

Note

A Merry-Go-Round of Metal and Manipulation: Toward a New Framework for Commodity Exchange Self-Regulation

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Twenty-three-year-old Tyler Clay, a former forklift driver for a Goldman Sachs-owned aluminum warehouse, described the process as a “merry-go-round of metal.”¹ A fleet of trucks would shuffle thousands of pounds of aluminum from one Detroit warehouse to another a few miles away, only to repeat the circuit two to three times a day, day after day.² But why? The simple answer: money. Goldman Sachs and other financial holding companies (FHCs) were able to artificially increase the price of physical aluminum deliverable in the United States by lengthening its storage time.³ The benefits were multifold for the financial institutions, as they received rent payments for storing the metal in their warehouses as well as increased the value of proprietary physical aluminum and aluminum-related financial instruments.⁴ The practice, meanwhile, was estimated to cost American consumers more than \$5 billion over three years because manufacturers of products such as soda and beer

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1. David Kocieniewski, *A Shuffle of Aluminum, but to Banks, Pure Gold*, N.Y. TIMES (July 20, 2013), <http://www.nytimes.com/2013/07/21/business/a-shuffle-of-aluminum-but-to-banks-pure-gold.html>.

2. *Id.*

3. *Id.*; see *infra* Part I.C (detailing the specifics of the Goldman Sachs scheme).

4. See Matt Taibbi, *The Vampire Squid Strikes Again: The Mega Banks' Most Devious Scam Yet*, ROLLING STONE (Feb. 12, 2014), <http://www.rollingstone.com/politics/news/the-vampire-squid-strikes-again-the-mega-banks-most-devious-scam-yet-20140212>; *infra* Part I.C (detailing, for example, the financial benefits of the Goldman Sachs scheme).

passed on their increased aluminum costs to customers.⁵ Revelation of the scheme resulted in severe backlash, including investigations,⁶ lawsuits,⁷ and a congressional hearing.⁸

FHCs are legally permitted to engage in physical commodities activities, such as owning aluminum warehouses and trading physical aluminum, subject to ongoing regulation by the Board of Governors of the Federal Reserve System (the Board).⁹ The Board vowed to review its regulation of FHCs' "commodity-related activities"¹⁰ and issued an Advance Notice of Proposed Rulemaking in January 2014.¹¹ FHCs, however, are merely the latest to engage in a type of misconduct that spans the history of commodities exchanges.¹² The threat of market manipulation remains ever-present. Large commodities traders, for example, have begun to look more like banking institutions while escaping the associated regulatory scrutiny.¹³ As such, they present

5. Kocieniewski, *supra* note 1.

6. *E.g.*, Susan Thomas, *IOSCO Surveys Warehouse Impact on Commodity Derivatives Market*, REUTERS (Aug. 8, 2014), <http://www.reuters.com/article/2014/08/08/regulations-commodities-iosco-idUSL6N0QE3LF20140808>.

7. *See* Andrew Harris, *Goldman Sachs Aluminum Antitrust Suits Shipped to NYC*, BLOOMBERG (Dec. 16, 2013), <http://www.bloomberg.com/news/2013-12-16/goldman-sachs-aluminum-antitrust-suits-shipped-to-nyc.html>. These lawsuits were eventually dismissed. *Wall Street Banks Get Rid of Aluminum Price Fixing Suits*, ZACKS (Sept. 2, 2014), <http://www.zacks.com/stock/news/145836/Wall-Street-Banks-Get-Rid-of-Aluminum-Price-Fixing-Suits>.

8. *Regulating Financial Holding Companies and Physical Commodities: Hearing Before the Subcomm. on Fin. Insts. & Consumer Prot. of the S. Comm. on Banking, Hous., & Urban Affairs*, 113th Cong. (2014) [hereinafter *Hearing*].

9. *See* 12 U.S.C. § 1843(k)(1) (2012); *infra* Parts I.A, I.C (detailing, respectively, the legal and regulatory environment of FHCs and the specifics of the Goldman Sachs case).

10. *Hearing*, *supra* note 8, at 36–37 (statement of Michael S. Gibson, Director, Division of Banking Supervision and Regulation, Board of Governors of the Federal Reserve System).

11. Complementary Activities, Merchant Banking Activities, and Other Activities of Financial Holding Companies Related to Physical Commodities, 79 Fed. Reg. 3329 (advanced notice given Jan. 21, 2014) [hereinafter *Commodities ANPR*]; *see also* Kate Davidson, *Yellen: Fed To Issue Bank Commodity Rules This Year*, WALL ST. J. ECON. BLOG (Feb. 25, 2015, 11:16 AM), <http://blogs.wsj.com/economics/2015/02/25/yellen-fed-to-issue-bank-commodity-rules-this-year> (“[T]he Fed plans to propose new rules this year.”).

12. *See, e.g.*, Stephen Craig Pirrong, *The Self-Regulation of Commodity Exchanges: The Case of Market Manipulation*, 38 J.L. & ECON. 141, 165–69 (1995) [hereinafter *Self-Regulation*] (discussing the manipulation of grain and provisions markets between 1865 and 1922).

13. Lina Khan, *The Folks Who Sell Your Corn Flakes Are Acting Like Goldman Sachs—and That Should Worry You*, NEW REPUBLIC (Sept. 11, 2013), <http://www.newrepublic.com/article/114577/commodities-trading-hedge>

similar (if not greater) hazards to the efficiency and integrity of commodities markets as FHCs.¹⁴

Although market manipulation involves the confluence of numerous different factors, commodities exchanges—providers of environments for commodities futures trading activities¹⁵—represent a (sometimes unwitting) linchpin in manipulation schemes.¹⁶ These organizations create their own rules defining proper futures trading practices,¹⁷ subject to deferential Commodity Futures Trading Commission (CFTC) oversight.¹⁸ While exchanges used to be member owned, there has been a recent trend toward demutualization: the conversion to a publicly traded, shareholder-owned company.¹⁹ This structural shift raises potential conflicts of interest, as exchanges may be incentivized to create rules that maximize their profits rather than maintain the integrity and efficiency of markets.²⁰

This Note offers a solution to the current self-regulatory

-funds-spook-wall-st-banks (“Over the last decade, some of the world’s biggest traditional traders in grains, oil, and metals have quietly taken on many attributes of banks—running billion-dollar hedge funds, launching private equity arms, and selling derivatives to clients.”).

14. See *id.* (“These [financial] businesses enable trading firms to tie up large sums of money in bets and profit off insider information.”).

15. See, e.g., *About Us*, LONDON METAL EXCHANGE, <http://www.lme.com/about-us> (last visited Oct. 12, 2015). The terms “commodity exchange” and “futures exchange” are often used interchangeably, as commodities futures contracts are a subset of the futures contract universe. See *infra* note 47 (defining “futures exchange” and “futures contract”). Because this Note specifically focuses on commodities trading activities, it will generally use the term “commodity exchange.”

16. See *infra* Parts I.C, II.A (detailing, respectively, the specifics of the Goldman Sachs scheme and the flawed assumptions underlying current self-regulatory systems).

17. See, e.g., LONDON METAL EXCH., LONDON METAL EXCHANGE RULES & REGULATIONS (2014), <https://www.lme.com/~media/Files/Regulation/Rulebook/Full%20Rulebook/Rulebook%20as%20of%20September%202014.pdf>; see also *infra* Part I.B (discussing exchange regulation).

18. See *infra* text accompanying note 49. The CFTC has not shown the same willingness to reexamine commodity exchange regulation as has the Board with FHCs’ commodities activities. Compare Commodities ANPR, *supra* note 11 (inviting public comment on issues related to FHCs’ commodities activities), with Silla Brush, *Senate Democrats Urge CFTC Review of LME Aluminum Trading*, BLOOMBERG (Sept. 27, 2014), <http://www.bloomberg.com/news/articles/2014-09-26/senate-democrats-urge-cftc-review-of-lme-aluminum-trading> (reporting that members of Congress have implored the CFTC to “investigate whether [exchange] rules sufficiently protect against conflicts of interest between firms’ trading and warehouse operations”).

19. See *infra* Part I.B (discussing the shift in exchange ownership structure).

20. See *infra* Part II.A.3 (discussing the effects of the shift in exchange ownership structure).

framework of commodities exchanges that facilitates market manipulation. It does not engage in the debate over whether FHCs should be allowed to engage in commodity-related activities.²¹ Rather, this Note contends that commodities exchanges need to be better regulated. Subsection I examines the convergence of banking, commerce, and commodity exchange regulation that resulted in the recent manipulation of markets. Subsection II analyzes the current model of self-regulation, ultimately arguing that commodities exchanges' self-promulgated rules do not offer enough protection against market manipulation. Subsection III draws from the strengths of the Financial Accounting Standards Board (FASB) model for establishing financial accounting standards and proposes delegating authority for commodity exchange rule promulgation to a new, similarly-structured entity.

I. BANKING, COMMERCE, AND EXCHANGE DEMUTUALIZATION: A PATH TO COMMODITY MARKET MANIPULATION

Although FHCs are not the only potential manipulators of commodities markets, their involvement in these markets brought new light to the issue. Thus, it is helpful to understand the interplay between FHCs' commodities activities and commodity exchange self-regulation before assessing possible changes to such regulation. Section A frames the legal landscape for the general separation of banking and commerce and FHCs' reaction to the blurring of the line. Section B outlines the shifting structure of exchanges. Section C brings the two together in describing how Goldman Sachs was able to gain monopoly power with respect to the United States aluminum market.

