Federal Regulation of Foreign Currency Trading for Future Delivery on Interbank and Futures Markets

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INTRODUCTION

Contracts for the future delivery of foreign currencies are the basis of a rapidly expanding business. Such contracts are of two

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1. Daily trading of currency futures on the commodity futures exchanges often approaches $1 billion. Daily trading of forward exchange on the interbank market often ex-
types, forward and future. Both are purchased, sold, and traded in markets by a variety of participants, including hedgers, speculators, arbitrageurs, and market-makers. The forward market consists primarily of banks trading for their own account or for the accounts of customers, in what has come to be called the "interbank" market. The futures market consists primarily of participants trading on the organized commodity futures exchanges located in Chicago, New York, and London.

Contracts for the delivery of foreign exchange in the future are subject to regulation by official U.S. government agencies in various ways. A bank with international dealings must report all currency transactions within certain limits to the Federal Reserve Board. Any enterprise or individual who trades futures on one of the organized exchanges is subject to regulation by the Commodity Futures Trading Commission. And finally, any business association or individual who realizes a gain or loss on a forward or futures transaction will be subject to the rules and regulations promulgated and enforced by the Internal Revenue Service. This article examines the free-market mechanisms of trading in foreign currency for future delivery and evaluates the governmental regulations that relate to such trading.

I. MARKET MECHANISMS

The free-market mechanisms of trading in foreign currency for future delivery will differ depending upon whether the trading is done on the interbank market or on one of the organized commodity futures exchanges. The principles and motivations governing such trading will remain the same, however, regardless of the market in which trading takes place.

A. Forward and Future Contracts Distinguished

Forward contracts are purchased and sold on the interbank market. One party to the contract seeks to purchase foreign currency at a certain point in the future and the other party seeks to sell foreign currency at some point in the future. In most circumstances, one party to the contract is an international bank and the other party a customer of the bank. Both parties negotiate the exchange rate that will apply on the date when the contract matures, although the price ranges will approximate the international mar-

ceeds $50 billion. See The Influence of the IMM, Euromoney, Jan. 1980, at 89.
ket's expectation of what the exchange rate will be. Most contracts provide that either party may assign its rights, duties, and obligations on the contracts. If the contracts are held to maturity, the party on the selling side must deliver the currency at the agreed exchange rate to the party on the buying side. The buyer must in turn deliver the currency due to the seller. In the actual operation of the interbank market, most deliveries take the form of a debit or credit on the customer's account with the bank.

Futures contracts are purchased and sold on one of the organized commodity futures exchanges. The contracts are of standard amount and duration. The contracts available on the International Monetary Market of the Chicago Mercantile Exchange, for example, are set in units of 25,000 British pounds, 100,000 Canadian dollars, 12.5 million Japanese yen, 125,000 Swiss francs, or 125,000 Deutsche marks with expiration dates of December, March, June, or September. Parties that trade futures contracts rarely intend to deliver or accept delivery on the contracts and, correspondingly, less than one percent of such contracts ever result in delivery. The organized exchanges are highly competitive and thus the spread between the bid and ask prices tends to be less than on the interbank market. Also, because contracts are standardized, the commissions charged in the futures markets are less than the commissions charged on the interbank market.

B. Transactions on the Interbank Market

Exchange rates in foreign currency markets fluctuate daily (and often violently) in response to changes in world economic conditions, changes in expectations regarding those conditions, and the vagaries of supply and demand. Many large banks have an international division trading in foreign currencies on the spot market, which is the current day-to-day market for immediate delivery.

2. CHICAGO MERCANTILE EXCHANGE, UNDERSTANDING FUTURES IN FOREIGN EXCHANGE 5 (1979).
3. Id. See also R. CONINX, FOREIGN EXCHANGE TODAY 10 (1978).
4. CHICAGO MERCANTILE EXCHANGE, UNDERSTANDING FUTURES IN FOREIGN EXCHANGE 8 (1979).
5. See Wall St. J., daily at 46.
6. G. GOLD, MODERN COMMODITY FUTURES TRADING 51 (1975). The vast amount of contracts are traded prior to maturity. When delivery is demanded, however, it is the duty of the clearing house to effect such delivery.
7. CHICAGO MERCANTILE EXCHANGE, UNDERSTANDING FUTURES IN FOREIGN EXCHANGE 8 (1979).
Larger banks engaged in multinational banking have entire separate and distinct foreign exchange departments with specialists who act as dealers in forward exchange contracts. These dealers serve as market-makers by continuously executing forward contracts for multinational corporations, other banks, and speculators. The supply and demand for these forward contracts results from the basic market operations of hedging, speculation, and arbitrage. Each of these operations must be examined for a complete understanding of the mechanisms of the interbank market.

1. Hedging

Hedging in the forward exchange context is practiced by multinational corporations (MNCs) and other business entities that are exposed to gains and losses caused by changes in the exchange rates of the currencies in which they deal. Such exposure may arise in two different situations; the exposure may be either in the form of a "transaction exposure," whereby the entity is exposed to actual gains and losses, or a "translation exposure," whereby the entity is exposed to accounting gains and losses. To reduce the effects of exposure, MNCs will often enter a forward exchange contract, thereby creating a forward position in the foreign currency.

a. Hedging to Offset Transaction Exposure

Transaction exposure refers to potential gains or losses which arise when an MNC is faced with the settlement of transactions whose terms are stated in a foreign currency. An MNC may face a potential loss when its actual obligations increase or its actual receivables decrease due solely to fluctuations in exchange rates.

To take a simple example, consider a U.S. MNC which has ordered some wool cloth from a British manufacturer. The arrangement specifies that a 100,000 British pound payment will be made on delivery of the wool in three months. The exchange rate on the order date is 1 pound = $2.00. The MNC thus has an obligation to

10. Some commentators refer to a general "economic exposure" which includes "transaction exposure" as one type of economic exposure. D. Eiteman & A. Stonehill, Multinational Business Finance 76 (2d ed. 1979) [hereinafter cited as Eiteman]. This article refers only to exposure known as "transaction exposure."
11. Eiteman, supra note 10, at 77. Some commentators refer to "translation exposure" as "accounting exposure." A. Shapiro, FOREIGN EXCHANGE RISK MANAGEMENT 1-27 (1978). This article uses only the term "translation exposure."
12. Eiteman, supra note 10, at 78.
deliver 100,000 pounds, which is the equivalent of $200,000 at current exchange rates.

If, after three months, the pound has appreciated to 1 pound = $2.25, the MNC will have to deliver $225,000 in order to purchase the 100,000 pounds necessary to pay for the wool. Thus, the MNC's cost will have increased by $25,000. On the other hand, if the pound depreciates to $1.75, the MNC will only have to deliver $175,000, and will gain $25,000.

If the MNC believes that it is likely that the pound will appreciate, it can hedge against this loss exposure by entering into a contract with an international bank to buy 100,000 pounds in three months. The exchange rate for the forward contract might be 1 pound = $2.00. Suppose the MNC actually enters into a forward contract to purchase 100,000 pounds in three months. When the wool is delivered, the MNC can make payment of $200,000 to the bank and take delivery of the 100,000 pounds due on the contract. The 100,000 pounds would then be used to pay for the wool. If the actual spot exchange rate at delivery is 1 pound = $2.25, it will not matter to the MNC because it has contracted at 1 pound = $2.00.

A financially equivalent alternative would be for the MNC to sell the contract prior to the specified delivery date and to purchase the pounds sterling in the spot market. If the spot rate at expiration of the contract is 1 pound = $2.25 and the contract is for 1 pound = $2.00, then the contract is worth ($2.25 - $2.00) x 100,000 = $25,000. If this alternative is chosen, the MNC will have to purchase 100,000 pounds in the spot market at 1 pound = $2.25, a price $25,000 greater than would have been paid had the MNC taken delivery on the contract. The net effect of the $25,000 gain on the sale of the forward contract and the $25,000 loss due to the $25,000 increase in the spot rate is that the MNC is able to fix the exchange rate at $2.00 per pound on the date when it contracted to purchase the wool. The sale of the contract and the taking of delivery on the contract are financially equivalent, and both have the desired result of effectively hedging against the exposure to loss which arose solely because of the fluctuating exchange rates.

