51 (requiring contract markets to use "due diligence" in enforcing their rules). For a discussion of the Commission's intent concerning 17 C.F.R. § 166.3 (1978), see 42 Fed. Reg. 44,742, 44,746 n.7 (1977).

¹¹⁴ 17 C.F.R. § 166.3 (1981) (emphasis added).

secondary liability of a principal or controlling person for the acts or omissions of an agent or employee. As one writer has noted, it seems that under regulation 166.3 there may exist a good faith, due diligence defense to an assertion of secondary liability.¹¹⁵

Regulation 166.3 must be studied in light of section 2(a)(1) of the Act,¹¹⁶ however, which provides in pertinent part:

[T]he act, omission, or failure of any official, agent, or other person acting for any individual, association, partnership, corporation, or trust within the scope of his employment or office shall be deemed the act, omission, or failure of such individual, association, partnership, corporation, or trust, as well as of such official, agent, or other person.¹¹⁷

Section 2(a)(1) of the Act appears to adopt the common law doctrine of respondeat superior or "let the master beware"¹¹⁸ in holding the principal secondarily liable for the acts of an agent committed within the scope of the agent's employment.¹¹⁹ Indeed, cases construing section 2(a)(1) have focused on agency principles rather than the relative fault of the supervision. For example, in *McHaney v. Winchester-Hardin-Openheimer Trading Co.*,¹²⁰ a CFTC reparation proceeding involving a customer who invested with what he believed to be a branch office of a commodity futures commission merchant, an administrative law judge found that where an investor reasonably relied on objective indication that the branch office was acting on behalf of the ostensible firm and was subject to its control, the latter was liable for the acts and omissions of the former "under agency principles governing apparent authority and Section 2(a)(1) of the Act."¹²¹ Similarly, in *DiPietro v. London Commodity House*¹²² also a CFTC reparation proceeding, a commodity trading advisor was held liable for the unauthorized fraudulent conduct of one of its employees in soliciting an account, the central inquiry being not whether the employee was "engaged in a fraud upon a third person,"¹²³ but

¹¹⁵ See Markham & Meltzer, *Secondary Liability Under the Commodity Exchange Act—Respondeat Superior, Aiding and Abetting, Supervision, and Scienter*, 27 EMORY L.J. 1115, 1160 (1978).

¹¹⁶ 7 U.S.C. § 4 (1976).

¹¹⁷ *Id.*

¹¹⁸ BLACK'S LAW DICTIONARY 1475 (4th ed. 1968).

¹¹⁹ See RESTATEMENT (SECOND) OF AGENCY § 219 (1968).

¹²⁰ [1977-1980 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶20,586 (April 3, 1978).

¹²¹ *Id.* at 22,426.

¹²² [1977-1980 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶20,562 (Feb. 22, 1978).

¹²³ *Id.* at 22,302.

whether such employee was acting within the scope of his authority when perpetrating such fraud.¹²⁴ In view of the well-settled interpretation of section 2(a)(1) which incorporates traditional notions of respondeat superior, the apparent due diligence defense contained in regulation 166.3 may be of limited effect. Suits brought under section 2(a)(1) will continue to trigger an agency law analysis regardless of whether the standards of regulation 166.3 are allegedly violated. Moreover, although congressional mandates are considered the law, administrative regulations promulgated pursuant to statutory authority may not be given the same effect.¹²⁵

C. Aiding and Abetting

Section 13(a) of the Act¹²⁶ establishes specific grounds for aiding and abetting liability. That provision provides:

Any person who commits, or who willfully aids, abets, counsels, commands, induces, or procures the commission of, a violation of any of the provisions of this Act, or any of the rules, regulations or orders issued pursuant to this Act, or who acts in combination or concert with any other person in any such violation, or who willfully causes an act to be done or omitted which if directly performed or omitted by him or another would be a violation of the provisions of this Act or any of such rules, regulations, or orders may be held responsible in *administrative proceedings* under this Act for such violation as a principal.¹²⁷