A. THE INTEGRATION OF BANKING AND COMMERCE

The fundamental principle of the separation of banking and commerce underlies the complex regulatory regime surrounding United States banks and bank holding companies (BHCs).²² Yet, it was somewhat abandoned in recent years, par-

21. For such a debate, see Commodities ANPR, *supra* note 11 (encouraging public debate over FHC involvement in commodities markets).

22. See Saule T. Omarova, *The Merchants of Wall Street: Banking, Commerce, and Commodities*, 98 MINN. L. REV. 265, 268 (2013); Bernard Shull, *The Separation of Banking and Commerce in the United States: An Examination of the Principal Issues*, 8 FIN. MKTS. INSTITUTIONS & INSTRUMENTS 1, 1 (1999).

ticularly following the 2008 financial crisis. Subsection 1 outlines the statutory changes that gave rise to the mixing of banking and commerce, while Subsection 2 discusses FHCs' commodities businesses.

1. The Bank Holding Company Act and the Graham-Leach-Bliley Amendments

The Bank Holding Company Act (BHCA) explicitly invokes the separation of banking and commerce principle, as it generally restricts BHCs—companies that own or control national banks—from engaging in any business activities other than banking and managing banks.²³ There are clear rationales for separating banking from purely commercial business activities, including safety and soundness risks to federally insured depository institutions, potential conflicts of interest between banks and their commercial affiliates, and “excessive concentration of economic—and ultimately political—power in the hands of large financial-industrial conglomerates.”²⁴

Nonetheless, the Gramm-Leach-Bliley Act of 1999 (GLBA) amended the BHCA and created a new FHC structure that opened the door for the mixing of banking and commerce.²⁵ The statute states that an FHC may “engage in any activity, and may acquire and retain the shares of any company engaged in any activity,” that the Board determines “(A) to be financial in nature or incidental to such financial activity; or (B) is complementary to a financial activity.”²⁶

As an activity that is “financial in nature,” the so-called “merchant banking” authority allows an FHC to acquire full ownership in a purely commercial enterprise,²⁷ provided the

23. 12 U.S.C. § 1843 (2012). Moreover, BHCs must register with the Board and face extensive regulation and supervision. *See id.* § 1844(a)–(b); *cf.* Robert Schroeder, *Goldman, Morgan To Become Holding Companies*, MARKETWATCH (Sept. 21, 2008), <http://www.marketwatch.com/story/goldman-sachs-morgan-stanley-to-become-bank-holding-companies> (describing “greater scrutiny by regulators and new capital requirements” as the “price” of becoming a BHC).

24. Omarova, *supra* note 22, at 275–76. For a general discussion of the potential policy implications of combining banking and commercial activities, *see id.* at 333–55.

25. Financial Services Modernization (Gramm-Leach-Bliley) Act, Pub. L. No. 106-102, 113 Stat. 1338 (1999) (codified as amended throughout 12 U.S.C.); *see also* 12 U.S.C. § 1841(p) (2012) (defining “financial holding company”); *id.* § 1843(l)(1) (listing the requirements to be categorized as an FHC).

26. 12 U.S.C. § 1843(k)(1).

27. *Id.* § 1843(k)(4)(H) (listing five requirements for an FHC’s investment in a commercial enterprise).

principal purpose of the investment remains purely financial—to make a profit on the eventual disposition of its ownership stake—as opposed to operational—to conduct the non-financial business of the portfolio company.²⁸ In other words, an FHC's investment in a commercial firm pursuant to its merchant banking powers must be passive rather than active.

The GLBA also grants FHCs the power to engage in commercial activities that are not financial in nature so long as they are “complementary” to a financial activity.²⁹ An FHC applies for the Board's approval of such an activity by filing a written notice.³⁰ In the notice, the FHC must describe the commercial activity, its relation to a financial activity, and the expected public benefits of engaging in the activity, among other items.³¹ The Board then determines whether the proposed activity's potential public benefits outweigh its potential negative effects.³² Given these new statutory avenues to pursue commercial interests, Subsection 2 discusses the trajectory of FHCs' commodities operations.

2. The Rise of Banking and Commerce

FHCs used the GLBA amendments to build physical commodities businesses. Although the trading of commodity-related financial instruments has never raised any legal issues under the BHCA, FHCs are generally prohibited from trading in the physical commodities underlying the derivative securities, even after the GLBA amendments.³³ The Board, nonetheless, used its complementary activities authority under the GLBA to approve the trading of physical commodities by FHCs,

28. Bank Holding Companies and Change in Bank Control, 66 Fed. Reg. 8466, 8469 (Jan. 31, 2001) (codified at 12 C.F.R. § 225 (2015)); see Omarova, *supra* note 22, at 281–84. The Board, for example, prohibits FHCs from being involved in the routine management or operation of its portfolio companies. 12 C.F.R. § 225.171.

29. 12 U.S.C. § 1843(k)(1)(B).

30. 12 C.F.R. § 225.89(a) (requiring written notice if the FHC is to obtain more than a five percent stake in a commercial firm's voting securities).

31. *Id.* § 225.89(a)(1)–(6).

32. *Id.* § 225.89(b). In addition to the merchant banking and complementary activity avenues, the GLBA contains a special grandfathering provision that specifically permits certain FHCs to engage in commodities activities. See 12 U.S.C. § 1843(o); see also *Hearing, supra* note 8, at 9–11 (discussing the ambiguity as to whether the grandfathering provision applies to FHCs purchasing assets in either existing or new commodities markets). However, FHCs have yet to widely utilize this provision. See Omarova, *supra* note 22, at 289–90.

33. See Omarova, *supra* note 22, at 301.

finding that such activities “flowed” from FHCs’ legitimate financial activities, made FHCs more competitive with other financial institutions not subject to regulatory restrictions on physical commodities transactions, and allowed FHCs to provide clients with a full range of commodity-related services in a more efficient manner.³⁴

Although several FHCs entered physical commodities markets during the years preceding the 2008 financial crisis, three dominant players—Goldman Sachs, JPMorgan Chase & Co. (JPMC), and Morgan Stanley—emerged following it.³⁵ All three would continue to grow their physical commodities businesses during the years after the height of the crisis.³⁶ All three would also later be accused of manipulating various commodities markets.³⁷ Even if FHCs were to be severely restricted in their commodity-related activities, other, less-regulated institu-

34. See, e.g., *Citigroup Inc., Order Approving Notice To Engage in Activities Complementary to a Financial Activity*, 89 FED. RES. BULL. 508, 509 (2003). The Board also placed several conditions on FHCs’ commodities trading businesses. See, e.g., *id.* at 510 (stating that Citigroup was not “authorized to (i) [o]wn, operate, or invest in facilities for the extraction, transportation, storage, or distribution of commodities; or (ii) [p]rocess, refine, or otherwise alter commodities” (emphasis added)); see also *JPMorgan Chase & Co., Order Approving Notice To Engage in Activities Complementary to a Financial Activity*, 92 FED. RES. BULL. C57, C58 (2006) (placing the same conditions on JP Morgan Chase).

35. Omarova, *supra* note 22, at 310. Goldman Sachs and Morgan Stanley, two previously independent investment banks, were hastily approved to become FHCs in 2008 as part of the effort to bolster public confidence in the financial system. See *Goldman Sachs Grp., Inc., Order Approving Formation of Bank Holding Companies*, 94 FED. RES. BULL. C101, C103 (2008), 2008 WL 7861871; *Morgan Stanley, Order Approving Formation of Bank Holding Companies and Notice To Engage in Certain Nonbanking Activities*, 94 FED. RES. BULL. C103, C106 (2008), 2008 WL 7861872.

36. See Omarova, *supra* note 22, at 310–33. The recent regulatory and political scrutiny of FHCs’ physical commodities activities, however, has somewhat reversed that trend. Compare Josephine Mason, *Exclusive: Goldman Puts Metro Metals Warehousing Unit Up for Sale*, REUTERS (May 20, 2014), <http://www.reuters.com/article/2014/05/21/us-goldman-metals-sale-idUSBREA4J0NO20140521> (reporting Goldman Sachs’s attempt to scale down its physical commodities business), and Dmitry Zhdannikov & Silvia Antonioli, *JP Morgan Sells Commodity Arm to Mercuria for \$800 Million: Sources*, REUTERS (Oct. 6, 2014), <http://www.reuters.com/article/2014/10/06/us-mercuria-jpmorgan-idUSKCN0HV0TJ20141006> (reporting JPMC’s exit from physical commodities markets), with Lauren Tara LaCapra, *Exclusive: Morgan Stanley Rebuilds in Commodities Trading*, REUTERS (July 18, 2014), <http://www.reuters.com/article/2014/07/18/us-morgan-stanley-commodities-idUSKBN0FN1RW20140718> (“After more than a year of scaling back in commodities, Morgan Stanley is ready to expand.”).

37. See *infra* note 70; see also *infra* Part I.C (detailing Goldman Sachs’s alleged manipulation of the aluminum market in the United States).

tions stand ready to take their place—through the mixing of commerce and banking.³⁸ While the combination of the banking and commerce spheres opens the door for commodity market manipulation, Section B describes the role of commodities exchanges as facilitators of such manipulation.

