IN THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

In Re: KEITH D. BYBEE, SR., and ELEONORE J. BYBEE, dba KEITH BYBEE ENTERPRISES, Debtors.	Docket No. 90-35604
JOHN H. KROMMENHOEK, Trustee Appellant, v. A-MARK PRECIOUS METALS INCORPORATED, A-MARK FINANCIAL CORPORATION, SPIRAL METALS, INC., and UNKNOWN XYZ CORPORATIONS, Appellees.	

BRIEF OF THE COMMODITY FUTURES TRADING COMMISSION, *AMICUS CURIAE*

On Appeal From the United States District Court
for the District of Idaho

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INTEREST OF THE COMMODITY FUTURES TRADING COMMISSION

The Commodity Futures Trading Commission ("CFTC" or "Commission") is the independent federal regulatory agency created to administer and enforce the Commodity Exchange Act ("CEA" or "Act"), 7 U.S.C. § 1, et seq. The CEA provides an exclusive and comprehensive scheme for regulation of commodity futures contracts. Implicit in this mandate is the CFTC's responsibility to ensure that the provisions of the CEA are interpreted in a manner consistent with congressional purposes.

The appellant trustee and the State of Idaho as amicus curiae seek, inter alia, reversal of the district court's holding below that appellee's precious metals "deferred delivery/margin" sales agreement with the debtor retail metals dealer could not be a futures contract solely because the public was not involved. They urge that the lower court's rationale is inconsistent with this Court's seminal opinion in CFTC v. Co Petro Marketing Group, Inc., 680 F.2d 573 (9th Cir. 1982)("Co Petro"). Thus, this appeal raises a fundamental issue under the Act's statutory scheme, namely, whether public involvement is a critical definitional element of a "contract of sale of a commodity for future delivery" within the meaning of Section 2(a)(1)(A) of the CEA, 7 U.S.C. § 2.

As explained below, there is absolutely no support in the CEA, its legislative history, the case law, or Commission pronouncements for the district court's determination that futures contracts between commercials in which the public is not involved are "forward contracts" excluded from CEA jurisdiction. To the contrary, this proposition undercuts the basic regulatory scheme established by Congress, which is predicated on the trading of futures contracts by all persons, including commercials, on federally licensed exchanges as a means to combat fraud and manipulation. Moreover, as the district court's rationale has no support in existing law, its operative effect is to "legislate" an entirely new exception to the prohibition against trading off-exchange futures. As explained below, where Congress has explicitly fashioned certain exceptions to this statutory prohibition, additional exceptions are not to be implied in the absence of evidence of a contrary legislative intent. No evidence exists that Congress intended to permit commercials to trade futures contracts off-exchange; rather, as will also be shown, the precise opposite is true.

For all these reasons, the district court's legal analysis on this point should not be permitted to stand.1/

STATEMENT OF THE CASE 2/

On June 20, 1988, John Krommenhoek, the trustee in bankruptcy for Keith Bybee, a retail metals dealer, filed an adversary proceeding against A-Mark Precious Metals, Inc. ("A-Mark"), a wholesale precious metals dealer, and its affiliated companies.

1/ The Commission takes no view as to which party should ultimately prevail in this appeal.

2/ The facts relied on for purposes of this *amicus* brief are based exclusively on the proposed findings of the bankruptcy court, which in turn were adopted by the district court.

In Count Seven of the complaint, the trustee alleged, inter alia, that A-Mark's so-called "deferred delivery/margin" sales agreements (hereafter referred to as "margin transactions") constituted off-exchange futures contracts sold in violation of the CEA. On that basis, the trustee sought to recover from A-Mark all investments, precious metals, interest and margin calls that Bybee had personally lost in these transactions.3/