13. This is called "buying forward pounds" or "selling forward dollars."

14. Actually, if the market anticipates the appreciation, the pound may be selling at a forward premium, i.e., the forward exchange rate could be above the spot exchange rate. In this case the forward rate might be 1 pound = $2.05 and it would cost the MNC a $5,000 forward premium in order to hedge the risk of loss of a depreciating pound. In the extreme case where the market fully anticipates the appreciation, there would be no advantage to arbitraging.
Similarly, an MNC may also be exposed to a loss because it has receivables due in a foreign currency which is expected to depreciate. Consider the situation faced by a U.S. MNC engaged in coffee production through its Columbian subsidiary, Columbia Coffee House (CCH). Suppose CCH has dividends payable to its U.S. parent on a quarterly basis in Columbian pesos. The U.S. parent is exposed to a loss in the transaction which will arise if the value of the peso depreciates relative to the dollar before the dividend is due. To hedge against this potential loss, the parent could create a short position in pesos by contracting with an international bank to sell pesos in an amount approximating the amount receivable on the date when CCH is expected to pay the dividend. If the exchange rate indeed declines, the MNC would have protected itself against loss by being able to sell the pesos it received for a dollar amount which reflected the higher rate of three months before.

b. Hedging To Offset Translation Exposure

Translation exposure refers to the impact of exchange rate fluctuations upon the recorded economic position of a business. Such exposure occurs for a U.S. MNC when it must translate its foreign-denominated assets and liabilities into a dollar value for bookkeeping and other reporting purposes. The rules of translation applicable to U.S. MNCs are specified in the Financial Accounting Standards Board’s Rule 8. These rules generally require that current assets and liabilities be translated at the current exchange rate and that all resultant gains or losses be reflected in income. Many MNCs will hedge against possible translation losses by entering into an appropriate forward exchange contract.

Suppose in the examples discussed above that CCH obtained a short-term Eurocurrency loan denominated in French francs. When the U.S. parent reports its consolidated financial statements,

15. Etteman, supra note 10, at 77.
18. See Banks Cash in on FASB-8, BUS. WEEK, Dec. 6, 1976, at 104. "Gyrating foreign exchange rates and the accounting gymnastics required by Rule 8 of the Financial Accounting Standards Board may be creating havoc for U.S. corporations that do business abroad but the nation’s big commercial banks are profiting handsomely." Id.
the franc-denominated liability must be translated into units of dollars at the current exchange rate. If the franc appreciates from the time CCH incurs the obligation to the time the U.S. parent must report, the value of the liability will increase and the U.S. parent will have sustained a paper loss which will flow through to the income statement.

The U.S. parent may hedge against this translation exposure to loss by creating an offsetting position in francs. As soon as the parent anticipates the appreciation of the franc, it will create a long position in francs by contracting with an international bank to purchase an amount of francs equal to its franc-liability on the date when the financial statement must be reported. If the franc does indeed appreciate, the MNC will have gained an amount on the contract approximately equal to the loss it sustained on its books.

The same hedging technique can be applied to offset exposure from a translation of the current asset value of the U.S. parent's overseas properties. Normally, CCH's cash account and accounts receivable would be valued in pesos for purposes of Columbia's tax laws. When the parent reports its consolidated financial statement, it must value these current assets in terms of dollars based upon the current exchange rate. If the peso depreciates relative to the dollar in the period between reporting dates, the parent's financial statements will reflect a paper loss due to the translation of its current assets into dollars. As in the case of liabilities, the MNC may enter a forward transaction to offset the potential effect of this translation loss. The relevant transaction is for the parent to create a short position in Columbian pesos by contracting to sell pesos in the amount of its exposed assets near the date when its financial statements are due. If the parent has correctly anticipated the depreciation of the peso, it will realize a gain on the transaction. It will be selling pesos at a rate which commands more dollars than the spot rate. This gain will typically be sufficient to offset the loss due to the translation exposure of CCH's peso-denominated current assets and the parent will have successfully hedged.

2. Speculation

The second basic market operation which affects the supply and demand for forward exchange contracts is speculation. Speculation is generally engaged in by sophisticated individuals or institutions with a strong financial base who are willing to take risks on exchange rate fluctuations that hedgers are unwilling to take. As
such, speculators play a very significant role in the forward exchange market. Banks will often trade for the account of speculators since the generally accepted policy of most international banks is to avoid large "open" positions in a given currency.\textsuperscript{19}

An international bank is exposed to an open position in a currency when the bank enters a forward contract with a customer which is not offset by another contract. Banks will normally have enough customers so that a party taking the opposite side of the transaction can be found. Large international banks with sophisticated currency trading operations have so many customers in the countries whose currencies they specialize in that there is no shortage in either the supply of currencies or the supply of willing buyers and sellers. A large bank with branches or correspondent banks located in France and Columbia, for instance, will be in continual contact with many banks and businesses in both countries. Thus, in the 1(b) example above, after CCH had contracted with the bank to purchase francs forward, the bank would quickly attempt to locate another customer who needed to sell francs at approximately the same date.\textsuperscript{20} The role of the speculator is highlighted at this point. If the bank cannot find a customer who desires a forward contract for hedging purposes, it is quite likely that it will be able to find a customer who desires a forward contract for speculative purposes.

In times of crisis, the role of the speculator is absolutely essential to the functioning of the system and to the bank's ability to hedge its exposure and thereby protect what may be many outstanding open positions. Speculators tend to move in and out of forward contracts very quickly, often well before the contracts mature, and as a result lend a great deal of liquidity to the market. By rapidly turning over many contracts in both directions, speculators often achieve significant gains (or losses) in a short amount of time (days to months). Most large banks appreciate the role of speculators and will trade for their account as long as the speculative trading itself doesn't result in too large a risk to the bank's position in a given currency.\textsuperscript{21}

\textsuperscript{19} R. Coninx, supra note 8, at 38-39.

\textsuperscript{20} For instance, if the bank executes a contract to deliver 1,000,000 francs to a customer in three months for dollars, an offsetting contract would exist if it also had a contract to take delivery of 1,000,000 francs in three months.


The banks are, of course, not the only market-makers. Multinational as well as international trading companies operate from time to time in the market on a
3. Arbitrage

Arbitrage is the third basic market operation which contributes to the supply and demand of the forward exchange market. In its most general sense, arbitrage is the simultaneous purchase and sale of a single commodity in two different markets so as to take advantage of price differentials. Market participants engaged in arbitrage use forward contracts to arbitrage interest rate differentials between different countries. Indeed, it is the actions of arbitrageurs which keep exchange rates within small fractions of each other in markets which are geographically dispersed around the world. When arbitrage opportunities are available, the profit is typically locked in and certain at the time the trades are undertaken.

Covered interest arbitrage is a special kind of arbitrage. Suppose three-month interest rates are fourteen percent in the U.S. and twenty percent in Columbia. A U.S. investor seeking to take advantage of this differential could purchase pesos in the spot market and invest them in a three-month Columbian Treasury issue. Simultaneously, he could enter the forward market and sell pesos for dollars three months in the future. When the Columbian bill matures, he would take his money plus twenty percent interest, deliver on the forward contract, and receive the dollars due him. His gain due to the arbitrage transaction would be equal to a six percent return.

R. Coninx, supra note 8, at 40-41. A large open position may quickly result in the failure of a bank with large foreign currency dealings. For a brief account of one such failure, Germany’s Herstatt Bank, see J. Baker, International Bank Regulation 15, 25 (1978).


23. Note that Reimann refers to covered interest arbitrage as international interest arbitrage. Id. at 434.

24. An interesting sidelight is that the actions of arbitrageurs in the case of covered interest arbitrage will cause one of the currencies to sell at a forward discount equal to the interest differential, eliminating the arbitrage opportunity. In this case, the actions of arbitrageurs selling forward pesos would cause it to sell at a six percent forward discount, i.e., one would receive six percent fewer dollars for pesos in the forward market than in the spot market. This would eliminate the Columbian interest advantage. Interest rates sometimes fluctuate rather violently, giving rise to interest arbitrage during the time it takes forward markets to adjust.
Arbitrage is generally engaged in by MNCs or other large business entities which seek to earn some extra return on their investments of short-term funds. Banks routinely accommodate such transactions for their customers.

C. Transactions on the Organized Exchanges

The principles involved in trading currency futures on the organized exchanges in Chicago and New York are much the same as the principles involved in the trading of forward exchange contracts by banks and their customers in the international market. The exchange market is composed of parties engaged in the same operations of hedging, speculation, and arbitrage. A major difference between the two markets is that the commodity futures exchanges involve a much greater proportion of speculators. The organized exchanges publicly encourage speculation, whereas the banks quietly accept it. In the organized exchanges, hedgers are able to find the speculators who are willing to take the unattractive side of a transaction.

A commodity futures exchange operates in much the same manner as a stock exchange, although there are significant differences. Each futures exchange has its own clearing association, the primary purpose of which is to assure the trader that any contract can be liquidated at any time and that the obligations of the contract will be fulfilled even if the party on the other side of the contract has gone bankrupt. Every member of the clearing house association owns a seat on the exchange, but not all seat owners are clearing house members. Ownership of a seat entitles a party to have a broker trading on the floor of the exchange and to pay lower commission rates than nonmembers. All seat owners, however, must deal through a clearing house member.