B. THE CHANGING STRUCTURE OF EXCHANGES:
DEMUTUALIZATION

Exchanges developed based on general demand for a common trading environment.³⁹ They “centralize the execution, clearing, and settlement of market transactions,” thus “increasing liquidity, reducing the costs of capital, and encouraging investment and innovation.”⁴⁰ As specialized firms, they are able to produce a more efficient trading environment and achieve lower transaction costs than any single market participant could on its own.⁴¹ Thus, participating members share a “homogenous interest in the success” of the exchange, notwithstanding their “heterogeneous commercial interests.”⁴² Exchanges also “aggregate and disseminate trading data” and “serve a governing role, introducing a regulatory framework in which market participants govern themselves.”⁴³

Exchanges were traditionally structured as non-profit organizations (although they paid taxes, unlike charities and educational institutions) owned by market participants, or members.⁴⁴ The members created “an internal governance arrangement, adopting bylaws, implementing a hierarchical decision-making process, electing directors, and appointing officers to govern” the exchange.⁴⁵ Any profits realized by the exchange would be “returned to members in the form of lower access fees or other benefits,”⁴⁶ thus aligning, at least theoretically, the interests of the exchange and its members.

Futures exchanges, specifically, provide an environment

38. See *supra* notes 11–14 and accompanying text.

39. See Kristin N. Johnson, *Governing Financial Markets: Regulating Conflicts*, 88 WASH. L. REV. 185, 197–201 (2013).

40. *Id.* at 200–01 (footnotes omitted).

41. See *id.* at 198–201.

42. *Id.* at 199.

43. *Id.* at 201.

44. See Roberta S. Karmel, *Turning Seats into Shares: Causes and Implications of Demutualization of Stock and Futures Exchanges*, 53 HASTINGS L.J. 367, 403 (2002).

45. Johnson, *supra* note 39, at 199.

46. Karmel, *supra* note 44.

for trading futures contracts and options on futures contracts.⁴⁷ Congress gave exclusive jurisdiction over futures contracts and commodity options trading in the United States to the CFTC, an independent agency.⁴⁸ The CFTC has deferred to commodities exchanges' rulemaking and self-regulation, as the exchanges have a long history of self-regulation.⁴⁹ In addition, the National Futures Association (NFA), a freestanding self-regulator, "works with the CFTC to set standards for ethics training of industry professionals, the review of disclosure documents and issues concerning statutory disqualification of registered persons and entities."⁵⁰ In short, commodities exchanges are self-regulatory organizations (SROs) with CFTC oversight.

Advancements in communication technologies and global competition have resulted in increasing cost pressures on exchanges.⁵¹ One response to these challenges has been demutualization.⁵² Member firms have voted to convert exchanges from "non-profit cooperatives to private business[es]," with the newly-private exchanges selling their equity shares to the public.⁵³ Because exchanges are now "international public corporations with freely transferable equity shares," the potentially "diverse and widely dispersed shareholders . . . no longer share a ho-

47. *Futures Exchange*, INVESTOPEDIA, <http://www.investopedia.com/terms/f/futuresexchange.asp> (last visited Oct. 12, 2015). A "futures contract" is "[a] legally binding agreement to buy or sell a *commodity* or financial instrument in a designated future month at a price agreed upon at the initiation of the contract by the buyer and seller." *Futures Contract*, NASDAQ, <http://www.nasdaq.com/investing/glossary/f/futures-contract> (last visited Oct. 12, 2015) (emphasis added). "Options are contracts through which a seller gives a buyer the right, but not the obligation, to buy or sell a specified number of shares at a predetermined price within a set time period." *Options Defined*, NASDAQ, <http://www.nasdaq.com/investing/options-guide/definition-of-options.aspx> (last visited Oct. 12, 2015). "Other underlying investments on which options can be based include stock indexes, Exchange Traded Funds (ETFs), government securities, foreign currencies or *commodities like agricultural or industrial products*." *Id.* (emphasis added).

48. Commodity Futures Trading Commission Act of 1974, 7 U.S.C. § 2 (2012). By comparison, the SEC has jurisdiction over the sale and trading of *securities*, thus overseeing *stock* exchanges and not futures exchanges. See *Commodity Futures Trading Commission*, SEC, <http://www.sec.gov/answers/cftc.htm> (last visited Oct. 12, 2015) ("The SEC administers and enforces the federal laws that govern the sale and trading of securities, such as stocks, bonds, and mutual funds, but we do not regulate futures trading."); see also Karmel, *supra* note 44, at 400, 402 ("To a large extent the CFTC is an analogue to the SEC with respect to the regulation of futures exchanges.")

49. Karmel, *supra* note 44, at 402.

50. *Id.* at 402–03.

51. See *id.* at 368.

52. *Id.*

53. Johnson, *supra* note 39, at 204.

mogenous interest in promoting the SRO's governance goals."⁵⁴ Moreover, large shareholders of the exchange can potentially dictate such governance goals.⁵⁵ Section C discusses a specific instance where the intersection of FHC commodity-related activities and commodity exchange demutualization resulted in manipulation of the United States aluminum market, in part because the exchange failed to serve as an effective governing authority.

C. CASE STUDY: GOLDMAN SACHS, METRO WAREHOUSES, AND THE LONDON METAL EXCHANGE

Strong evidence shows that Goldman Sachs was able to gain monopolistic power in the United States aluminum market following the 2008 financial crisis. In February 2010, Goldman Sachs purchased Metro International Trade Services LLC (Metro), a global metals warehousing company that owns and operates nineteen warehouses in Detroit,⁵⁶ pursuant to its merchant banking authority.⁵⁷ Goldman Sachs, meanwhile, also had a significant ownership stake in the London Metal Exchange (LME)⁵⁸ until late 2012.⁵⁹ Because the LME approved Metro's warehouses as storage facilities for metals traded on the exchange, Goldman Sachs' acquisition of Metro "strategically positioned the firm in the middle of the global metals trading chain" and "led other market participants to worry about unfair advantages for such firms."⁶⁰

It appears that the other market participants' worries were justified. Exit delays for removal of aluminum stored in Metro's

54. *Id.* at 204–06.

55. *See infra* text accompanying notes 117–18.

56. Omarova, *supra* note 22, at 321. Goldman Sachs, however, "has begun a formal process" to sell the metals warehousing company. Mason, *supra* note 36.

57. STAFF OF PERMANENT SUBCOMM. ON INVESTIGATIONS OF THE S. COMM. ON HOMELAND SEC. & GOVERNMENTAL AFFAIRS, 113TH CONG., REP. ON WALL STREET BANK INVOLVEMENT WITH PHYSICAL COMMODITIES 185 (Comm. Print 2014) [hereinafter REP. ON BANK INVOLVEMENT WITH PHYSICAL COMMODITIES]; *see also supra* Part I.A.1 (discussing the GLBA provisions permitting FHCs to engage in commercial activities).

58. The LME is the "world [center] for the trading of industrial metals." *About Us*, *supra* note 15.

59. REP. ON BANK INVOLVEMENT WITH PHYSICAL COMMODITIES, *supra* note 57, at 182–83.

60. Omarova, *supra* note 22, at 321–22 ("Ownership of the key LME warehouses by large commodity traders with integrated financial and physical metals operations allows them to control the supply of aluminum to commercial users and, as a result, to control prices.").

Detroit warehouses skyrocketed between 2010 and 2014.⁶¹ The Midwest Premium, a measure for the cost of delivering physical aluminum in the United States, also increased dramatically during the same period, both in real dollars—over 300%—and as a proportion of the “all-in” aluminum price.⁶² The Midwest Premium and exit queue length at Metro’s Detroit warehouses were highly correlated during that span, as the premium is “intended to reflect, in part, storage costs.”⁶³

Goldman Sachs, arguably, was able to effect these changes in the United States aluminum market through its ownership of Metro and the LME. It orchestrated several “merry-go-round” transactions in which the metal owner involved in the deal would cancel its warrants on hundreds of thousands of metric tons of aluminum, wait in line, load out its metal from the Metro warehouses, load it back into different Metro warehouses, and re-warrant the metal.⁶⁴ These metal owners received “surreptitious financial incentives for leaving their metal within the Metro warehouse system,” while other warehousing clients were superfluously blocked from exiting and charged with increased rent costs.⁶⁵ Astoundingly, Metro’s warehouses were able to satisfy the LME’s minimum load-out requirement, notwithstanding their significant exit delays and “loaded out” metal not actually leaving the Metro system.⁶⁶ In the end, these

61. REP. ON BANK INVOLVEMENT WITH PHYSICAL COMMODITIES, *supra* note 57, at 178 (describing how the exit “queue went from about 40 days to over 600 days”).

62. *Id.* at 171–73, 178 (“Physical aluminum contracts typically establish the aluminum price using several pricing components which, when combined, produce an ‘all-in’ aluminum price. One key component is the LME Official Price for aluminum as of a specific date or as an average over a specified period. That price is established through trading on the LME exchange and is generally recognized for aluminum as the ‘global reference for physical contracts.’ The second key pricing component is a regional ‘premium,’ which is intended to reflect the availability of aluminum in a particular geographic area and the cost of delivering aluminum there. The relevant premium for aluminum sold in the United States is the Midwest Aluminum Premium (Midwest Premium).” (footnotes omitted)).

63. *Id.* at 179.

64. *Id.* at 194–206. “Warrants” are “documents that convey actual legal title to specific lots of metal stored in LME-approved warehouses.” *Id.* at 175. If an owner wants to remove its metal from the warehouse, it “cancels” the warrant and has the metal delivered to a location of its choice. *Id.* at 175–76.

65. *Id.* at 222.