As the language in the statute indicates, application of section 13(a) appears to be limited to administrative proceedings. Nonetheless, in *Bogard v. Abraham-Reitz & Co. West*,¹²⁸ a CFTC reparation proceeding between private litigants, an administrative law judge applied section 13(a) in imposing liability upon a futures commission merchant.¹²⁹ Moreover, some decisional law suggests that non-Act theories of aiding and abetting may be invoked in other forums under

¹²⁴ *Id.*

¹²⁵ *Manhattan Gen. Equip. Co. v. Commissioner*, 297 U.S. 129, 134 (1936); *Reid v. Memphis Pub. Co.*, 521 F.2d 512, 520 (6th Cir. 1975), *cert. denied*, 429 U.S. 964 (1976); *Commissioner v. Clark*, 202 F.2d 94, 98 (7th Cir. 1953). Section 6 of the Administrative Procedure Act, 5 U.S.C. § 551(4) (1976), states that "'rule' means the whole or a part of an agency statement of general or particular applicability and future effect *designed to implement, interpret, or prescribe law or policy*" *Id.* (emphasis added). For a discussion of agency rule-making authority, see generally III L. LOSS, *SECURITIES REGULATION* 1936-44 (2d ed. 1961).

¹²⁶ 7 U.S.C. § 13c(a) (1976).

¹²⁷ *Id.* (emphasis added).

¹²⁸ [1977-1980 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶20,963 (Jan. 23, 1980).

¹²⁹ *Id.* at 23,838.

appropriate circumstances. For example, in *CFTC v. Crown Colony Commodity Options, Ltd.*,¹³⁰ injunctive relief was granted by a district court judge on the basis of a finding that the defendants had "promoted, aided and abetted or participated" in violating the commodity laws.¹³¹ In reaching its decision, the court apparently applied tort law standards *sub silencio*,¹³² rather than section 13(a), thus suggesting that a determination of aiding and abetting may be made without reliance on section 13(a), at least in contexts other than that of the administrative proceeding.

An important question arising under section 13(a) is what standard to apply in assessing aider and abettor liability. The language of section 13(a) indicates a legislative intent that liability be limited to instances of "willful" conduct.¹³³ Section 13(a) basically mirrors the federal criminal aiding and abetting statute.¹³⁴ Unlike the criminal statute, however, section 13(a) contains the word "willfully" as a modifier of "aids, abets, counsels, commands, induces or procures."¹³⁵ An examination of the legislative hearings concerning section 13(a) also reveals that the drafters' intent was to predicate aiding and abetting liability upon a knowing and willful act in which the alleged aider and abettor shared in the evil intent of the principal actor.¹³⁶

¹³⁰ 434 F.Supp. 911 (S.D.N.Y. 1977).

¹³¹ *Id.* at 918.

¹³² In his discussion, Judge Weinfeld did not even mention section 13(a). Instead, after discussing the defendants' "boiler room" operations, he concluded that "[e]ach of the defendants promoted, aided, abetted or participated in the 'boiler room.'" *Id.* Section 876 of RESTATEMENT (SECOND) OF TORTS provides:

For harm resulting to a third person from the tortious conduct of another, one is subject to liability if he (a) does a tortious act in concert with the other or pursuant to a common design with him, or (b) knows that the other's conduct constitutes a breach of duty and gives substantial assistance or encouragement to the other so to conduct himself, or (c) gives substantial assistance to the other in accomplishing a tortious result and his own conduct separately considered, constitutes a breach of duty to the third person.

RESTATEMENT (SECOND) OF TORTS § 876 (1979).

In the context of securities and other investment transactions, many courts have appeared to rely upon tort law principles governing aider and abettor liability. *See e.g.*, *Rochez Bros. v. Rhoades*, 527 F.2d 880, 886 (3d Cir. 1975); *Landy v. FDIC*, 486 F.2d 139, 162 (3d Cir. 1973), *cert. denied*, 416 U.S. 960 (1974).