A clearing house member must conform to rigid financial and professional qualifications. When the day’s trading session ends, the floor brokers exchange trading slips confirming their transactions and the slips are sent to the clearing house members who did the trading. The transactions are tallied by each member and sent to the clearing house. The clearing house then substitutes itself as

26. Id.
27. See G. Gold, supra note 6, at 51.
28. Id.
the opposite party in every single transaction. Thus, each day’s purchaser or seller becomes obligated solely to the clearing house and may liquidate the contract through normal trading procedures at any time.\(^{29}\)

Performance on all contracts is guaranteed by the clearing house through its financial relationship with its members and their customers. An original margin deposit is required on each long and short position of each member. At the close of every trading day, variation margin must be paid by each member of any net contract outstanding on which there has been a loss.\(^{30}\) Finally, a guarantee fund is established from the contributions of each clearing house member which serves as recourse in the event that a member fails due to its inability to fulfill the contractual obligations.

An individual speculator or hedger usually obtains a futures contract by entering a margin agreement with a brokerage house.\(^{31}\) The brokerage house in turn contacts a dealer on the floor who finds a willing purchaser or seller. The margin agreement stipulates that the customer’s position will be liquidated in the event that the customer is unable to meet a margin call.\(^{32}\) If a customer is unable to fulfill his obligation, the brokerage house is liable on the contract for any further margin call. If the brokerage house fails to meet the margin call, the contract is entirely liquidated.\(^{33}\)

Speculators on commodity exchanges assume great risks. The potential losses and gains are phenomenal compared to those possible on the stock exchanges.\(^{34}\) In times of crisis, trading is hectic and successive margin calls not met may result in the liquidation of thousands of contracts.\(^{35}\) The exchanges attempt to limit the traders’ overall exposure by limiting the daily fluctuations of the

\(^{29}\) Id.

\(^{30}\) Id. at 53. Variation margin is set as a percentage of initial margin. The customer’s equity position is equal to the capital he has deposited plus any net unrealized gain or losses on the contracts he has purchased or shed. When the equity falls below the variation margin the customer is required to deposit sufficient additional capital to increase his equity position to the initial margin requirements.

\(^{31}\) Id. at 52.

\(^{32}\) Margin rates currently stand at eight percent.

\(^{33}\) G. Gold, supra note 6, at 52.

\(^{34}\) This is because margin requirements are very low compared to those of the stock market. Commodity futures margins are typically in the range of 5% to 10%, whereas stock margins run between 50% to 100%. Because of the far lower margins, financial leverage and thus risk are greatly increased.

price of a given commodity to a set maximum. As of this date, trading in currency futures has avoided chaos. However, it is significant to note that there has been no major international currency crisis since the trading first began in Chicago on May 16, 1972. In the event that there is such a crisis, the effectiveness and stability of the currency futures markets will be tested.

II. IRS Regulation

Trading in foreign currency for future delivery is indirectly regulated by the U.S. Internal Revenue Service. The tax treatment afforded each transaction can serve as an incentive or disincentive to the original making of the contract, regardless of whether a forward exchange or currency futures contract is involved. The legal principles that are applied to the gains and losses generated in either case are basically the same. However, the application of these principles will vary depending upon whether the trading was done with a hedging or a speculative or investment purpose. This differing treatment can be illustrated by examining the application of tax principles to transactions arising in international commercial dealings, international bank dealings, and trading on the organized exchanges.

A. Commercial Transactions

Administrative pronouncements and judicial rulings on the taxation of the forward exchange operations undertaken in international commercial dealings are scarce. As a general rule, where any transaction is held to involve a capital asset, and where there has been a bona fide purchase and sale of the asset, the transaction will be afforded capital gain and loss treatment. This rule has been subject to the judicial exception known as the Corn Products doctrine in the context of commodity futures. The doctrine holds that if the transaction involves the sale of an asset purchased as an integral part of the taxpayer’s business, then the gain or loss is to

36. However, under emergency conditions these may be subject to change. See id.
37. See R. Connix, supra note 8, at 14-36.
38. This is most likely due to the fact that no transactions entered into by MNCs for purposes of hedging against the translation exposure brought about by Rule 8 have yet to reach the courts.
be treated as an ordinary gain or loss.\textsuperscript{41} The motivation of the business entering the futures contract seems to be of primary importance in this determination.\textsuperscript{42} Thus, if the MNC enters a forward contract for purposes of hedging against exposure to a loss which arises in the usual course of business, the forward transaction is arguably within its ordinary trade or business and the gain or loss is to receive ordinary treatment. However, a forward exchange contract may be used to hedge against exposure to a translation loss as opposed to a transaction loss. In such a case, although the transaction is definitely a hedge, it may not be held to be within the \textit{Corn Products} exception\textsuperscript{43} and capital gain or loss treatment will result. If the transaction ultimately is held to require capital gain or loss treatment, the method chosen for closing out the contract may also determine whether the applicable holding period is long-term or short-term. In the case of gain, the holding period will determine whether the tax rate is at more favorable capital gains rates or less favorable ordinary rates, and in the case of loss, whether the loss will be more fully deductible from ordinary income.\textsuperscript{44} The question whether a given transaction falls within the \textit{Corn Products} doctrine depends upon the purpose of the transaction. A review of the major cases provides insight into the judicial understanding of the difference between transactions entered into for the purpose of hedging and those entered into for the purpose of speculation or investment.

1. \textit{Hedging Purpose}

The first major case to apply the \textit{Corn Products} doctrine to forward exchange contracts was \textit{Wool Distributing Corp. v. Commissioner}.\textsuperscript{45} Wool Distributing Corporation was an MNC engaged in trading wool throughout the world. It maintained large inventories of wool valued in the various currencies of the countries from which the wool was purchased. The corporation feared a devaluation of the pound sterling and the French franc which would result in a substantial decrease in the value of its wool inventory valued in those currencies. To hedge against this loss exposure, the corpo-

\textsuperscript{41} {Corn Prod. Ref. Co. v. Commissioner, 350 U.S. 46, 52 (1955).}
\textsuperscript{42} {The motivation of the business was emphasized in Booth Newspapers, Inc. v. United States, 303 F.2d 916 (Ct. Cl. 1962).}
\textsuperscript{43} {As will subsequently be illustrated, the courts are having difficulty determining precisely what is a bona fide hedge.}
\textsuperscript{44} {In such a case, the short-sale provisions of I.R.C. § 1222 apply.}
\textsuperscript{45} {34 T.C. 323 (1960).}
ration entered into thirty-five forward contracts for the sale of sterling and seven forward contracts for the sale of French francs, all within one year. The corporation delivered on all forty-two of the contracts and sustained losses of approximately $114,000. The Tax Court sustained the corporation's contention that the losses were ordinary and therefore deductible from gross income on the basis of the Corn Products doctrine.

The court held that for the Corn Products doctrine to apply, the transactions in currency futures must be legitimate "hedging operations carried on in connection with and as a part of . . . regular business." In further refining the doctrine, the court said that hedging would exist if there were an "intimate price relationship" between the futures purchased and the "actuals" which was exposed to risk. With no trouble, the court found such a relationship between the currency futures entered into and the wool inventory actuals valued in the same currencies. That is, any gain or loss from the short sale of the currencies would clearly offset any loss or gain from the devaluation's effect on inventory.

The next case to apply the Corn Products doctrine and the Wool Distributing refinement to forward exchange contracts was International Flavors & Fragrances, Inc. v. Commissioner. International Flavors and Fragrances (IFF) is an MNC engaged in the sale and manufacture of flavor and fragrance products used worldwide in a variety of consumer products. IFF's international corporate structure includes a British subsidiary which was wholly-owned by a Dutch subsidiary, which was in turn wholly-owned by the U.S. parent. The corporation worried that the pound sterling would soon be devalued, thereby exposing the parent to an accounting loss in the translation of the British subsidiary's assets for purposes of IFF's consolidated financial statement. To hedge against this loss exposure, the U.S. parent entered into a forward contract for the sale of sterling in the amount of the subsidiary's exposed net current asset position calculated on an after-tax basis. The pound sterling was devalued as expected. Rather than deliver on

46. Id. at 329.
47. Id. at 330.
48. Id. at 331.
49. Id. at 330.
50. Id. at 331.
51. Id.
52. 62 T.C. 232, rev'd and remanded, 524 F.2d 357 (2d Cir. 1975), on remand 46 T.C.M.(P-H) ¶ 72,058 (1977).
53. 62 T.C. at 233.
the contract, as IFF had done in years past (losses in years past on contracts delivered on were treated as ordinary), IFF chose to sell the contract to a third party and realized a gain of $387,000. After initially requiring ordinary income treatment on the gain, the Tax Court, on remand from the Second Circuit, sustained IFF’s contention that the gain required long-term capital gain treatment.