66. *Id.* at 194–206, 222. Rather than applying the minimum load out rate to each individual warehouse, the LME rules allowed Metro to apply the load out rate on a “collective basis” for all of its Detroit warehouses, thus creating a “single exit queue” for the entire Metro system. *Id.* at 192. While LME rules prohibited the loaded out metal from being immediately returned to the same

complex transactions seemed to “have had little economic rationale, but increased revenues to Metro and its owner, Goldman [Sachs].”⁶⁷

Goldman Sachs, meanwhile, was also actively trading physical aluminum and aluminum-related financial instruments. Notwithstanding information barrier policies designed to eliminate impermissible access to proprietary information, Goldman Sachs “increased its aluminum trading, hired new aluminum traders friendly with Metro management, accumulated massive aluminum holdings, engaged in outsized aluminum transactions, and traded in aluminum-related” financial products after obtaining access to Metro’s non-public information.⁶⁸ Thus, Goldman Sachs had emerged as an “increasingly influential participant in the aluminum markets” following its acquisition of Metro.⁶⁹ It is all but apparent that FHCs and other institutions have the tools needed to manipulate physical commodities markets.⁷⁰

Upset by delivery delays and increased aluminum costs, Coca-Cola filed a complaint with the LME in 2011, alleging that Goldman Sachs was purposely limiting the release of aluminum from its Metro-operated warehouses.⁷¹ Although the LME did eventually change its rules—doubling the minimum delivery rate for large warehouses—in response to consumer complaints, it was viewed as too little, too late.⁷² The LME, as

warehouse, the owner was free to have it delivered to any other desired location, including another Metro warehouse in the vicinity. *Id.* at 204–07.

67. *Id.* at 222. Goldman Sachs also engaged in “large proprietary aluminum cancellations,” which had the same blocking effect. *Id.*

68. *Id.* at 182–83, 224–25 (noting that Goldman Sachs “owned no physical aluminum at all” when it purchased Metro, but held a stock exceeding “1.5 million metric tons worth more than \$3.2 billion dollars” by the end of 2012). Goldman Sachs was able to trade physical aluminum as a “complementary” activity. *See supra* Part I.A.2.

69. *See REP. ON BANK INVOLVEMENT WITH PHYSICAL COMMODITIES, supra* note 57, at 182.

70. Goldman Sachs was not the only FHC engaging in this type of conduct. Morgan Stanley and JPMC were also able to gain monopoly power over various commodities markets. *See generally id.* at 227–396 (discussing Morgan Stanley and JPMC’s questionable behavior in several commodities markets). FHCs were not the only entities involved in these activities. For example, Glencore, a commodity trading and mining company, participated in merry-go-round transactions. *See id.* at 202–04.

71. *See Omarova, supra* note 22, at 323.

72. *See* Pratima Desai et al., *Goldman’s New Money Machine: Warehouses*, REUTERS (July 29, 2011), <http://www.reuters.com/article/2011/07/29/us-lme-warehousing-idUSTRE76R3YZ20110729> (“Critics dismiss the move as too small to have any real effect, especially because of the delay until [the new

an SRO, creates its own trading rules. As a demutualized exchange, the LME's owners decide whether and to what extent the exchange's rules and procedures need to be changed. Given its ownership of both Metro and the LME, Goldman Sachs was called to reevaluate exchange warehousing rules stemming from its own alleged wrongdoings, thus clearly raising a conflict of interest.⁷³

The GLBA presents FHCs with the statutory authority to mix banking and commerce, thus increasing their ability to manipulate commodities markets. Other non-FHCs also possess such ability.⁷⁴ The demutualization of self-regulating commodities exchanges exacerbates the potential for market manipulation, as exchange ownership is now open to the general public and owners are arguably incentivized to adopt profit-maximizing, self-serving rules. The underlying issue of exchange self-regulation transcends the question of who is doing the manipulating: Is it viable to rely on commodities exchanges to protect the integrity and efficiency of the trading markets given their transformation to shareholder-owned, for-profit businesses?⁷⁵ Part II analyzes the merits of the current self-regulatory model as well as explores ways to shore up its deficiencies.

II. COMMODITIES EXCHANGES ARE NOT PROPERLY INCENTIVIZED TO PROMOTE MARKET EFFICIENCY AND INTEGRITY

It has long been accepted that exchanges are ideal candidates for self-regulation because they have appropriate incentives to deter manipulation of their markets and possess the expertise to do so.⁷⁶ Section A discusses the assumptions underlying the self-regulatory framework and argues that exchanges are not properly incentivized to promote market efficiency and integrity, especially in light of demutualization. Section B ex-

rule] comes in.”).

73. Moreover, Metro had personnel on an LME advisory committee for warehousing rules. REP. ON BANK INVOLVEMENT WITH PHYSICAL COMMODITIES, *supra* note 57, at 182–83.

74. See *supra* notes 13–14 and accompanying text.

75. See generally Karmel, *supra* note 44, at 420–27 (recognizing that exchange demutualization potentially creates conflicts of interest and briefly discussing different self-regulatory models).

76. See *infra* Part II.A.1.

plores options to compel exchanges to better deter manipulation but recognizes their inadequacies, thus ultimately concluding that there needs to be a fundamental shift in the current self-regulatory framework.

A. THE CURRENT SELF-REGULATORY MODEL RESTS ON FLAWED ASSUMPTIONS

Exchanges have traditionally been self-regulatory organizations free to set trading rules as they see fit. Subsection 1 outlines the economic theories supporting exchange self-regulation against market manipulation. Subsection 2 challenges their underlying assumptions, positing that exchanges are not incentivized to adequately deter manipulation. Subsection 3 describes further problems with exchange self-regulation given the trend toward demutualization.

1. Economic Arguments in Favor of Exchange Self-Regulation Against Market Manipulation

Futures market manipulation is defined as “the exercise of monopoly power as a futures contract nears expiration, commonly termed a ‘squeeze’ or a ‘corner.’”⁷⁷ Such manipulation “distorts prices in both delivery and nondelivery markets, induces uneconomic flows of the commodity, and distorts production, storage, and transport decisions.”⁷⁸ It also “redistributes wealth . . . to the manipulator,” “increases trading costs for nonmanipulators,” “increases basis risk, thereby harming hedgers,” and “reduces the informativeness of futures prices.”⁷⁹

77. *Self-Regulation*, *supra* note 12, at 141. Although this is a fairly narrow definition, Goldman Sachs allegedly engaged in this exact type of manipulation by using monopoly power to limit the supply of physical aluminum, thus “squeezing” or “cornering” the market. For detailed explanations of the economics behind market power manipulation, see generally Stephen C. Pirrong, *Mixed Manipulation Strategies in Commodity Futures Markets*, 15 J. FUTURES MKTS. 13 (1995); Stephen C. Pirrong, *Manipulation of the Commodity Futures Market Delivery Process*, 66 J. BUS. 335 (1993).

78. *Self-Regulation*, *supra* note 12, at 148.

79. *Id.* A “hedge” occurs when an individual makes “an investment to reduce the risk of adverse price movements in an asset. Normally, a hedge consists of taking an offsetting position in a related security, such as a futures contract.” *Hedge*, INVESTOPEDIA, <http://www.investopedia.com/terms/h/hedge.asp> (last visited Oct. 12, 2015). “Basis risk” is the “risk that offsetting investments in a hedging strategy will not experience price changes in entirely opposite directions from each other. This imperfect correlation between the two investments creates the potential for excess gains or losses in a hedging strategy, thus adding risk to the position.” *Basis Risk*, INVESTOPEDIA, <http://www.investopedia.com/terms/b/basisrisk.asp> (last visited Oct. 12, 2015).

Market manipulation, therefore, is to be avoided.⁸⁰

The theories supporting exchange self-regulation share the same basic premise: exchanges have a profit-maximizing incentive to deter manipulation and adopt efficient rules.⁸¹ Inefficient rules increase trading costs, which results in lower trading volume.⁸² Because of the direct relationship between trading volume and exchange profits, exchanges will maximize their profits by adopting the most efficient rules.⁸³ In other words, “[i]t is plainly in the interest of exchanges to define the terms of contracts and establish rules that reduce the amount of monopoly and manipulation,”⁸⁴ as customers will cease to trade on the exchange if it inadequately deters manipulation and allows trading costs to rise beyond acceptable levels. Thus, these theories conclude that anti-manipulation laws are unnecessary, as exchanges internalize the costs and benefits of deterring manipulation.⁸⁵

The next issue, then, is whether the private costs and benefits of deterrence are equal to the social costs and benefits.⁸⁶ While some scholars simply assume this to be true,⁸⁷ others substantiate the claim based on the limited reach of futures markets inefficiencies: traders “bear most of the costs and receive most of the gains from trading in these markets.”⁸⁸ Thus, only the exchanges and their customers substantially suffer from market manipulation, not the public at large.⁸⁹

Moreover, self-regulation advocates contend that external effects of manipulation are inconsequential to those who rely on

80. For a more thorough discussion of the adverse consequences, see *Self-Regulation*, *supra* note 12, at 144–48.

81. Compare Frank H. Easterbrook, *Monopoly, Manipulation, and the Regulation of Futures Markets*, 59 J. BUS. S103, S112 (1986) (explaining that commodities exchanges are incentivized to reduce monopoly and manipulation), with *Self-Regulation*, *supra* note 12, at 148–68 (criticizing commentators, such as Easterbrook, who argue that commodities exchanges are efficient).

82. See *Self-Regulation*, *supra* note 12, at 148–49.

83. See *id.*

84. Easterbrook, *supra* note 81.

85. See *Self-Regulation*, *supra* note 12, at 142.

86. See Easterbrook, *supra* note 81, at S113.

87. *E.g.*, *id.* at S113; Linda N. Edwards & Franklin R. Edwards, *A Legal and Economic Analysis of Manipulation in Futures Markets*, 4 J. FUTURES MKTS. 333, 355 (1984) (“[I]t is difficult to discern a significant divergence between the private costs and benefits and the social costs and benefits that are associated with preventive self-regulation.”).