After a six-day trial, the bankruptcy court on May 8, 1989 issued proposed findings of fact and conclusions of law. Specifically, the bankruptcy court found the following similarities between A-Mark's margin transactions and futures contracts: 1) a determination of the sales price at the inception of the transaction; 2) a requirement for future delivery of the commodities; 3) use of margin calls to protect the seller; and 4) the right to extinguish the obligation to take delivery by an offsetting sale. It also found some dissimilarities: 1) the agreements were not standardized contracts "of the type used in regulated exchanges;" 2) they were not entered into primarily for speculative purposes as opposed to transfer of ownership of the metals purchased; and 3) the delivery date in the A-Mark contract was not fixed at the time of sale. Slip op. at 11. Ultimately, the court concluded that these contracts were not illegal off-exchange futures

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3/ The trustee also sought another $3 million lost by Bybee's customers. In March 1989, the bankruptcy court granted A-Mark partial summary judgment on Count Seven, ruling that the trustee lacked standing to pursue a claim by Bybee's customers directly against A-Mark. Nonetheless, it permitted the merits of Count Seven to be litigated to the extent that the trustee sought to recover Bybee's personal losses.

because they were not offered to the general public by A-Mark directly or indirectly. Accordingly, it denied the trustee relief on Count Seven.

The trustee then appealed to the U.S. District Court for the District of Idaho. On review, the district court adopted the bankruptcy court's findings, as well as its conclusion that A-Mark's margin transactions were not futures contracts. Its rationale differed, however. The district court found that, unlike forward contract transactions excluded from CEA regulation by Section 2(a)(1)(A) of the Act,4/ the margin transactions with A-Mark did allow Bybee to speculate on the price of silver with a minimal down payment. It also found that, like futures, over 95% of Bybee's margin purchases were offset without delivery.

The district court acknowledged that the foregoing characteristics were normally associated with the trading of futures contracts under the analysis of Co Petro. Nevertheless, the court, relying on an article by a committee of the New York City Bar Association, nevertheless determined that "the congressional intent behind the Commodity Exchange Act was not to regulate transactions between commercial entities." Slip op. at 11,

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4/ Section 2(a)(1)(A) of the CEA, 7 U.S.C. § 2, excludes from regulation "any sale of any cash commodity for deferred shipment or delivery." This is referred to as the "forward contract exclusion," the scope of which this Court considered at length in Co Petro. See 680 F.2d at 577-79. Among other things, this Court observed that "a cash forward contract is one in which the parties contemplate physical transfer of the actual commodity." Id. at 578.

citing The Forward Contract Exclusion: An Analysis of Off-Exchange Commodity-Based Instruments, 41 Bus. Law. 853 (1986). Finding that Bybee was a "commercial precious metals dealer," and that Bybee's transactions with A-Mark were for his own account only, the court further concluded that the margin transactions "have all the indications of futures contracts save one: the public was not involved." Slip op. at 11. Because of this, the district court determined that A-Mark's margin sales were not futures contracts, and thus fell within the forward contract exclusion of section 2(a)(1)(A).

ARGUMENT

THE DISTRICT COURT ERRED AS A MATTER OF LAW IN CONCLUDING THAT PUBLIC INVOLVEMENT IS AN ESSENTIAL ELEMENT OF A FUTURES CONTRACT.

A. Neither The Commodity Exchange Act Nor The Case Law Establishes That Public Involvement Is A Necessary Element Of A Futures Contract.

The CEA grants to the CFTC exclusive jurisdiction over "accounts, agreements and transactions involving contracts of sale of a commodity for future delivery traded or executed on a contract market . . . ." 7 U.S.C. § 2.5/ However, the term "contract of sale of a commodity for future delivery" is not

5/ Futures contracts may be traded lawfully only on or subject to the rules of exchanges designated as contract markets by the CFTC. 7 U.S.C. § 6(a).

specifically defined in the Act.6/ Accordingly, to determine whether a particular instrument constitutes a futures contract, the courts and the CFTC have looked to the legislative history of the CEA, judicial and CFTC case law, and agency interpretations.