In the Tax Court’s initial holding, the Corn Products doctrine and the Wool Distributing refinement were relied upon to find that the gain required ordinary income treatment since the transaction was entered to hedge against the risk of future losses of income; that is, the Tax Court held that the alleged translation loss exposure was, in fact, an exposure to a real transaction loss connected with IFF’s normal business operations. On IFF’s appeal of the ruling to the Second Circuit, the Service dropped its argument for ordinary income treatment on the basis of the Corn Products doctrine and adopted the rationale of Judge Tannewald’s concurring opinion in the Tax Court arguing for short-term capital gain treatment. In dismissing the applicability of the Corn Products doctrine, the Second Circuit referred to the Service’s unwillingness to extend the doctrine to a hedging operation “entered into by one corporation as a protection against a potential inventory loss of another corporation, even where the second corporation is a subsidiary of the first.”

The court thus held that the forward contract was a capital asset and remanded the case to the Tax Court for a factual determination of whether the holding period was short-term or long-term. On remand, the Tax Court found that the assignment of the contract to the third party was a bona fide “sale” within I.R.C. § 1222(3), since the purchaser assumed the delivery obligations of the contract. Since the sale occurred over six months after the entering of the contract, the holding price was long-term.

The first case to apply the International Flavors interpretation

54. Id. at 239.
55. 46 T.C.M.(P-H) at 259.
56. 62 T.C. at 239.
57. 524 F.2d at 357. See 62 T.C. at 240-43 (Tannewald, J., concurring).
58. 524 F.2d at 360.
59. I.R.C. § 1222(3) defines “long-term capital gain” as “gain from the sale or exchange of a capital asset held for more than 1 year, if and to the extent such gain is taken into account in computing gross income.”
60. 46 T.C.M. (P-H) at 260.
61. Id.
of the *Corn Products* doctrine was *Hoover Co. v. Commissioner*. The Hoover Company is an MNC engaged in the worldwide manufacture and distribution of vacuum cleaners, washers, dryers, and similar products. Hoover’s international structure includes various wholly-owned and partially-owned subsidiaries in Europe. In 1968, the U.S. parent became concerned with possible devaluations in the currencies of the European countries in which Hoover had subsidiaries. The threat of devaluations subjected the parent to a loss exposure in the reported earnings of its consolidated financial statements. To hedge against this exposure, the parent entered into a total of eighteen forward exchange contracts to sell pounds sterling, French francs, Dutch guilders, Norwegian kroner, Swedish kroner, and Canadian dollars in the amount of its subsidiaries’ net asset position in each of these countries. Hoover used three different methods for closing out its obligations on the contracts. It delivered on four of the contracts, entered into an offsetting contract with the other party to the contract on thirteen of the contracts, and sold its rights to a third party on the remaining contract. It sustained a loss on seventeen of the contracts. The Tax Court rejected Hoover’s contention that the losses should be afforded ordinary loss treatment.

In arguing for ordinary loss treatment, Hoover did not rely upon the *Corn Products* doctrine or any of its progeny. Presumably, it recognized the similarity of its situation with that of IFF and realized that court might be unwilling to extend “the integral part of the business” test to include a hedging transaction entered into for purposes of eliminating risk of loss from translation exposure. Accordingly, Hoover instead argued that the court should expand the judicially developed definition of a hedge to include such transactions, independent of any consideration of the *Corn Products* doctrine, and require ordinary loss treatment on the basis of the hedging exclusion to capital gain/loss treatment in I.R.C. § 1233, governing the tax treatment afforded short sales.

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63. *Id.* at 218-24.
64. *Id.* at 250.
65. *Id.* at 240. The gain/loss provisions of § 1233 applicable to short sales of commodity futures specifically preclude application to legitimate hedging transactions.

§ 1233. Gains and losses from short sales

(a) Capital assets.—For purposes of this subtitle, gain or loss from the short sale of property shall be considered as gain or loss from the sale or exchange of a capital asset to the extent that the property, including a commodity future, used to close the short sale constitutes a capital asset in the hands of the taxpayer.
The Tax Court chose to follow a narrower definition of a hedge than that urged by Hoover. In doing so, the court recounted the history of the judicial development of the concept of a hedge in reference to commodity futures and acknowledged that the *Corn Products* doctrine had slightly blurred the general rules. The court agreed in principle with Hoover’s contention that the concept of a hedge for purposes of section 1233 is broader than the “integral part of the business” test of the *Corn Products* doctrine. But the court would not go so far as to hold that the concept of a hedge for purposes of section 1233 includes a forward sale contract of the type entered by Hoover.66

The court summarized the state of the law as comprising two tests. First, a hedge can exist only in the context of a balanced market position. That is, the transaction must be undertaken to protect a market position maintained in the same or a similar asset. This would require that Hoover’s forward sale contracts be entered in an attempt to avoid an exposure in “its holdings of currency.” But, to the contrary, Hoover was trying to avoid loss in the stock value of its subsidiaries, which it theorized would result from a devaluation of the currencies of the countries where the subsidiaries were located. The second test is that the transaction must be “a means of protecting ordinary operating profits realized in the day-to-day operation of the business enterprise.”67 The court held that Hoover’s ownership interest as expressed in the value of the stock of the parent’s subsidiaries was not an aspect of the day-to-day operation of the business. Further, any fluctuation in the stock value of the subsidiaries would have an effect only on the value of the parent’s capital assets, not on its earnings. As such, the fluctuation would be unrealized for tax purposes until the time when Hoover sold the capital assets. Thus, although the court recognized the exposure to a translation loss in Hoover’s consolidated financial statements, it said that exposure to a real transaction loss would be required if the futures transaction was to be considered a bona fide hedge for purposes of ordinary income treatment.68

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(g) Hedging transactions.—This section shall not apply in the case of a hedging transaction in commodity futures.

I.R.C. § 1233(a), (g).

66. *Id.* at 240-41.

67. *Id.* at 238.

68. *Id.* at 238-39. Hoover tried to argue that the drop in the share value of its foreign subsidiaries would indirectly affect its own share value. The consequences of this could arguably result in a transaction loss to Hoover in many ways.
The *Hoover* decision shows that the Service has so far succeeded in preventing the courts from applying the *Corn Products* doctrine to allow ordinary gain or loss treatment for the gains or losses resulting from a forward exchange sales contract, where the contract was entered into by the parent to avoid a loss arising from a translation exposure of its subsidiaries. The court made no distinction with regard to the method used for closing out the contract. Thus, it would seem that if the MNC seeks to avoid a translation loss exposure of the type in *Hoover*, it will not receive ordinary income treatment on the gains or losses no matter what method it uses to close the contract.

Shortly after the *Hoover* decision was filed, the Court of Claims had the opportunity to apply the *International Flavors* interpretation of the *Corn Products* doctrine in *American Home Products Corp. v. United States.*69 *American Home Products* is an MNC engaged in the manufacture and distribution of prescription and non-prescription drugs, foods, and housewares. Its international corporate structure includes five wholly-owned and partially-owned subsidiaries in the United Kingdom. In 1968, the parent became concerned with the possible devaluation of the pound sterling and the effect such devaluation might have on the dividends payable to the parent at year-end in pound sterling.

To avoid this risk of loss in its foreign source income, the parent entered into four forward contracts to sell pound sterling at $2.80/pound near the time when the dividends were due. As expected, prior to maturity of the contracts the pound was devalued to $2.40/pound. *American Home Products* settled two of the contracts by delivering the pounds sterling received from the dividend payments of its subsidiaries. It settled the other two by selling its rights and obligations under the contracts to a third party. The parent realized a gain on all four contracts.70 The Court of Claims accepted *American Home Products'* contention that the gain on the two latter contracts was long-term capital gain.71

With respect to the contracts which were closed out by delivery, the court presumably accepted the application of the *Corn Products* doctrine. That is, since the transaction was entered into to hedge against an exposure to a real economic loss, a transaction clearly within the "integral part of the business" test, the gain

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69. 601 F.2d 540 (Ct. Cl. 1979).
70. Id. at 542-43.
71. Id. at 548. The Service initially characterized the gain as ordinary income but altered its position before the Court of Claims and claimed short-term capital gain. Id. at 544.
would receive ordinary income treatment.\textsuperscript{72}

With respect to the contracts which were closed out by sale to a third party, the court implicitly accepted the characterization of the gain as capital gain. The issue before the court was whether the applicable holding period was short-term or long-term. Presumably, the court required capital gain treatment because the corporation convinced the court that these particular contracts were entered into for speculative purposes, thus taking the transaction out of the scope of the "integral part of the business" test of the \textit{Corn Products} doctrine.\textsuperscript{73}

The Court of Claims did not have the Tax Court's \textit{Hoover} decision before it when \textit{American Home Products} was decided, but the two cases are consistent. Together with \textit{Wool Distributing}, and the

\textsuperscript{72} The court, however, was not completely convinced of American Home Products' hedging purpose.