88. Daniel R. Fischel & David J. Ross, *Should the Law Prohibit “Manipulation” in Financial Markets?*, 105 HARV. L. REV. 503, 549 n.200 (1991).

89. *Contra supra* text accompanying note 5.

the accuracy of information embedded in futures prices to make allocative decisions (but do not actually trade on the exchange) because price distortions are short-lived and understood.⁹⁰ These passive information-consumers, in other words, are largely unaffected because they can discern when market manipulation is occurring and effectively adjust their expectations and behavior. Furthermore, those who rely on accurate futures prices also trade in futures markets; thus, inaccurate prices will cause them to trade less and spur the exchange to better deter manipulation.⁹¹ Similarly, those dependent on informative futures prices also trade in spot markets,⁹² so exchanges are incentivized to deter even short lived, tail-end price manipulation.⁹³ Exchanges then, at least theoretically, are in the best position to regulate against market manipulation because they internalize the vast majority of the costs and benefits. Nonetheless, Subsection 2 explains why this is likely not the case in reality.

2. Exchanges Are Not Incentivized To Adequately Deter Manipulation

It is not sound to assume that exchanges internalize nearly all of the costs and benefits of manipulation deterrence. Manipulation may decrease the demand for an exchange's services, as it reduces the efficacy of hedging and increases trading costs.⁹⁴ The exchange, however, does not "necessarily bear the entire burden of this fall in demand" because customers bear some of the costs of insufficient precautions against manipulation.⁹⁵ For example, manipulation increases the volatility of futures prices, thus inducing marginal speculators to enter the market but also harming inframarginal users of futures contracts, such as highly risk-averse hedgers.⁹⁶ The reduced demand from hedgers is somewhat (if not fully) offset by in-

90. See Easterbrook, *supra* note 81, at S108 n.4; Edwards & Edwards, *supra* note 87, at 346–47.

91. See Easterbrook, *supra* note 81, at S113.

92. A "spot market" is "[a] commodities or securities market in which goods are sold for cash and delivered immediately. Contracts bought and sold on these markets are immediately effective." *Spot Market*, INVESTOPEDIA, <http://www.investopedia.com/terms/s/spotmarket.asp> (last visited Oct. 12, 2015).

93. See Fischel & Ross, *supra* note 88.

94. See *Self-Regulation*, *supra* note 12, at 151.

95. *Id.*

96. See *id.* at 152. Suppose there are 100 users of an exchange's services. Users 1 to 100 are "inframarginal" users while the 101st user would be the "marginal" user.

creased demand from other exchange users.

Furthermore, “the trading of the manipulators themselves (which is often massive) tends to increase the demand” for exchange services.⁹⁷ As such, “it is possible that manipulation can actually increase” exchange wealth, even though it reduces other traders’ wealth by a larger amount.⁹⁸ Because exchanges may incur “only a small fraction of the total costs of manipulation,” they face “imperfect incentives” to deter it.⁹⁹

Advocates of self-regulation suggest that competition from other exchanges could mitigate these imperfect incentives, as the inframarginal users negatively affected by manipulation will take their business elsewhere.¹⁰⁰ It is not clear, however, that exchanges can effectively compete with each other with regard to a particular contract: “Although exchanges may compete vigorously to adopt new contracts, there are no major examples of the successful entry of a new contract in direct competition with an established one.”¹⁰¹ This phenomenon could be due to existing contracts embodying efficient rules, but it could also be attributable to barriers to entry.¹⁰² Commodities futures contracts are conducive to natural monopolies because “concentrating all trading in a single contract increases liquidity and thereby reduces trading costs.”¹⁰³

In order to overcome illiquidity, a successful new contract must simultaneously attract a sufficient contingent of existing traders from the incumbent in addition to the dissatisfied traders currently out of the market altogether.¹⁰⁴ Because of the difficulty in coordinating a widespread defection, “it is quite costly for an entrant contract to survive, even if its terms and the policies of the exchange offering it dominate the incumbent contract and exchange.”¹⁰⁵ Nonetheless, if another exchange can in-

97. *Id.*

98. *Id.* at 153–54.

99. *Id.* at 154.

100. *See id.*

101. *Id.*

102. *Id.*

103. *Id.*

104. *See id.* at 155.

105. *Id.*; *see also* REP. ON BANK INVOLVEMENT WITH PHYSICAL COMMODITIES, *supra* note 57, at 177 (stating that “the new [Chicago Mercantile Exchange] aluminum products have been thinly traded”); Luzi-Ann Javier, *Aluminum Futures Debut on CME Amid Wrangling on LME Rules*, BLOOMBERG (May 6, 2014), <http://www.bloomberg.com/news/articles/2014-05-06/aluminum-futures-debut-on-cme-amid-wrangling-on-lme-rules.html> (noting that the Chicago Mercantile Exchange “know[s] that it takes times [sic] for new contracts to grow and develop liquidity”).

roduce a new contract that successfully competes with an existing one, “any lack of incentives to deter manipulation would afflict incumbent and potential entrant alike.”¹⁰⁶ Thus, competition itself does not guarantee that an exchange will adequately deter manipulation and adopt efficient rules.¹⁰⁷

It is also tenuous to dismiss the importance of information externalities.¹⁰⁸ Although it is possible that less efficient prices reduce demand for exchange services (since those who rely on efficient prices also trade on futures and spot markets—for example, hedgers), “it is by no means clear that the costs imposed on exchanges” from this demand reduction “are even approximately equal in magnitude to the total costs arising from less informative prices.”¹⁰⁹ This is because the value of risk reduction to a hedger is not binary—dependent “on whether prices are complete noise or perfectly informative”—but instead falls on a continuum—the greater the price efficiency, the greater the value.¹¹⁰ In other words, hedgers may continue to utilize exchange services, notwithstanding less informative prices, because there is still value in doing so (albeit not as much). While exchanges may bear some of the costs of inadequate manipulation deterrence, there is reason to believe that they do not “internalize anywhere near all such costs, either in total or at the margin.”¹¹¹ Notwithstanding an incomplete internalization of costs, Subsection 3 details how the trend toward demutualization may positively incentivize exchanges to inadequately deter manipulation.

3. Demutualization Exacerbates Inadequate Manipulation Deterrence

Aside from the shortcomings of exchange-specific economic theories supporting self-regulation, there are also flawed as-

106. *Self-Regulation*, *supra* note 12, at 155.

107. *Id.* (“One therefore cannot expect competition to ensure efficiency any more than one would expect competition between steel producers to induce them to control the costs of the pollution from their stacks that others bear.”).

108. *See supra* text accompanying notes 91–93.

109. *Self-Regulation*, *supra* note 12, at 156.

110. *Id.*

111. *Id.* at 156–57 (emphasis omitted). For a thorough discussion of empirical evidence supporting the view that exchange self-regulation is ineffective in deterring manipulation, see *id.* at 165–95. *Contra* Paul G. Mahoney, *The Exchange as Regulator*, 83 VA. L. REV. 1453, 1471 (1997) (“There is a large popular literature that suggests that manipulation was ubiquitous in the American financial markets before the turn of the century, but little detailed evidence of such manipulation exists. In most instances manipulation is inferred from large price swings.” (footnote omitted)).

assumptions underlying the overarching self-regulatory framework employed in financial markets. The framework assumes that “SROs adopt innovative, timely regulatory solutions” and “implement and enforce rules consistent with federal regulations and the public’s interest in market integrity and stability.”¹¹² The framework also presumes that “the person or group that exercises decision-making authority for the SRO will prioritize these regulatory norms.”¹¹³ The final assumption that SROs “embrace their role as enforcers of public policy” is likely the most questionable, as SROs are “neither government agencies nor proxies of regulators.”¹¹⁴ Thus, SRO regulation does not necessarily align market participants’ behavior with the public interest.¹¹⁵

Demutualization presents significant resistance to the presumption that exchanges will adequately promote market integrity and efficiency, as ownership is now open to the general public.¹¹⁶ Shareholders with profit-maximizing incentives may govern the exchange, and the exchange’s board of directors may choose to “prioritize[] earnings or the commercial interests of certain classes of shareholders above regulatory norms.”¹¹⁷ Thus, demutualization increases the risk that exchanges will “fail to serve as effective governing authorities” in the context of market manipulation.¹¹⁸ Given the flawed assumptions underlying the arguments in favor of the current self-regulatory framework, Section B explores options to improve, but not fundamentally change, commodity exchange self-regulation.

B. POTENTIAL CHANGES THAT PRESERVE THE CURRENT SELF-REGULATORY FRAMEWORK

While the current self-regulatory framework for exchanges has its shortcomings, it also has merit. Exchanges do internal-

112. Johnson, *supra* note 39, at 202.

113. *Id.*

114. *Id.* at 203; cf. Donna M. Nagy, *Playing Peekaboo with Constitutional Law: The PCAOB and Its Public/Private Status*, 80 NOTRE DAME L. REV. 975, 1007 (2005) (discussing the Public Company Accounting Oversight Board’s status as a non-profit corporation with an “inherently governmental mission”).

115. Johnson, *supra* note 39, at 203; see also *supra* Part I.C (explaining how the LME failed to serve its public policy role).