As this Court has observed, there is "no bright-line definition or list of characterizing elements" which determines what constitutes a futures contract. Co Petro, 680 F.2d at 581. Rather, the transaction must be "viewed as a whole with a critical eye toward its underlying purpose." Id. Nonetheless, both the courts and the CFTC have recognized certain elements common to such contracts. In general, futures contracts encompass transactions for the purchase or sale of a specified amount of a commodity, with payment and delivery in the future at a price established when the contract is entered into. While satisfaction of a futures contract may occur either by delivery or by entering into an offsetting transaction, in practice most contracts are settled by offset. Moreover, futures contracts are undertaken principally to assume (speculate) or to shift (hedge) the risk of price change without transferring title to (and without making cr taking delivery of) the underlying commodity.7/

6/ On the other hand, the term "commodity" is defined in the CEA. In addition to traditional agricultural products, it embraces "all other goods and articles, ... and all services, rights, and interests in which contracts for future delivery are presently or in the future dealt in . . . ." 7 U.S.C. § 2.

7/ See, e.g., Co Petro; NRT Metals, Inc. v. Manhattan Metals (Non-Ferrous) Ltd., 576 F. Supp. 1046 (S.D.N.Y. 1983); CFTC v. National Coal Exchange, Inc., [1980-1982 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,424 at 26,046 (W.D. Tenn. 1982); CFTC v. Commercial (continued...)

In addition, there are identifiable characteristics which, while not considered essential, serve to facilitate the trading of futures contracts on exchanges. These include standardized commodity units, margin requirements related to price movements, clearing organizations which guarantee counterparty performance, open competitive trading in centralized markets, and publicly disseminated prices. Leverage Interpretation, 50 Fed. Reg. at 11657, n.2; see also Hybrid Interpretation, 52 Fed. Reg. at 47023.

As shown above, "public involvement" has never been identified in the case law as an essential element of a futures contract.8/ Nor has any case or CFTC pronouncement ever held that the absence of public involvement transforms a futures contract

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7/(...continued)
Petrolera Internacional, S.A., [1980-1982 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,222 at 25,088 (S.D.N.Y. 1981); In re First National Monetary Corp., [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,698 at 30,970 (CFTC 1985); In re Stovall, [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,941 at 23,775 (CFTC 1979)("Stovall"); OGC Interpretative Statement (Characteristics Distinguishing Cash and Forward Contracts and "Trade" Options), 50 Fed. Reg. 39656 (Sept. 30, 1985); and OGC Statutory and Regulatory Interpretation (Regulation of Leverage Transactions and Other Off-Exchange Future Delivery Type Instruments), 50 Fed. Reg. 11656 (Mar. 25, 1985)("Leverage Interpretation"); see also, Advance Notice of Proposed Rulemaking, "Regulation of Hybrid and Related Instruments," 52 Fed. Reg. 47022, 47023 (Dec. 11, 1987)("Hybrid Interpretation").

8/ In Stovall, the Commission cited Stovall's tactics of marketing to the public as contrary to cash forward practices. Instead, it characterized such marketing as one of the "earmarks of an undesignated futures operation." [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,941 at 23,778. However, the Commission has never stated that public involvement per se is essential to a finding that an instrument is a futures contract. See also note 18, infra.

into a forward contract excluded from CEA coverage. Accordingly, it was clearly legal error for the district court to have concluded that a transaction having all the indications of a futures contract under Co Petro, but lacking public involvement, was therefore a forward contract rather than a futures contract.

B. The Injection Of A Requirement Of Public Involvement Into The Definition Of A Futures Contract Is At Odds With The Congressional Scheme For Futures Regulation.

Section 4(a) of the CEA, 7 U.S.C. § 6(a), requires that all futures transactions by "any person" be executed by or through a member of an exchange that has been designated by the CFTC as a contract market. Stated another way, the statute on its face does not except commercial entities from the requirement that futures contracts be traded on CFTC-designated "contract markets," *i.e.*, licensed exchanges. This is important because Congress is fully aware that futures traders fall into two general classifications, namely, hedgers and speculators, and that hedgers are commercial traders:

> Broadly speaking, futures traders fall into two general classifications, *i.e.* 'trade' hedging customers, and speculators. All orders which reach the trading floor originate with one or the other group of traders. The 'trade' customer is the hedger who seeks, at low cost, to protect himself or his company against possible loss due to adverse price fluctuations in the market place. Speculators, on the other hand, embrace all representatives of the general public, including some institutions, plus floor scalpers and position traders, who seek financial gain by taking positions in volatile markets. The principal role of the speculator in the markets is to take the risks that the hedger is

> unwilling to accept. The opportunity for profit makes the speculator willing to take those risks.