¹³³ *See* 7 U.S.C. § 13c(a) (1976).

¹³⁴ 18 U.S.C. § 2 (1976).

¹³⁵ 7 U.S.C. § 13c(a) (1976).

¹³⁶ That it was the intent of Congress to require willful conduct under section 13(a) is clear from the following discussion during the legislative hearings:

MRS. PROKOP. What we are trying to accomplish here is to make applicable to administrative proceedings, the same type of responsibility that applies in criminal proceedings under the provisions of title 18 U.S.C., section 2. Now, title 18 U.S.C.,

Decisional law has been consistent with the apparent legislative intent to require knowing participation as a basis for section 13(a) liability. Thus, in *In re Williams*,¹³⁷ a CFTC administrative disciplinary proceeding, culpability under section 13(a) was held to require some willful conduct, the performance of mere ministerial acts by a brokerage house secretary being insufficient for liability.¹³⁸ Similarly, in a recent CFTC administrative enforcement proceeding, *In re Richardson Securities*,¹³⁹ the Commission found that "proof of a specific unlawful intent to further the violation is necessary before a broker can be found liable for aiding and abetting a violation of the Act,"¹⁴⁰ and refused to impose remedial sanctions upon a futures commission merchant for negligently permitting its agents and em-

section 2, does not have the word "willfully" in it. It is perhaps inherent under the decisions in regard to offenses like abetting and I think it would be implied with respect to counseling, commanding, inducing, procuring, and so forth. It is not clear that it is inherent in the word "aiding." We did not tend to hold someone responsible for an unintentional aiding of someone's improper actions in an administrative proceeding. So we put in the word "willfully" in conjunction with "aiding." We did not tend to hold someone responsible for an unintentional aiding of someone's improper actions in an administrative proceeding. So we put in the word "willfully" in conjunction with "aiding," feeling that this would solve the problem from the standpoint of the trade who were concerned.

....
MR. DOLE: In other words, you mean one can commit a violation unknowingly or unwillfully and be punished under section 27[§13(a)]?

MRS. PROKOP: No. You see, we put the word "willfully" ahead of "aiding," because the word "aid" under some of the decisions was not clearly limited to situations in which there was a knowing participation. It did not seem to be necessary to add that word with respect to the rest of the activities in that series, because inherently, they include some element of knowledge.

What we are trying to do in this section is to make applicable to administrative proceedings the same standard that would apply under 18 U.S.C. 2.

MR. DOLE: So really, it would not make any difference if the word "willfully" were moved ahead of the word "commits?"

MRS. PROKOP: As long as it was understood that this is not going to add any requirement beyond what we would have to show in a criminal case. . . .

MR. DOLE: I do not think you are going to proceed unless somebody has willfully done this thing.

MRS. PROKOP: If it is an unknowing action, we would not hold him, certainly.

Proposed Amendments to the Commodity Exchange Act: Hearings on H.R. 11930 and H.R. 12317 Before the House Comm. on Agriculture, 90th Cong., 1st Sess. 66-7 (1967).

¹³⁷ [1975-1977 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶20,201, *aff'd*, [1977-1980 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶20,560 (Feb. 13, 1978).

¹³⁸ *Id.* at XXX. In *Williams*, the secretary prepared and disseminated commodity advisory materials while knowing that her principal was not duly registered with the Commission. Nonetheless, because the secretary's actions were not in willful violation of the law, she was not found guilty of aiding and abetting her employer. *Id.* at XXX.

¹³⁹ 2 COMM. FUT. L. REP. (CCH) ¶21,145 (Jan. 27, 1981).

¹⁴⁰ *Id.* at 26,642.

ployees to engage in what was held to be fraudulent and deceptive violative activities.¹⁴¹

Thus, while section 13(a) liability for engaging in aiding and abetting conduct is clearly applicable to CFTC disciplinary administrative proceedings, it has also been applied by the Commission in private reparation proceedings, and common law aiding and abetting liability has been invoked by district court judges in civil injunctive actions commenced by the Commission. The Commission itself appears to predicate section 13(a) aiding and abetting liability upon a knowing and willful intentional act in furtherance of the primary illegal violator's conduct, necessitating an unlawful and improper motive on the part of the alleged aider and abettor.