We add that we are not convinced on this record that taxpayer had the single, protective purpose it now asserts. The facts show that: (1) there was no contractual arrangement in any of the futures contracts tying them to plaintiff's receipt of sterling dividends; (2) plaintiff did not automatically apply all of its dividends to the futures contracts; (3) at the end, plaintiff exercised its option to buy pounds on the open market and satisfy the residue of its contractual obligation for delivery of pounds; (4) ... plaintiff sold two of its four futures contracts to a Canadian bank; and (5) the major advantage claimed by plaintiff for using its dividends to satisfy two of the futures contracts with Continental is a saving in the United States income tax. In light of these facts, it is not easy to accept the point that the whole arrangement was solely for the purpose of protecting the expected British dividends against the ravages of devaluation.

\textit{Id.} at 546.

The two cases are consistent only on the above analysis of the Court of Claims' interpretation of the two contracts actually delivered on by American Home Products. That is, the court presumably applied the \textit{Corn Products} doctrine and found the motivation for entering these two contracts to be for the purpose of hedging against a transaction exposure. If, on the other hand, the court allowed ordinary treatment solely on the basis of the method used for closing the contracts, then such a result would be inconsistent with the Tax Court's requiring capital treatment on the four contracts delivered upon in \textit{Hoover}. For a different attempt at reconciling the two decisions, see Wehrenberg & Helfand, \textit{Tax Consequences of Hedging Against Foreign Currency Fluctuations: An Update}, 10 Tax Adv. 644 (1979).

\textsuperscript{73} The decision is not at all clear. The court seems to assume that the two contracts closed prior to delivery were entered into for speculative purposes: "Courts and the IRS have treated foreign currency (when used for speculation, as here) as a capital asset." 601 F.2d at 548 n.15. Admittedly, American Home Products entered into two more contracts than necessary to hedge against its exposure, but it is not at all clear in the decision why the court decided that the two contracts delivered upon were the ones which were entered into with the purpose of hedging.

According to William Chanson, counsel for American Home Products, the court apparently based its decision on the several methods taxpayer used to close out its positions. Correspondingly, the case seems to stand for the proposition that \textit{Corn Products} was not applicable, that all four contracts were capital assets, but that only the two that were sold produced capital gain.
International Flavors cases, these cases seem to present a set of basic, guiding principles. First, if an MNC enters a forward sale contract for the purpose of avoiding an exposure to a real transaction loss, the gain or loss on the transaction will receive ordinary gain or loss treatment. Any other purpose for entering the contract will most likely require that any gain or loss receive capital gain or loss treatment, since the transaction will be viewed as a speculation or an investment.

2. Speculation or Investment Purpose

The principles governing the tax treatment afforded gains and losses in forward exchange contracts which are determined to be entered into for speculation and investment purposes must be generally derived from the provisions of sections 1222 and 1233 of the Internal Revenue Code and from the opinions in the above four cases.

Hoover holds generally that a transaction entered into for the purpose of avoiding a translation loss exposure is a speculative or investment transaction regardless of the method used for closing out the contract. Thus, the gain or loss on any forward exchange transaction entered into for such purposes can be expected to require capital gain or loss treatment. The important issue thus faced by the MNC is whether the applicable holding period is short-term or long-term.

In International Flavors II, the Tax Court was asked to decide whether the assignment of the rights of the contract to a third party constituted a bona fide sale or a "sham" sale. If the sale was bona fide, the capital gain would have been long-term since it was made more than six months after the entering of the contract. If the sale was a sham, the third party's purchase of the sterling necessary for delivery would have been imputed to assignor and the closing transaction would have constituted the purchase and sale of the capital asset within six months, thus affording short-term capital gain treatment. In finding a bona fide sale within the meaning of section 1222(3), the Tax Court emphasized that the third party was not acting as an agent for IFF and that its actions in covering the short sale immediately after purchasing the contract indicated that it was acting entirely independently.

In Hoover, the Tax Court found the gain on the sold contract to

74. 46 T.C.M. (P-H) at 260.
75. Id.
be long-term since the sale was bona fide within the criteria laid down in *International Flavors II*. The Court found the capital loss on the contracts which were settled by delivery to be short-term since the currency bought for the purpose of delivery was generally purchased only two or three days prior to the due date, thus bringing the transactions clearly within the terms of section 1222 and 1223(8). Finally, the capital gains and losses on the contracts which were settled by entering into offsetting contracts were also deemed to be short-term, since the offsetting contracts were entered into within six months of the delivery date.76

The Court of Claims in *American Home Products* held that the forward contracts were assigned with a bona fide sale pursuant to the criteria of *International Flavors II*. The court posited some additional criteria for determining a "good faith" sale, finding it significant that American Home Products retained no liability on either of the contracts, entered no arrangements prior to the sale for assisting the buyer in purchasing the pounds necessary for delivery, and left the choice of method for closing out to the discretion of the buyer. The gain was held to be long-term since the contracts were held for more than six months prior to the sale.77

The Court of Claims also addressed the issue of whether section 1233 would apply to the sale of the forward exchange contract. In holding that section 1233 could not apply because the taxpayer never held the "substantial identical property" required,78 the court indicated that where the taxpayer acquires the underlying commodity or offsets the original sale contract with a purchase contract, the transaction might fall within the provisions of section 1233.79

The Tax Court in *Hoover* considered the same question in some general dicta which appears to contradict the Court of Claims dicta. Specifically, the court stated that if the taxpayer purchases the actual currency for delivery, such may not constitute "substan-

76. 72 T.C. at 3313. I.R.C. § 1223 (8) provides that: "[i]n determining the period for which the taxpayer has held a commodity acquired in satisfaction of a commodity futures contract there shall be included the period for which he held the commodity futures contract if such commodity futures contract was a capital asset in his hands."

77. 601 F.2d at 550.

78. In order for the provisions of § 1233 to apply to the short sale of a commodity future, the taxpayer must hold "substantially identical property" at some time within six months before the purchase of the short sale contract or within the period prior to closing out the contract.

79. 601 F.2d at 550.
tially identical property” for purposes of section 1233.80 Suffice it to say, the issue has not been sufficiently litigated and remains an open question.

B. Banking Transactions

Multinational banks are engaged in the daily business of trading in forward exchange contracts. Thus, their trading comes neatly within the Corn Products exception as transactions constituting an "integral part of the business." It is difficult to visualize a situation where a multinational bank would receive capital gain or loss treatment for any gains or losses realized in its international currency dealing absent a clear showing that the contracts were entered into for speculative purposes. The Hoover rationale could not be used to convert ordinary losses into capital losses because a bank under prudent management could always allege and most likely prove that it was hedging against a loss exposure in its currency inventory.

Although there are no cases, regulations, or revenue rulings dealing with this problem, Private Letter Ruling 79-25122 is directly on point. It says that the multinational bank which enters into forward sale contracts to avoid translation loss exposure due to the gains or losses from translation of the currency and currency futures assets in its foreign branches or subsidiaries is engaged in a legitimate hedge. The private ruling emphasizes the fact that due to the large volume of such business, there will be significant problems with regard to which contracts “may be definitely identified with the exposed net asset position of any of the branches or subsidiaries.”81 The ruling also relies upon an extension of the Corn Products doctrine to the business of multinational banks which the Service was unwilling to extend to the business to Hoover: “The forward sale contracts entered into by X to hedge against the recognition of translation gains or losses are directly related to X’s day-to-day international banking business and constitute an integral part of its operations as a dealer in foreign currency.”82 It is quite conceivable that a very large MNC in Hoover's position might be able to get ordinary income treatment for gains and losses if it is able to show that, due to Rule 8, its trading in

80. 72 T.C. at 3309.
82. Id.
83. See text accompanying notes 16-18 supra.
forward sale contracts is immense and has become an integral part
of its business.\textsuperscript{84} It is a fact that many MNCs are now bypassing
the multinational banks and entering forward exchange contracts
for their own account.\textsuperscript{85}

If a multinational bank desires capital gain or loss treatment for
gains or losses resulting from contracts entered into for speculative
or investment purposes, the bank will bear the burden of proving
that the specific contracts were entered into for such purposes.\textsuperscript{86}

\section*{C. Transactions on the Organized Exchanges}

A currency future traded on one of the exchanges is considered a
commodity future. Commodity futures contracts are capital assets
in the hands of an investor.\textsuperscript{87} As such, currency futures contracts
are treated for tax purposes much like forward exchange contracts
entered into on the interbank market. That is, gain or loss realized
by a legitimate hedge is considered a factor in the cost of inventory
and is thus characterized as ordinary gain or loss pursuant to the
\textit{Corn Products} doctrine and I.R.C. § 1233(g).\textsuperscript{88} Similarly, if the
transaction is entered into for speculative or investment purposes,
gain or loss will be afforded capital treatment.