H.R. Rep. No. 975, 93d Cong., 2d Sess. 138 (1974).9/ More to the point, Congress has gone to great lengths for almost 70 years to ensure that commercial hedgers confine their futures trading activities to regulated futures exchanges.

Since 1922, Congress has consistently recognized the importance of commercial participation in futures transactions. In that year, it enacted the Grain Futures Act ("GFA")(predecessor to the CEA).10/ Section 3 of the GFA (now codified largely verbatim in section 3 of the CEA, 7 U.S.C. § 5) expressly acknowledged the substantial involvement of commercials as well as the public in futures trading:

> Transactions in grain involving the sale thereof for future delivery as commonly conducted on boards of trade and known as "futures" are affected with a national public interest; that such transactions are carried on in large volume by the public generally

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9/ As the Supreme Court has also observed, hedgers are "those interested in selling or buying the commodity [and] . . . their primary financial interest is in the profit to be earned from the production or processing of the commodity." Merrill Lynch, Pierce, Fenner & Smith v. Curran, 456 U.S. 353, 359 (1982). "Of course, when a hedger takes a long or a short position that is greater than its interest in the commodity itself, it is to that extent no longer a hedger, but a speculator." Id.

10/ Pub. L. No. 67-331, 42 Stat. 998 (1922). Enacted as an exercise of authority under the Commerce Clause, the GFA was essentially a recodification of the Futures Trading Act of 1921, Pub. L. No. 67-66, 42 Stat. 187, which had been declared unconstitutional in Hill v. Wallace, 259 U.S. 44 (1922), as an invalid exercise of the taxing power. The constitutionality of the GFA was upheld in Chicago Board of Trade v. Olsen, 262 U.S. 1 (1923).

> and by persons engaged in the business of buying and selling grain and the products and by-products thereof in interstate commerce; that the prices involved in such transactions are generally quoted and disseminated throughout the United States and in foreign countries as a basis for determining the prices to the producer and the consumer of grain and the products and by-products thereof and to facilitate the movements thereof in interstate commerce; that such transactions are utilized by shippers, dealers, millers, and others engaged in handling grain and the products and by-products thereof in interstate commerce as a means of hedging themselves against possible loss through fluctuations in price.

(Emphasis added.)

The GFA was designed to eliminate bucket shop operators and to curb excessive speculation and manipulation in the grain futures markets by prohibiting all futures contracts not executed by or through members of a contract market, regardless of the type of participant. GFA, § 4.11/ In taking this approach, Congress recognized the legitimacy and commercial necessity of commodity futures trading, but chose to allow it to continue only

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11/ In section 2(a) of the GFA, Congress provided an exception for contracts (commonly known as "forwards") calling for actual delivery in the future, by specifying that the term "'future delivery' . . . shall not include any sale of cash grain for deferred shipment or delivery." This provision, which has undergone very minor changes since 1922, is codified today in section 2(a)(1)(A) of the CEA. The GFA also excluded future delivery-type transactions by owners and growers in grain but, as this Court observed in Co Petro, this exclusion likewise was intended only to permit forward contracts by owners and growers, and did not apply to futures contracts by these entities. See 680 F.2d at 578. When Congress enacted the CEA in 1936, the "owner/grower" exception was repealed as redundant because of the forward contract exclusion. Id.

in a strictly controlled environment, namely, on regulated exchanges.