116. See *supra* text accompanying notes 52–55.

117. Johnson, *supra* note 39, at 206; see also *supra* Part I.C (discussing Goldman Sachs’s ownership of the LME).

118. See Johnson, *supra* note 39, at 206; see also Onnig H. Dombalagian, *Self and Self-Regulation: Resolving the SRO Identity Crisis*, 1 BROOK. J. CORP. FIN. & COM. L. 317, 317 (2007) (“Market-based self-regulatory organizations (SROs) are in the throes of an identity crisis.”).

ize some of the costs associated with market manipulation, thus providing some incentive to deter it. More generally, SROs often use their “unique expertise and sophistication” to “adopt and implement industry standards that enhance efficiency and organization” within their specific industry.¹¹⁹ SROs are also “unencumbered by the bureaucratic processes that stymie government regulators’ rule-making efforts” and decrease responsiveness to violations of community standards.¹²⁰ Self-regulation, therefore, presents “a dynamic alternative to the presumed binary choice between a laissez-faire and a command-and-control regulatory approach.”¹²¹

The complexity and global nature of the financial industry bolster the argument for exchange self-regulation.¹²² Moreover, the CFTC has shown signs of unwillingness to engage in more direct regulation of commodities exchanges.¹²³ Commodity exchange self-regulation, however, has strayed too far toward the laissez-faire end of the regulatory continuum. Even though many exchanges are now for-profit businesses, they still “provide a critical, public, infrastructure resource within financial markets.”¹²⁴ Subsections 1–2 discuss two suggestions aimed at focusing commodities exchanges on their public duties, but recognize that they fall short of a necessary, fundamental shift in the existing framework.

1. Increased Pressure by the CFTC Office of the Inspector General

Notwithstanding its oversight responsibilities, the CFTC has generally deferred to commodity exchange self-regulation.¹²⁵ Given this freedom, demutualized commodities exchanges are primed to adopt rules that maximize the exchange’s profits to the detriment of market efficiency and integrity. One way to hone concentration on the public interest is to

119. Johnson, *supra* note 39, at 189.

120. *Id.*

121. *Id.* at 235.

122. See Saule T. Omarova, *Wall Street as Community of Fate: Toward Financial Industry Self-Regulation*, 159 U. PA. L. REV. 411, 416 (2011) (arguing that financial industry self-regulation is a necessary component of a “workable long-term solution”). *But cf.* William A. Birdthistle & M. Todd Henderson, *Becoming a Fifth Branch*, 99 CORNELL L. REV. 1, 6 (2013) (“[T]he mismatch between SROs’ governmental powers and private unaccountability is leading our financial regulatory system towards an unstable and unsustainable structure . . .”).

123. See *supra* note 18.

124. Johnson, *supra* note 39, at 221.

125. See *supra* text accompanying note 49.

strengthen CFTC oversight and buck the traditional inclination toward deference and inaction.

Increased CFTC oversight could be achieved through the pressure of a “regulatory contrarian”: an entity that essentially regulates the regulator.¹²⁶ The key duty of a regulatory contrarian is to “counteract agency inaction or ossification in the face of changing market risks.”¹²⁷ The regulatory contrarian has three distinct features: (1) it is “at least partially affiliated with a particular regulatory body but simultaneously enjoy[s] meaningful independence from that agency”; (2) “possess[es] persuasive influence over its affiliated agency”; and (3) “stud[ies] and identif[ies] deficiencies and potential improvements in the regulatory process, regulatory policy, and/or the regulated market.”¹²⁸ Because regulatory contrarians have unique access to information and persuasive authority over their affiliated agencies, they likely have a “comparative advantage in emphasizing regulatory shortcomings and inaction.”¹²⁹

One recognized form of a regulatory contrarian is the office of the inspector general within an agency.¹³⁰ The CFTC Office of the Inspector General is an independent unit within the CFTC charged with the “mission . . . to detect waste, fraud, and abuse and to promote integrity, economy, efficiency, and effectiveness in the CFTC’s programs and operations.”¹³¹ The CFTC Inspectors General, therefore, assesses whether the CFTC is effectively monitoring exchanges and can recommend that the CFTC more closely scrutinize commodities exchanges’ efforts to promote the public interest.¹³² Increased CFTC scrutiny may force exchanges to better enforce their rules¹³³ and take a more

126. See Brett McDonnell & Daniel Schwarcz, *Regulatory Contrarians*, 89 N.C. L. REV. 1629, 1632–33 (2011).

127. *Id.* at 1646.

128. *Id.* at 1645–46.

129. *Id.* at 1647.

130. See *id.* at 1661.

131. *CFTC Organization*, U.S. COMMODITY FUTURES TRADING COMMISSION, <http://www.cftc.gov/About/CFTCOrganization/index.htm> (last visited Oct. 12, 2015).

132. The Inspector General of the SEC investigated the agency’s failure to prevent Bernard Madoff’s Ponzi scheme, ultimately influencing the scope and nature of SEC operational reforms. McDonnell & Schwarcz, *supra* note 126, at 1663. The Inspector General of the CFTC, similarly, could investigate the agency’s failure to prevent the LME’s tolerance for abusive warehousing practices. See *infra* note 198. Interestingly, it has been members of Congress, rather than the Inspector General, that has put pressure on the CFTC to more closely monitor the LME. See Brush, *supra* note 18.

133. Cf. REP. ON BANK INVOLVEMENT WITH PHYSICAL COMMODITIES, *supra* note 57, at 208 (stating that the LME viewed the merry-go-round transactions

public-oriented approach toward their promulgation.¹³⁴

While the use of internal audits and investigations likely increases agency accountability, inspectors general “are less effective than they could be at counteracting regulatory delay and inaction because they focus excessively on ‘compliance monitoring,’ or strict conformity with specific rules and regulations.”¹³⁵ It is also important to “establish[] positive incentives for achieving desired outcomes (‘performance accountability’) and promot[e] agency technologies and expertise (‘capacity building accountability’),”¹³⁶ but the typical inspector general is arguably ill-equipped to focus on these areas of accountability.¹³⁷

Notwithstanding the deficiencies of inspectors general, the CFTC is seemingly reluctant to become more involved with exchange regulation.¹³⁸ The CFTC currently acts as a backstop, whereby exchanges’ self-promulgated rules become effective unless the CFTC actively intervenes.¹³⁹ While the CFTC clearly has the ability to reject rules, history has shown that it does not in fact do so.¹⁴⁰ Moreover, the Dodd-Frank Act has imposed additional responsibilities upon the CFTC¹⁴¹ without providing

as “inconsistent with the ‘spirit’ of the relevant [LME] requirements” but that such transactions “may not violate the ‘letter’ of those requirements”).

134. See 7 U.S.C. § 7a-2(c)(5) (2012) (providing the circumstances where the CFTC is to reject exchange-promulgated rules).

135. McDonnell & Schwarcz, *supra* note 126, at 1663–64; accord PAUL C. LIGHT, *MONITORING GOVERNMENT: INSPECTORS GENERAL AND THE SEARCH FOR ACCOUNTABILITY* 224 (1993).

136. McDonnell & Schwarcz, *supra* note 126, at 1664; accord LIGHT, *supra* note 135, at 220.

137. See William S. Fields, *The Enigma of Bureaucratic Accountability*, 43 CATH. U. L. REV. 505, 518–19 (1994) (book review) (arguing that inspectors general are not well-suited to institute agency accountability methods other than compliance monitoring).

138. See *supra* note 18; see also SEC. INDUS. ASS’N, *WHITE PAPER: REINVENTING SELF-REGULATION* 23 (Oct. 14, 2003), <http://www.sifma.org/issues/item.aspx?id=21354> (noting the CFTC’s hesitation to administer “a program that required direct CFTC regulation for certain futures commission merchants” because it “would be difficult” and the agency “lacked sufficient resources to devote to such direct regulation”).

139. See Derek Fischer, Note, *Dodd-Frank’s Failure To Address CFTC Oversight of Self-Regulatory Organization Rulemaking*, 115 COLUM. L. REV. 69, 92 (2015) (contrasting the CFTC’s approach with that of the SEC, which reviews every proposed rule change except those that the SRO designates as exceptionally insubstantial).

140. See *id.* at 97 (finding that between 2008 and 2012, the CFTC did not reject a single proposed rule from the National Futures Association and adopted unchanged versions 93% of the time).

141. See Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203, tit. 7, 124 Stat. 1376, 1641–1802 (codified in vari-

additional resources, thus stretching the agency even thinner.¹⁴² Heightened CFTC oversight of exchanges would require a major shift from its current deferential approach, and the Inspector General is not in a strong position to hold the agency accountable for implementing such a shift. Given the challenges of strengthening CFTC oversight, Subsection 2 offers an alternative approach that focuses on preventing potential conflicts of interest caused by demutualization.

2. Limitations on Exchange Ownership and Control

As a result of demutualization, large financial institutions and securities dealers can potentially acquire significant ownership stakes (and voting control) in exchanges.¹⁴³ This raises a conflict of interest because, as owners of the exchange, they will be responsible for regulating their actions as market participants.¹⁴⁴ In governing an exchange, such financial institutions may be incentivized to prioritize their own interests over regulatory norms or the public interest.¹⁴⁵

One potential solution for such conflicts is to limit exchange ownership and control. With respect to clearinghouses,¹⁴⁶ the U.S. Securities and Exchange Commission (SEC) together with the CFTC proposed two options aimed at preventing large dealers from dominating boards of directors and preserving board independence.¹⁴⁷ The first proposal imposes individual and aggregate ownership limits for “specified entities” in an effort to promote diversity in board membership,

ous sections of 7 U.S.C., 12 U.S.C., and 15 U.S.C.).