There are certain methods of trading on the exchanges which
allow for favorable tax treatment not available to a trader on the
interbank market and which thus serve as another major incentive
for traders to utilize the exchanges. The most common method is
referred to as a "straddle."\textsuperscript{89} A straddle in simplest terms is a si-
multaneously held long and short position in two contracts of dif-
ferent maturities. An investor generally enters a straddle position
in hopes of realizing a profit from a widening or narrowing of the
price spread between the two contracts. For example, suppose the
general economic opinion is that the pound sterling will rise in the

\begin{footnotesize}
\begin{enumerate}
\setcounter{enumi}{83}
\item See \textit{Business Week, supra} note 18.
\item See \textit{R. Coninx, supra} note 8, at 40-41.
\item This is implicit from the court's finding in \textit{American Home Products} that two of the
four contracts were entered into for speculative purposes. The burden was on American
Home Products to produce evidence showing which contracts were entered into for such
purposes.
\item I.R.C. § 1233(g).
\item Unlike securities, however, commodity futures contracts in the hands of a commodi-
ties broker, dealer, or futures commission merchant are considered to be capital assets.
\item A "straddle" may also be referred to as a "spread." For a general discussion with
more examples, see Selig, \textit{Tax Aspects of Trading in Commodity Futures and Other Com-
\end{enumerate}
\end{footnotesize}
short-term due to the oil price increases anticipated as a result of the June meeting of the Organization of Petroleum Exporting countries. The investor, on the other hand, has reason to believe that the spot rate for the pound will not go up. He thus enters two contracts—one for selling pounds in the near maturity and the other for buying pounds in a more distant maturity.  

To illustrate, suppose that the spot rate for pounds in June, 1981, is $2.28/pound, the future rate for September delivery is at a premium for $2.40/pound, and the future rate for December delivery is $2.35/pound. The investor sells a September contract and buys a December contract. If indeed the investor was right and the pound did not go up as the market expected, the investor would make a profit when he simultaneously closed his contracts since the spread between the two dates narrowed. That is, if in mid-July the spot rate is $2.29/pound, the future rate for September delivery is $2.31, and the future rate for December delivery is $2.30, by closing both contracts in July, the investor realizes a gain on the September contract of $.09 and a loss on the December contract of $.05. His overall gain is thus $.04.

Admittedly, the investor would have realized a larger gain on the entire transaction if he had merely sold September pounds in June. The advantage of entering the straddle, however, is that changes in absolute price are neutralized and only relative prices are affected. Thus, the risk of loss to the investor is minimized since a position has been established on both sides of the market and the margin requirement is considerably lower.

The tax advantages of trading by using straddles arise because the investor is able to develop situations in which short-term capital gains can be deferred from one year to the next and converted into long-term capital gains. For example, suppose the investor enters a straddle position in June, 1981, by buying March, 1982, pounds and selling June, 1982, pounds. If the price of pounds goes up within six months (which could presumably give the investor a gain on the March, 1982, purchase contract), rather than close out the March contract, the investor could close out the June, 1982, short position and replace it with another distant short position, perhaps in September 1982 pounds. The close out would result in a short-term capital loss for the year 1981 and would in effect lock-in

90. Actually, he enters a spread with his broker which normally requires less margin than for a single contract.
91. See Selig, supra note 89, at 30-42.
the taxpayer's gain on the March 1982 contract. The March 1982 contract could thus be closed out in 1982 simultaneously with the September 1982 contract. If the pound continued to rise, or maintain its position of late 1981, the gain on the March 1982 contract would have been changed from short-term 1981 gain to long-term 1982 gain. Theoretically, the taxpayer could defer gain forever by always closing out the position which was at a loss and by opening another similar position for a later maturity.93

In 1977, the Service attempted to stop alleged abuse of this practice with the issuance of Revenue Ruling 77-185,93 which disallowed the practice of deducting capital losses resulting from simultaneously closing one side of a transaction and opening a new offsetting position in a different maturity. Tax attorneys generally not only failed to like the ruling's effect, they failed to accept its rationale.94 As a result, the Service has been lax in enforcing the ruling. However, Commissioner Kurtz recently testified before a Congressional subcommittee that the IRS was going to begin cracking down on the use of such tax shelters. Kurtz went so far as to state that proposed legislation would be presented to Congress within a few months which would outlaw such a practice.95

As it now stands, however, the use of straddles to achieve beneficial tax treatment is prevalent in commodity futures trading. Presumably, it is also common in currency futures trading. These tax benefits provide one of the major incentives for speculators to trade currency futures on the organized exchanges instead of on the interbank market.96

III. CFTC Regulation

Trading in currency futures on the organized exchanges is regulated by the Commodity Futures Trading Commission. In 1974, the Commodity Exchange Act of 1936, which governed trading in agricultural commodity futures, was amended by the Commodity Futures Trading Commission Act of 1974 (the Act).97 The 1974 Act

92. Where the investor closes out the short position, any gain or loss will be short-term pursuant to § 1233.
93. 1977-1 C.B. 49.
94. See Selig, supra note 89, at 30-42.
95. See IRS Clamps Down on Futures Trading Used to Avoid Taxes, Wall St. J., May 28, 1980, at 38, col. 3.
96. Most assuredly, the exchange will raise this point in future hearings if Kurtz follows through with his statement.
established the Commodity Futures Trading Commission (CFTC) as an independent federal regulatory agency to administer and enforce the provisions of the Act. The jurisdiction of the CFTC was to extend to all commodity futures trading on the organized commodity exchanges, all “over-the-counter” trading in commodity options, and all trading in gold and silver leverage contracts.

Congress was concerned that the lack of regulation in the commodity futures industry had resulted in widespread public disillusionment with commodities futures trading. Therefore, the CFTC was granted regulatory powers to prevent sudden or unreasonable fluctuations in futures prices resulting from speculation, manipulation, or control. Such powers included supervision over the self-regulation of the organized exchanges, regulation over traders, brokers, dealers, and futures commission merchants, and regulation of trading through the establishment of trading limits. Enforcement powers included the power to seek injunctive relief in federal court for any violation of the Act and to impose civil penalties of up to $100,000 for each violation.

In 1974, three organized commodity exchanges were involved in foreign currency futures trading: the Chicago Mercantile Exchange, the New York Mercantile Exchange, and the Commodity Exchange in New York. The rules, regulations, and judicial interpretations involved in the exercise of the CFTC’s exclusive jurisdiction over these exchanges must be examined.

A. Supervision Over the Self-Regulation of the Exchanges

An organized futures exchange must be designated a “contract market” by the CFTC before it can trade in a particular futures contract. Such a designation requires that the exchange meet certain conditions established by the CFTC. First and foremost, the exchange must be located at a terminal market where the cash commodity of the futures contract is sufficiently available that the local market price will reflect the real value of the commodity. Presumably, with regard to a contract market in currency futures, this would require that there be a large amount of foreign ex-

98. Id. § 4(a) (Supp. III 1979).
99. Id.
100. Id. § 5.
101. Id. § 13(a-1)-(6).
102. Id. § 7. A contract market is applicable to the clearing association as described earlier, although the two are separate corporate entities.
103. Id. § 7(a).
change business in the area. The exchange must be regulated by a governing board which regularly files CFTC approved reports regarding all its members and all its cash and futures transactions.\textsuperscript{104} The board must prevent "the dissemination . . . of misleading or knowingly inaccurate . . . market information" which will affect a given contract price, provide for the prevention of manipulation of prices and the cornering of any commodity, and provide for the implementation of any final order of the CFTC.\textsuperscript{105}

Two exchanges are presently designated contract markets in currency futures. The International Monetary Market of the Chicago Mercantile Exchange provides a contract market in pounds sterling, Canadian dollars, Deutsche marks, Dutch guilders, French francs, Japanese yen, Mexican pesos, and Swiss francs. The New York Mercantile Exchange provides a contract market in Belgian francs, Italian lira, and all of the above except French francs.\textsuperscript{106}

If an exchange is refused a contract market designation, it is entitled to a hearing before the CFTC with the right to appeal to the United States Court of Appeals.\textsuperscript{107} A designation may be revoked or suspended for up to six months if the exchange refuses to comply with a CFTC rule or regulation subject to the opportunity for notice and hearing and the right to appeal to the United States Court of Appeals.\textsuperscript{108}

Once an exchange receives a contract market designation, it must conform to the duties outlined in section 5(a) of the Commodity Exchange Act.\textsuperscript{109} Such duties include filing with the CFTC a copy of all bylaws, rules, regulations, and resolutions of the exchange; keeping records of all matters discussed by the governing board, and of all relevant action taken by any of its committees, subsidiaries, and affiliates; and enforcing all its bylaws, rules, regulations, and resolutions.\textsuperscript{110} The bylaws, rules, regulations, and resolutions must provide for surveillance of market activity and trading practices, examination of members’ records, investigation of customer complaints, and maintenance of effective disciplinary procedures. All rules regarding the terms and conditions of con-

\begin{footnotes}
\item[104.] Id.
\item[105.] Id.
\item[106.] A third contract market has recently been approved. See Currency Futures Unit of Big Board Approved by CFTC, Wall St. J., May 29, 1980, at 37, col. 3. Trading has yet to begin.
\item[108.] Id.
\item[109.] Id. § 7a.
\item[110.] Id.
\end{footnotes}
tracts must be submitted to the CFTC for prior approval, except rules instituted in the event of an emergency, and rules changing margin requirements.\textsuperscript{111}

The CFTC may issue a cease and desist order, after notice and hearing, for any failure to conform to the conditions of designation. Such an order requires that the contract market cease trading in its futures contracts or cease and desist from failing to enforce its rules and regulations.\textsuperscript{112}

Several cases have involved application of the above provisions of the Act, although none of the cases have dealt with contract markets trading specifically in currency futures. Inahn\textit{New York Mercantile Exchange v. CFTC},\textsuperscript{113} the exchange sought a restraining order in federal court to halt a pending CFTC inquiry into alleged manipulation of potato futures prices due to alleged failure by the exchange to exercise due diligence in enforcing its own rules and regulations. The court refused to stay the proceeding on the ground that judicial relief was not available until all administrative remedies had been exhausted.\textsuperscript{114} In\textit{Deaktor v. L.B. Schreiber & Co.},\textsuperscript{115} the Seventh Circuit Court of Appeals held that a private cause of action could be maintained under the Commodity Exchange Act against an exchange for having failed to enforce its rules to prevent manipulation of pork belly futures prices.