Moreover, legislative efforts in this area since 1922 have been specifically directed at preserving a substantial commercial presence in the regulated futures markets. In 1936, Congress enacted the Commodity Exchange Act, which extended the futures regulatory scheme of the GFA to other specified commodities, and for the first time granted the Secretary of Agriculture (the CFTC's predecessor) authority to impose limits on the number of futures contracts that could be held at any one time by speculative traders.12/ Also at this time, Congress manifested its desire to maintain substantial commercial involvement in the futures markets by exempting from those speculative position limits "bona fide hedging transactions" by commercial traders. See Section 4a(3) of the CEA, 49 Stat. 1493 (1936).13/

12/ Pub. L. No. 74-675, 49 Stat. 1491, § 5 (1936), codified in section 4a(1) of the CEA, 7 U.S.C. § 6a(1).

13/ In 1936, Congress explicitly defined "bona fide hedging transactions" to mean:

> sales of any commodity for future delivery on or subject to the rules of any board of trade to the extent that such sales are offset in quantity by the ownership or purchase of the same cash commodity, or, conversely, purchases of any commodity for future delivery on or subject to the rules of any board of trade to the extent that such purchases are offset by sales of the same cash commodity.

Congress subsequently amended this provision by repealing the definition and granting the CFTC the authority to define "bona fide hedging." See Section 4a(3) of the CEA, 7 U.S.C. § 6a(3) (1982).

When it enacted the Commodity Futures Trading Commission Act in 1974,14/ Congress further clarified that an overriding purpose of lawful futures trading was to facilitate hedging and price basing by commercial users and handlers of commodities.15/ The 1974 Act vested in the new CFTC exclusive regulatory jurisdiction over futures trading, including the authority to grant or deny applications by exchanges to trade new futures contracts. In the same legislation, Congress also imposed a new requirement that exchanges demonstrate in such applications "that transactions for future delivery in the commodity for which designation as a contract market is sought will not be contrary to the public interest." Section 5(g) of the CEA, 7 U.S.C. § 7(g).

Significantly, the legislative history of Section 5(g) reveals that the degree of commercial participation in a futures contract is a critical factor for the Commission to weigh in determining whether to grant or revoke designation. The House Report explains that the "public interest" showing under section 5(g) must include a demonstration by an exchange of an "economic justification" for a futures contract, and that this obligation

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14/ Pub. L. No. 93-463, 88 Stat. 1389 (1974). Relevant provisions of this legislation are generally cited as they appear in particular sections of the "Commodity Exchange Act," as amended.

15/ Price basing occurs when producers, processors, merchants or consumers of a commodity establish commercial transaction prices based on the futures prices for that or a related commodity (e.g., an offer to sell corn at 5 cents over the December futures price).

can be met only by establishing that the contract would be used by commercial interests for hedging or price basing on more than an occasional basis. H.R. Rep. No. 975, 93d Cong., 2d Sess. at 29 (1974).16/ Equally significant, the Report reveals that section 5(g) was intended to give the CFTC necessary authority to deny or revoke contract market designation to an exchange if, among other things, "the contract or proposed contract is, or can be expected to be, used entirely or almost entirely for speculation." Id.17/

In sum, Congress' legislative efforts over the past 70 years have consistently reflected its desire to regulate futures transactions by and between commercial entities. For this reason, the district court's conclusion that "the congressional

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16/ See also Guideline No. 1, Comm. Fut. L. Rep. (CCH) ¶ 6146 (revised November 3, 1982), in which the Commission has further expounded upon these requirements.

17/ This is not to suggest that speculative trading does not play a crucial role in the efficient operation of a futures market. As Congress and the Supreme Court have observed:

> The activity of speculators is essential to the composite bids and offers of large numbers of individuals that tend to broaden a market, thus making possible the execution with minimum price disturbance of large trade hedging orders. . . . Without the trading activity of the speculative fraternity, the liquidity, so badly needed in futures markets, simply would not exist. Trading volume would be restricted materially since, without a host of speculative orders in the trading ring, many larger trade orders at limit prices would simply go unfilled due to the floor broker's inability to find an equally large but opposing hedge order at the same price to complete the match.

Merrill Lynch, Pierce, Fenner & Smith v. Curran, 456 U.S. 353, 359 n. 11 (1982), *quoting*, H.R. Rep. No. 975, 93d Cong. 2d Sess. 138 (1974).

intent behind the [CEA] was not to regulate transactions between commercials" cannot be sustained.