142. See David Dayen, *Congress Is Starving the Agency That’s Supposed To Prevent Another Meltdown*, NEW REPUBLIC (Nov. 7, 2013), <http://www.newrepublic.com/article/115511/cftc-funding-will-prevent-it-regulating-derivatives> (“[The CFTC] has seen its operations squeezed by drastic underfunding, right at the time the Dodd-Frank financial reform law dropped a whole new set of responsibilities in its lap.”).

143. See, e.g., text accompanying *supra* note 59.

144. See, e.g., *supra* note 73 and accompanying text.

145. See *supra* text accompanying notes 117–18.

146. A “clearinghouse” is “[a]n agency or separate corporation of a futures exchange responsible for settling trading accounts, clearing trades, collecting and maintaining margin monies, regulating delivery and reporting trading data.” *Clearing House*, INVESTOPEDIA, <http://www.investopedia.com/terms/c/clearinghouse.asp> (last visited Oct. 12, 2015).

147. See Johnson, *supra* note 39, at 229–30; Ownership Limitations and Governance Requirements for Security-Based Swap Clearing Agencies, Security-Based Swap Execution Facilities, and National Securities Exchanges with Respect to Security-Based Swaps Under Regulation MC, 75 Fed. Reg. 65,882, 65,894–904 (proposed Oct. 26, 2010) [hereinafter Regulation MC] (to be codified at 17 C.F.R. § 242.00–02).

increase the likelihood of objective board decisions, and hamper large dealers' ability to gain voting control.¹⁴⁸ Under this proposal, a "specified entity" may not directly or indirectly own more than twenty percent (and a group of specified entities may not collectively own more than forty percent) of the clearinghouse's voting power.¹⁴⁹ The second option further restricts ownership, prohibiting any specified entity or individual member from owning more than five percent of the clearinghouse's voting control.¹⁵⁰

Both also impose board composition and committee requirements. The first alternative requires the board to be composed of at least thirty-five percent independent directors,¹⁵¹ while the second requires a majority of independent directors.¹⁵² Moreover, each proposal forces the board of the clearinghouse to create a nominating committee, disciplinary panel, and risk-management committee.¹⁵³ The CFTC could impose similar restrictions on commodity exchange ownership and control.

However, this corporate governance approach to eliminating conflicts of interest is not without its weaknesses. Notwithstanding these ownership and control limitations, large securities dealers may collaborate to defeat them.¹⁵⁴ In addition, "the appointment of independent directors may not effectively address concerns regarding policies that support large dealers' commercial incentives," as they may face conflicts of interest similar to those that inside directors face.¹⁵⁵ Even if such independent directors were effective in steering exchange policy away from certain owners' commercial interests, "it may be difficult to identify individuals who are truly independent"; that is, "free from relational ties to large dealers."¹⁵⁶ Thus, restrictions on exchange ownership and control may be circumvented or ineffective in establishing independent, public-oriented governance.

148. Regulation MC, 75 Fed. Reg. at 65,894–99; Johnson, *supra* note 39, at 230.

149. Regulation MC, 75 Fed. Reg. at 65,894–99.

150. *Id.* at 65,899–904.

151. *Id.* at 65,896.

152. *Id.* at 65,901.

153. *Id.* at 65,897–98, 65,901–02.

154. *See* Johnson, *supra* note 39, at 231.

155. *Id.*; accord Sanjai Bhagat & Bernard Black, *The Non-Correlation Between Board Independence and Long-Term Firm Performance*, 27 J. CORP. L. 231, 233 (2002); Lisa M. Fairfax, *The Uneasy Case for the Inside Director*, 96 IOWA L. REV. 127, 174–76 (2010).

156. Johnson, *supra* note 39, at 232 (emphasis omitted).

The suggestions discussed in Subsections 1–2 are pragmatic. The Inspector General within the CFTC already exists and can apply pressure on the CFTC to more closely scrutinize exchanges' self-regulation. The SEC and CFTC's two alternatives regarding limitations on clearinghouse ownership and control can serve as blueprints for establishing similar restrictions on commodities exchanges. In addition, these options are not mutually exclusive. The CFTC can strengthen its oversight of exchanges' self-promulgated rules while also imposing corporate governance controls. Neither, however, constitutes the type of wholesale reform needed to ensure that commodities exchanges focus their rulemaking efforts on adequately deterring manipulation and promoting market efficiency and integrity. Part III proposes a major shift in the commodity exchange self-regulatory framework: the creation of a new, independent regulatory entity structured similar to the FASB that is responsible for promulgating exchange rules and procedures.

III. A NEW SELF-REGULATORY MODEL: THE FASB FOR COMMODITIES EXCHANGES

Although the SEC has statutory authority to establish financial accounting standards for publicly traded companies, its “policy has been to rely on the private sector for this function to the extent that the private sector demonstrates ability to fulfill the responsibility in the public interest.”¹⁵⁷ Enter the Financial Accounting Standards Board: the designated organization for developing financial accounting standards that govern the preparation of nongovernmental financial reports.¹⁵⁸ Given the similarities between the stakeholders in financial accounting standards and those in commodity exchange rules, the strengths of the FASB-structure could be leveraged to improve commodity exchange self-regulation.¹⁵⁹

Section A discusses the FASB's ability to achieve institutional stability and legitimacy, notwithstanding its status as a private entity facing constant opposition from its own constituents. Section B analogizes the stakeholders in financial accounting standards to those in commodity exchange rules and procedures, concluding that their similarities warrant the creation of a FASB-structured regulatory entity. Finally, Section C

157. *Facts About FASB*, FASB, <http://www.fasb.org/facts> (last visited Oct. 12, 2015).

158. *Id.* As such, the SEC officially recognizes the FASB's standards as authoritative. *Id.*

159. *See infra* Parts III.A–B.

outlines a basic plan for organizing the new entity as well as acknowledges some of the challenges it will face.

A. THE FASB'S INDEPENDENCE AND GOAL OF "DECISION USEFULNESS"

The FASB is a self-regulatory organization for the accounting industry. It sets financial accounting standards for firms and management (Preparers), and auditors verify that Preparers properly follow these standards in producing financial reports for investors, creditors, and other financial market participants (Users). Subsection 1 provides the argument against self-regulation, or private standard-setting, while Subsection 2 explains how the FASB is able to overcome it, at least theoretically. Subsection 3 contends that the FASB's practices justify private standard-setting.

1. Argument Against Private Financial Accounting Standard-Setting

The line of reasoning critiquing private standard-setting focuses on the protection of the public interest. It is clear that accounting principles significantly influence allocative decisions,¹⁶⁰ and there is no such thing as a neutral and transparent accounting principle.¹⁶¹ Thus, setting accounting standards is "a high-stakes game in which the setter ha[s] no alternative but to balance interests."¹⁶² Because the standard-setter is largely resolving political rather than technical issues, its legitimacy is dependent on political responsiveness.¹⁶³ The use of a private, independent standard-setter, therefore, is likely to result in "irrelevance, isolation, and unaccountability."¹⁶⁴ Notwithstanding any potential loss in economic efficiency,¹⁶⁵ the power to set ac-

160. William W. Bratton, *Private Standards, Public Governance: A New Look at the Financial Accounting Standards Board*, 48 B.C. L. REV. 5, 19 (2007).

161. George Mundstock, *The Trouble with FASB*, 28 N.C. J. INT'L L. & COM. REG. 813, 822 (2003).

162. Bratton, *supra* note 160; accord ROBERT VAN RIPER, SETTING STANDARDS FOR FINANCIAL REPORTING: FASB AND THE STRUGGLE FOR CONTROL OF A CRITICAL PROCESS 73–74 (1994).

163. Bratton, *supra* note 160.

164. Mundstock, *supra* note 161, at 820.

165. A public standard-setter would not be without its costs. Regulatory failures are generally understood to include "rigidity, monetary waste, a tendency to uniformity, and the suppression of innovation." Orly Lobel, *The New Deal: The Fall of Regulation and the Rise of Governance in Contemporary Legal Thought*, 89 MINN. L. REV. 342, 444 (2004). On the other hand, see *supra* text accompanying notes 119–20 for a general discussion of the benefits of

counting standards must be vested in an agency directly responsible to Congress in order to ensure accountability.¹⁶⁶

Accountability and independence, however, are not necessarily mutually exclusive. Subsection 2 explains how the FASB's stated preference for "decision usefulness" epitomizes the idea of the new governance model: "economic efficiency and democratic legitimacy can, under certain conditions, point in the same direction."¹⁶⁷

2. The FASB's Explicit Choice To Favor Users of Financial Reports

The FASB's decision usefulness underpinning is contained in the Statement of Financial Accounting Concepts No. 1: "Financial reporting should provide information that is useful to present and potential investors and creditors and other users in making rational investment, credit, and similar decisions."¹⁶⁸ By raising external transparency, or decision usefulness, over internal managerial control of financial reporting treatments, the FASB created an "overriding goal" in developing standards.¹⁶⁹ Without an overriding goal, the FASB would end up with "the political task of accommodating conflicting interests as it pursue[d] multiple goals,"¹⁷⁰ thus compromising its independence. The FASB's explicit focus on Users, therefore, provides it with substantive legitimacy as an independent, expert organization.

Decision usefulness is also "generally accepted as a policy matter" and "aligns the FASB with information economics."¹⁷¹ Because financial information is a public good that would be underprovided without regulation, accounting standards with a decision usefulness underpinning reduce information asymmetries and the associated social costs—high transaction costs

self-regulation.