The extent to which an exchange can alter the terms and conditions of its futures contracts was indicated in\textit{Chicago Mercantile Exchange, Inc.}\textsuperscript{116} Therein, the exchange undertook emergency actions such as barring new trades, modifying trading and delivery periods, increasing price limits, and excusing defaults in delivery. The administrative law judge held that the governing board of the exchange had good reason to believe that a lifting of federal price controls would lead to a liquidity crisis in the trading of pork belly futures, which could disrupt a free and orderly market. Therefore, the governing board's actions were justified under the provisions of the exchange's emergency rule.\textsuperscript{117}

The question is open as to whether a private right of action

\begin{itemize}
\item \textsuperscript{111} Id.
\item \textsuperscript{112} Id. § 13b.
\item \textsuperscript{113} 443 F. Supp. 326 (S.D.N.Y. 1977).
\item \textsuperscript{114} Id. at 332. The CFTC later accepted a settlement offer by the exchange prior to the conclusion of its inquiry.
\item \textsuperscript{115} Deaktor v. L.B. Schreiber & Co., 479 F.2d 529 (7th Cir.), rev'd on other grounds sub. nom. Chicago Mercantile Exchange v. Deaktor, 414 U.S. 113 (1973).
\item \textsuperscript{117} Id. at 21,788.
\end{itemize}
against an exchange for failure to enforce its own rules can be implied under the Act. The District Court for the Northern District of California has answered in the negative, while the District Court for the Northern District of Illinois has answered in the affirmative.

Only members of a contract market may make trades on the floor of an exchange. A member is any individual, association, partnership, corporation, or trust holding a membership on an individual contract market. Membership is attained by fulfilling the requirements of the individual contract market. The responsibility for disciplining members lies with the individual exchanges, although the CFTC is authorized to do such if the exchanges fail. Members have the duty to file regularly with the CFTC. No cases or administrative proceedings applying these provisions have been reported.

B. Regulation of Market Professionals

All market professionals involved in the commodity futures industry must register with the CFTC and comply with all antifraud, reporting, financial, and recordkeeping provisions. Market professionals consist of floor brokers, futures commission merchants, associated persons, commodity trading advisors, and commodity pool operators. The CFTC has the authority to refuse registration to any applicant deemed unfit to serve its public purpose after an opportunity for hearing.

A "floor broker" is any person on a contract market's "pit", "ring", or "post" who purchases or sells a futures contract for another person. Registration must be made annually. The CFTC is authorized under the Act to establish fitness standards with respect to training, experience, and other qualifications. The Commission has yet to establish any such standards. There do not appear to be any reported instances where registration of a floor

121. Id. § 9.
122. Presumably, a member must hold a seat on the exchange.
124. Id. § 7.
125. Id. § 9.
126. Id. § 2.
127. Id. § 6f.
128. Id. § 6p.
broker has been denied, revoked, or suspended.

A "futures commission merchant" is any individual, association, partnership, corporation, or trust that accepts consideration for engaging in the solicitation or acceptance of orders for the purchase or sale of any commodity futures contract traded on a contract market. The application for registration must include such information as the names and addresses of the managers of all branch officers and of all agents and correspondents involved with the purchase and sale of commodity futures. The applicant must meet certain minimum financial requirements established by the CFTC.

In In re Act American Inc., the CFTC accepted an offer of settlement by a futures commission merchant for alleged violation of the minimum financial segregation, recordkeeping, and reporting requirements. The respondent apparently had treated letters of credit as part of its working capital in direct violation of sections 6d and 6f(2). Respondent agreed to cease and desist from further violations and to maintain in its adjusted net capital an amount equal to or in excess of $100,000.

An "associated person" is a partner, officer, or employee of a futures commission merchant. Such a person must register with the CFTC if the person plans to solicit or accept customer's orders or to supervise a person in such a capacity. If such a person is already registered as a floor broker or as a futures commission merchant, registration is not necessary. Registration may be denied, revoked, or suspended on the same grounds as discussed above with regard to floor brokers. In In re Frederic S. Mates, the applicant was denied registration on the ground that the Securities and Exchange Commission (SEC) had barred him from association with any broker-dealer in the securities industry without prior approval from the SEC.

A "commodity trading advisor" is any person who, for compensation or profit, engages in the business of advising others either directly or through publications or writings on the value of com-

129. Id. § 2.
130. Id. § 6f.
131. Id.
133. Id.
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modities or the advisability of trading in commodities or commodity futures. The statutory definition excepts journalists, publishers, floor brokers, futures commission merchants, and others regularly engaged in the dissemination of such information solely as an incident to their employment. Registration with the CFTC requires such information as the name and form of organization, the capital structure, the state of incorporation, the names and addresses of all partners, officers, directors, and shareholders (where applicable), and other facts deemed relevant. Suspension or revocation may be affected as discussed above. In Kunitani v. International Commodity Advisors, Inc., the CFTC held that an unregistered corporation engaged in acts within the definition of a commodity trading advisor was subject to its jurisdiction in a reparations proceeding.

A “commodity pool operator” is any person who is engaged in a business in the nature of an investment trust, syndicate, or similar form of enterprise, and who solicits, accepts, or receives consideration from others either directly or through capital contributions for the purpose of trading in commodity futures. Registration requires supplying information such as the name, form, and capital structure of the organization, the number of employees, the education of all affiliated persons, and the proposed nature of the business. Denial, suspension, and revocation may occur as discussed above.

The antifraud provisions of the Act apply to all of the above-mentioned professionals and are easily the most heavily litigated provisions of the Act. The provisions make it unlawful for any such person in connection with a futures transaction to cheat or defraud, to willfully make false reports, statements, or records, to willfully deceive or attempt to deceive, or to bucket or offset a person’s order.

The provision dealing with cheating and defrauding has been applied to many different areas of trading abuse. For example, unauthorized trading in customers’ accounts has been a rather common complaint against futures commission merchants. Misrepresent-
tation and omission of material facts is another common allegation. These allegations have occurred with regard to loss limiting capabilities of trading,\(^\text{144}\) potential profits in a managed account,\(^\text{145}\) and guarantees of risk-free investment.\(^\text{146}\)

Generally, the culpability requirement for a violation of section 6b has been held to constitute knowledge that the act is being violated,\(^\text{147}\) although authority exists holding that "careless disregard" for the statutory requirements is sufficient.\(^\text{148}\)

The question is open as to whether a private right of action exists under the antifraud provisions of the Act. Such a cause of action has been implied in some jurisdictions\(^\text{149}\) and not implied in others.\(^\text{150}\)

Many important questions have yet to reach the court of appeals level. With the continued growth in commodity futures trading in general and currency futures trading in particular, litigation in this area can only multiply.

C. Regulation of Trading

The CFTC is mandated to prevent manipulation of prices in the commodities futures industry. It is thereby authorized to regulate trading through the prevention of certain anticompetitive transactions and through the establishment of certain trading limits for speculative traders.

Section 4c of the Act prohibits "fictitious" sales and transactions such as "wash trading", "cross-trading", and "accommodation trading." "Wash trading" generally occurs when a futures commission merchant enters into simultaneous short and long positions for a customer, generating nothing but commissions for the merchant. "Cross-trading" occurs when a floor broker executes a buy and sell order by himself or with another broker who is in reality trading for the original broker's account. Cross-trades are allowed pursuant


\(^\text{147.}\) Commodity Futures Trading Comm'n v. Savage, 611 F.2d 270, 283 (9th Cir. 1979).