C. The District Court's Analysis Improperly "Legislates" An Exception To The General Statutory Prohibition Against Off-Exchange Futures Trading.

The district court applied this Court's analysis in Co Petro to A-Mark's margin transactions and found them to "have all the indications of futures contracts save one: the public was not involved." Slip op. at 11. However, as already shown, public involvement has never been recognized as an essential element in the definition of a futures contract under Co Petro or any other authority.18/ And, as noted, the district court has held, based entirely on a bar association committee article in a business law journal, that "the congressional intent behind the Commodity Exchange Act was not to regulate transactions between commercial entities." Id. But, as just shown, regulation of futures transactions involving commercial entities has been a hallmark of the congressional scheme for almost seventy years. Thus, as neither of the district court's justifications can be sustained, the operative effect of the district court's analysis is to create a new exception to the general prohibition against

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18/ Although this Court in Co Petro did focus on "marketing to the public," its analysis of that factor was confined to the question of whether the gasoline contracts there were forward contracts excluded from CEA jurisdiction. 680 F.2d at 578-79. Because the Court found that Co Petro's "customers were, for the most part, speculators from the general public," id. at 578, it concluded that these transactions were not cash forwards.

off-exchange trading for futures contracts in which the public is not a participant.

The Supreme Court has admonished against similar efforts to fashion new exceptions to such general statutory prohibitions:

> Where Congress explicitly enumerates certain exceptions to a general prohibition, additional exceptions are not to be implied, in the absence of evidence of a contrary legislative intent.

Andrus v. Glover Construction Co., 446 U.S. 608, 616-17 (1980). Further, the Court has made clear that even appeals to the ends of justice or remedial purposes of a statute cannot otherwise justify judicial lawmaking: "The ultimate question is one of congressional intent, not one of whether this Court thinks it can improve upon the statutory scheme Congress enacted into law." Touche Ross & Co. v. Redington, 442 U.S. 560, 578-79 (1979).

The history of futures regulation confirms that when Congress has intended to exclude from CEA jurisdiction commodity-related transactions solely between commercial participants, it has done so explicitly. The forward contract exclusion is one example.19/ Another is the so-called "Treasury Amendment" in section 2(a)(1)(A) of the Act enacted by Congress in 1974 to specifically provide that "[n]othing in this Act" is intended to apply to transactions in foreign currency, government securities, or mortgages and mortgage purchase commitments, and other financial instruments, unless they occur on formally organized ex-

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19/ See notes 4 and 11, supra.

changes. In deliberately carving out these transactions, Congress recognized that

> virtually all futures trading in foreign currencies in the United States is carried out through an informal network of banks and dealers. This dealer market, which consists primarily of the large banks, has proved highly efficient in serving the needs of international business in hedging the risks that stem from foreign exchange rate movements . . . .

S. Rep. No. 1131, 93d Cong., 2d Sess. 49-50 (1974).20/ See also CFTC v. American Board of Trade, 803 F.2d 1242, 1248-49 (2d Cir. 1986); Trading in Foreign Currencies, 50 Fed. Reg. 42983 (1985). Congress' previous readiness to carve out explicit exclusions or exceptions from the off-exchange futures prohibition where warranted is further evidence that it has not intended to create the exception applied by the district court. Andrus, 446 U.S. at 616-17. Accordingly, this Court should disavow the judicial exception created by the court below for futures transactions by and between commercial participants.

20/ Congress further demonstrated that CEA regulation was unnecessary because this informal market is subject to supervision by the bank regulatory agencies:

> The Committee believes that this market is more properly supervised by the bank regulatory agencies and that, therefore, regulation under this legislation is unnecessary. Likewise, the Committee believes that regulation by the Commission of transactions in the specified financial instruments . . . . which generally are between banks and other sophisticated institutional participants, is unnecessary, unless executed on a formally organized futures exchange.

Id. at 23.

CONCLUSION

The district court's holding that public involvement is an essential element of a futures contract is incorrect as a matter of law and contrary to congressional intent. Accordingly, it should not be permitted to stand.

Respectfully submitted,

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