CONCLUSION

In its administrative and investigative capacities, the CFTC has engaged in an aggressive enforcement program to protect the public from abuses in the trading of commodity instruments and to insure the integrity of domestic markets.¹⁴² This article has attempted to explore the broad and far-reaching investigative and enforcement powers of the Commission and to examine the administrative procedures and philosophy which the agency has invoked in the short time since its inception in 1974. The Commission has proven not to be the mirror image of the SEC, but has advanced to the forefront of federal regulatory agencies in seeking to invoke procedures for the equitable and efficient administration of the laws which it is charged with enforcing.¹⁴³ Although the Commission has admittedly experienced growing pains,¹⁴⁴ it has nonetheless shown itself to be sensitive to the rights of alleged violators who appear before it while remaining cognizant of its important obligation to expeditiously discipline those per-

¹⁴¹ *Id.* at 26,646.

¹⁴² As an important adjunct to the federal government's efforts to enforce the federal commodities laws, section 6d of the Act, 7 U.S.C. § 13a-2 (1978), enables designated state enforcement officials to enforce the Act and the regulations promulgated thereunder pursuant to the *parens patriae* doctrine.

¹⁴³ See generally Bagley, *Introduction: A New Body of Law in an Era of Industry Growth*, 27 EMORY L.J. 849 (1978).

¹⁴⁴ See, e.g., Smith, *The Commodities Futures Trading Commission and the Return of the Bucketheads: A Lesson in Regulatory Failure*, 57 N.D. L. REV. 7 (1981); the extensive four-part critique of the CFTC in the Washington Post: *How to Save an Agency or Blueprint for Change*, Wash. Post, Oct. 28, 1977, § B, at 6, col. 5; *Critics Urge That CFTC Be Dismantled*, *id.*, Oct. 27, 1977, § D, at 10, col. 1; *Difficulties at CFTC: Both Style and Substance*, *id.*, Oct. 26, 1977, § E, at 1, col. 5; *Commodities Futures Panel Target of Disparate Critics*, *id.*, Oct. 25, 1977 § D, at 7, col. 1.

sons and entities who ignore the standards to which the public expects the industry to adhere.

An examination of the investigative and administrative powers and philosophy of an agency such as the CFTC must necessarily delve both into the realm of procedural administrative law and substantive commodities regulation law. The CFTC exercises both (a) a judicial function, including the imposition of remedial and punitive sanctions, and the interpretation of the commodities laws which it regulates; and (b) a prosecutorial function, including the investigation and enforcement of the Act and the regulations promulgated thereunder.¹⁴⁵ As with similar agencies, this duality creates a difficult tension in terms of practical application. As a former Chairman of the CFTC has critiqued:

One serious structural defect that must be corrected involves the decisional process in adversarial administrative cases. An inherent and pervasive "undue process" exists at the CFTC and all comparable agencies when the Commission itself is rule maker, policeman, grand jury, prosecutor, judge, and jury with *de novo* powers in the same case at virtually the same time. The agency has "heard" your case at least three and perhaps more times before you have a hearing. The minds of men are simply not supple enough to judge a defendant's culpability fairly when vindication and reputation are also at stake in an adversarial proceeding.¹⁴⁶

It is within this context that the Commission will itself be judged and compared with other regulatory bodies. To continue as an effective agency with its own identity, the Commission must maximize enforcement of the Act through its own administrative efforts while maintaining an even-handed and equitable approach which is consistent with the goals underlying the commodities laws.

¹⁴⁵ See M. CARROW, *THE BACKGROUND OF ADMINISTRATIVE LAW* 16 (1948).

¹⁴⁶ Bagley, *supra* note 143, at 851.