\(^\text{148.}\) Silverman v. Commodity Futures Trading Comm'n, 549 F.2d 28, 31 (7th Cir. 1977).


to section 6c(a)(A) if the broker making the cross-trade buys or sells with an open outcry.\textsuperscript{151} For example, in \textit{Cohl v. Floor Brokers Associates},\textsuperscript{152} the floor broker was held liable for matching a stop-loss order in his hand with a buy order also in his hand at a price which he incorrectly claimed had been cried out on the floor that day.

Section 9b forbids a person to manipulate or corner or attempt to manipulate or corner the price of any commodity or of any commodity future. "Manipulation" has been defined by case law as keeping the price level from reaching the level where the natural forces of supply and demand would lead.\textsuperscript{153} Such an offense constitutes a criminal felony, punishable by a fine of not more than $200,000 or imprisonment for not more than five years.\textsuperscript{154} Whether or not there is a private cause of action under this section is an unresolved question.\textsuperscript{155}

The CFTC is authorized to establish limits on the number of contracts a speculative trader may enter.\textsuperscript{156} The limits so far established differ with respect to different commodities, different maturities, and different contract markets.\textsuperscript{157} Where the CFTC has yet to establish trading limits, the individual exchanges have in most circumstances done so. The CFTC's policy is to aggregate the trading of individuals who are acting pursuant to an express or implied agreement or understanding. For example, in \textit{CFTC v. Hunt},\textsuperscript{158} the individual trading in soybean futures by seven members of the Hunt family was aggregated for purposes of applying the limit provisions since the court found that the individual members had traded in concert.\textsuperscript{159}

There are no limits in effect for speculative trading in currency futures.\textsuperscript{160} Presumably, the CFTC and the exchanges will get around to establishing such limits when the first crisis occurs.

\begin{itemize}
\item 152. [1979] COMM. FUT. L. REP. (CCH) ¶ 20,790 (C.F.T.C. 1979).
\item 153. Volkhart Brothers, Inc. v. Freeman, 311 F.2d 52, 58 (5th Cir. 1962).
\item 156. That is, hedgers are exempt from the application of such limits.
\item 158. [1977] COMM. FUT. L. REP. (CCH) ¶ 20,496 (N.D. Ill. 1977).
\item 159. However, the disgorgement of profits relief requested by the C.F.T.C. was denied. \textit{Id}.
\end{itemize}
IV. Federal Reserve Board and Comptroller of the Currency Regulation

Neither the Federal Reserve System (FED) nor the Comptroller of the Currency directly regulates trading in forward exchange contracts on the interbank market or trading in currency futures on the organized exchanges. The Fed, in its capacity as the monetary policy-arm of the U.S. government does, however, have an impact upon such trading that amounts to a form of indirect control over the operation of both the forward exchange and currency futures market. In addition, there are reporting requirements in effect for all U.S. banks and business enterprises which trade in foreign currencies for spot or future delivery. A brief examination of the Fed's indirect control and the reporting requirements which relate to trading in forward exchange and currency futures is essential to this article's purpose.

A. Indirect Control

In the conduct of monetary policy, the Fed is paying an increasing amount of attention to the international impact of its decisions\(^1\)\(^6\)\(^1\)—a radical departure from its policy in the past. Understanding the international impact of the Fed's decisions requires comprehension of the relationship between domestic monetary policy and trading in foreign currency for future delivery. This relationship is extremely complex and beyond the scope of this article in all but the most cursory review.\(^1\)\(^6\)\(^2\) In general, the strength of the dollar is related to the number of dollars which the Fed allows to be created. In the intermediate and long run, creation of dollars in excess of the needs of an expanding economy causes inflation. If the rate of inflation in the United States is greater than the rate of inflation in the rest of the world, then the dollar will depreciate vis a vis other currencies. If the U.S. inflation rate is less, then the

\(^{161}\) As part of the Fed's "radical" anti-inflationary program announced in October of 1979, a new marginal reserve requirement was imposed upon managed liabilities including Eurodollar borrowings of member banks and other select financial institutions. In addition, the Fed "called on banks not to make speculative loans, for example loans to buy gold, silver, other commodities, or foreign exchange for speculation." [1979] XVIII CONTROL OF BANKING (P-H) \(\S\) 8.1(4) (Oct. 15, 1979). "The Fed, for its part, is betting that U.S. inflation will soon begin to fall dramatically and hopes that foreign exchange traders will start to concentrate on what it expects will be improving U.S. economic fundamentals instead of just focusing on interest rates." Don't Blame Iran for the Dollar's Fall This Time, Bus. Week, May 12, 1980, at 55.

\(^{162}\) See R. CONinx, supra note 8 at 45-81.
dollar will appreciate.\textsuperscript{163}

In the short run, such things as changes in the discount rate, changes in the reserve requirement, changes in interest rates in general, and changes in expectations may impact on exchange rates.\textsuperscript{164} It is virtually impossible to generalize about such relationships. However, any changes or expectations of changes in exchange rates will influence trading in foreign currencies for future delivery. Short run changes in Fed policy and the perception of Fed policy have caused violent fluctuations in exchange rates in the past and there is every indication that this situation will persist in the future.\textsuperscript{165} Thus, it can be anticipated that forward and futures markets will continue to be used as a necessary tool to hedge away the risks of international currency fluctuations.

\textbf{B. Reporting Requirements}

All businesses engaged in international transactions must file a report on their foreign exchange exposure with the Federal Reserve Bank of New York. All multinational banks must file a similar report with the Federal Reserve Bank of their district. Authorization for such reporting requirements was established in 1973 and has since been revised in 1978.\textsuperscript{166}

International businesses must file a monthly and a quarterly report form. The monthly report form deals solely with the domestic segment of the business. The quarterly report form must include the operations of all foreign branches and subsidiaries.\textsuperscript{167} Forward exchange positions in certain enumerated currencies must be reported in each form. The enumerated currencies are Canadian dollars, Dutch guilders, French francs, Deutsche marks, Italian lire, Japanese yen, Swiss francs, and pounds sterling.\textsuperscript{168} There is no requirement that the position be explained on the forms.

\textsuperscript{163} Id.
\textsuperscript{164} Whatever the Fed says it is doing, however, the foreign exchange markets still concentrate on interest rates. In particular, they perceive the recent 400 basis-point decline in the Fed funds rate as an easing in Fed monetary policy. And unless the Fed switches back from a policy of interest-rate neglect and takes increasing notice of rate levels both at home and abroad, the late-April value of the dollar may look very good by July or August.
\textit{Don't Blame Iran for the Dollar's Fall This Time}, \textit{Bus. Week}, May 12, 1980, at 55.
\textsuperscript{165} See id.
\textsuperscript{167} 31 C.F.R. §§ 128,35-.36 (1980).
\textsuperscript{168} Id.
Banks engaged in international business must file both a weekly and a monthly report regarding their forward exchange positions in their domestic as well as their international operations. Only positions in the currencies enumerated above need be reported.

Enforcement of the reporting requirements is effected by the Secretary of the Treasury. Any willful failure to report is punishable by criminal prosecution leading to a fine of not more than $10,000 or imprisonment of not more than ten years, or both.

The reporting legislation was initially passed because Congress found that "movements of mobile capital can have a significant impact on the proper functioning of the international monetary system." Congress recognized the vital importance of having "as complete and current data as feasible on the nature and source of these capital flows." The extent of the completeness and currentness of the data cannot be conjectured.

No direct controls on the massive flows of foreign currencies and forward exchange contracts have yet to be instituted. The United States is the only major country in the world that does not have exchange control regulations in effect. As a matter of policy, the United States is committed to the principles underlying the doctrine of free trade. It also fears the consequences to the world economy of retribution in the event that a departure from these principles is undertaken.

CONCLUSION

There is little public information available on the extent of trading in forward and futures contracts for foreign currencies in the United States. The extent of trading is undeniably very large and can only increase in the future. Existing U.S. government agencies regulate certain aspects of this trading, but cannot hope to oversee and control the day-to-day transactions which occur on a vast scale.

The trading of forward exchange requires maximum freedom due to the complexities of the international monetary system and the rapidity with which changes occur in that system. The position of the United States as an advanced industrial country in the world economic order strongly depends upon the freedom of these
United States corporations to compete successfully with the other major financial and business entities of the world.

Countries of the world are becoming increasingly interdependent and the international economy is more and more subject to shocks and severe stress. There is an increased possibility of a disruption of the international payments mechanism. Given the increasing interdependence, such a disruption would be quickly transmitted from country to country. Thus, there is rising concern in the United States about the strength of international markets. Such concern traditionally leads to a protectionist attitude. Increased regulation and the resultant inefficiencies are probably inevitable.

The question whether more extensive control of the forward exchange and currency futures markets is desirable is currently unanswerable. There is not yet enough information compiled to lead to an adequate understanding of the relationship between these markets and the domestic economy. If more extensive control is eventually found to be desirable, however, the U.S. government appears to have in place the fundamental regulatory structures necessary for performing such a task.