166. See Bratton, *supra* note 160; ROBERT CHATOV, CORPORATE FINANCIAL REPORTING: PUBLIC OR PRIVATE CONTROL? 7–8 (1975).

167. Lobel, *supra* note 165, at 443.

168. FIN. ACCOUNTING STANDARDS BD., STATEMENT OF FINANCIAL ACCOUNTING CONCEPTS NO. 1: OBJECTIVES OF FINANCIAL REPORTING BY BUSINESS ENTERPRISES 5 (1978), http://www.fasb.org/jsp/FASB/Document_C/DocumentPage?cid=1218220132512&acceptedDisclaimer=true.

169. See Bratton, *supra* note 160, at 29 (remarking on the "expertise model"); see also JAMES M. LANDIS, THE ADMINISTRATIVE PROCESS 50–51 (1938) (discussing the need for a stated objective similar to an overriding goal).

170. Bratton, *supra* note 160, at 29; see Richard B. Stewart, *The Reformation of American Administrative Law*, 88 HARV. L. REV. 1667, 1702 (1975).

171. Bratton, *supra* note 160, at 26–27.

and thin, illiquid capital markets.¹⁷² If investors had access to different levels of information, then those with access to higher levels would likely experience outsized returns while those with access to lower levels would drop out of the market.¹⁷³ As a result, “spreads would widen, transaction costs would rise, and volume would drop.”¹⁷⁴ User-focused standards place investors on a relatively equal footing (at least in terms of publicly available information), thus enhancing allocative efficiency.¹⁷⁵

User-oriented standards also balance the reporting system, as dispersed Users of financial statements “have no incentive to produce standards.”¹⁷⁶ If financial statement Preparers and auditors worked together to create financial accounting standards, then “management would have an advantage in getting rule innovations to suit its interests, causing information asymmetries.”¹⁷⁷ Thus, the FASB is justified in favoring decision usefulness instead of applying an interest-balancing approach. Subsection 3 discusses how the FASB has stayed true to its public-oriented mission in practice.

3. The FASB’s Practices Legitimate Private Standard-Setting

Notwithstanding Preparer opposition, the FASB has consistently pursued decision usefulness. Preparers have used both the FASB notice and comment process¹⁷⁸ and the Financial Accounting Standards Advisory Council (FASAC)¹⁷⁹ advisory process to lobby for their interests, but to no avail.¹⁸⁰ Although

172. *Id.* at 30–31; Baruch Lev, *Toward a Theory of Equitable and Efficient Accounting Policy*, 63 ACCT. REV. 1, 9 (1988).

173. Bratton, *supra* note 160, at 31; Lev, *supra* note 172, at 6–7.

174. Bratton, *supra* note 160, at 31; accord Lev, *supra* note 172, at 8.

175. See Bratton, *supra* note 160, at 31; Lev, *supra* note 172, at 4–9.

176. Bratton, *supra* note 160, at 31; accord Ronald King & Gregory Waymire, *Accounting Standard-Setting Institutions and the Governance of Incomplete Contracts*, 9 J. ACCT. AUDITING & FIN. 579, 594–96 (1994).

177. Bratton, *supra* note 160, at 31; see King & Waymire, *supra* note 176, at 594–95.

178. The FASB’s standards-setting process is structured to “encourage[] broad participation” and “objectively consider[] all stakeholder views.” *Standard-Setting Process*, FASB, <http://www.fasb.org/jsp/FASB/Page/SectionPage&cid=1351027215692> (last visited Oct. 12, 2015) (providing an overview of the FASB’s seven-step standard-setting process). See generally FIN. ACCOUNTING STANDARDS BD., RULES OF PROCEDURE (2014), http://www.fasb.org/cs/ContentServer?c=Document_C&pagename=FASB%2FDocument_C%2FDocumentPage&cid=1176162391050 (detailing the FASB’s organizational mission, structure, and operating procedures).

179. See *infra* note 210.

180. See Bratton, *supra* note 160, at 34; see also VAN RIPER, *supra* note 162, at 99; Dennis R. Beresford, Commentary, *How Should the FASB Be Judged?*,

Preparers “complain and get occasional concessions,” the FASB “continues to promulgate standards that they oppose.”¹⁸¹ Because the FASB’s dedication to providing standards with decision usefulness aligns with the SEC’s mission to protect Users, the two institutions have a symbiotic relationship.¹⁸² The FASB largely operates free from political pressure and overbearing oversight, and the SEC saves resources by relying on a private entity to create financial accounting standards.¹⁸³ Its power, however, is not unchecked: “The FASB’s authority depends on SEC certification, and because the SEC maintains its own standard-setting capacity, it can overrule the FASB by taking a matter into its own hands.”¹⁸⁴ The FASB’s decision usefulness underpinning ensures that it maintains a public tilt and remains in the SEC’s good graces, thus liberating it from constituent pressures and allowing it to positively sustain independence. Given the FASB’s ability to consistently act in the public interest, Section B argues for the creation of a FASB-structured regulatory entity for commodities exchanges.

B. COMMODITY EXCHANGE SELF-REGULATION IS CONDUCTIVE TO THE FASB MODEL

The current commodity exchange self-regulatory framework fails to effectively promote the public interest in market efficiency and integrity. The FASB, however, “provides an excellent example of a successful public-to-private contract” for creating financial accounting standards that protect Users.¹⁸⁵ Given the similarities between the stakeholders in financial accounting standards and those in commodity exchange rules, the creation of a FASB-structured regulatory entity for commodi-

ACCT. HORIZONS, June 1995, at 56, 60–61.

181. Bratton, *supra* note 160, at 34; see VAN RIPER, *supra* note 162, at 98, 118–31, 183. *But see* Mundstock, *supra* note 161, at 839 (“When faced with controversy, particularly critiques from business interests, the private standard-setter has either reorganized or capitulated.”).

182. Bratton, *supra* note 160, at 35–36 (“The alignment, thus set in theory, works in practice because the FASB’s appointments structure and rules of independence assure that its members pursue its formal mission rather than constituent or personal interests.”).

183. *Id.* The two institutions regularly communicate and collaborate. See *id.* at 36; see also Lobel, *supra* note 165, at 376–79 (discussing collaborative governance).

184. Bratton, *supra* note 160, at 36; see Matthew J. Barrett, *The SEC and Accounting, in Part Through the Eyes of Pacioli*, 80 NOTRE DAME L. REV. 837, 868 (2005); Lawrence A. Cunningham, *Private Standards in Public Law: Copyright, Lawmaking and the Case of Accounting*, 104 MICH. L. REV. 291, 323 (2005).

185. Bratton, *supra* note 160, at 35.

ties exchanges is a logical and viable solution.¹⁸⁶ Subsection 1 analogizes the stakeholders in financial accounting standards to those in commodity exchange rules, contending that the new regulatory entity explicitly favor the interests of end-users/producers (Hedgers) over large financial institutions/other speculative traders (Speculators). Subsection 2 briefly explains the new organization's position with respect to the Financial Industry Regulatory Authority (FINRA), a self-regulator for the securities industry, and the National Futures Association (NFA), a self-regulator for the futures industry.

1. The Stakeholders of Financial Accounting Standards and Commodity Exchange Regulation

Preparers produce financial statements using financial accounting standards while Users rely on those statements to make decisions.¹⁸⁷ Preparers and Users generally have conflicting interests.¹⁸⁸ Auditors, meanwhile, assure that Preparers are properly adhering to financial accounting standards. Because Preparers are the auditors' clients, auditors and Preparers' interests are reasonably aligned.

In commodities futures markets, Hedgers use hedging strategies to reduce the risk of commodity price movements while Speculators aim to profit from such price movements.¹⁸⁹

186. It is worth noting one potential objection to the comparison. Accounting is widely viewed as a "profession," while work in the financial industry is generally not associated with the same formal designation. Thus, it is arguably illogical to compare rulemaking for the two industries. However, "professions" are generally characterized by the use of a "specialized language" that separates those within the profession from those outside of it. See Mundstock, *supra* note 161, at 822; see also Dietrich Rueschemeyer, *Professional Autonomy and the Social Control of Expertise*, in *THE SOCIOLOGY OF THE PROFESSIONS* 38, 53 (Robert Dingwall & Philip Lewis eds., 1983) ("Exaggerated claims of validity and effectiveness, selective development of knowledge, protective maintenance of mystique and complexity, over-education with the aim of professional respectability and limitation of access to the profession are more or less common."). The financial industry is undoubtedly complex and requires a specific knowledge base. Because trading commodities futures (and work in the financial industry in general) requires the use of a "specialized language," the lack of a formal designation as a "profession" is irrelevant for this comparison.

187. See Bratton, *supra* note 160, at 7–9.

188. See *id.* at 9. Preparers would prefer less disclosure, while Users would prefer greater disclosure.

189. Reem Heakal, *Futures Fundamentals: The Players*, INVESTOPEDIA, <http://www.investopedia.com/university/futures/futures3.asp> (last visited Oct. 12, 2015); see also *supra* Parts II.A.1–2 (discussing the economics of commodities markets). Financial institutions speculate in commodities by holding proprietary positions in commodity-linked securities and/or physical commodities

Thus, Hedgers and Speculators have opposite goals.¹⁹⁰ Exchanges, meanwhile, supply orderliness to the trading process and assure that trades are properly executed (i.e., according to exchange rules). Because Speculators seek price volatility, they are incentivized to gain market power and induce artificial price movements through manipulative behavior.¹⁹¹ Commodities exchanges stand to benefit from manipulation (especially in light of demutualization),¹⁹² so their interests are reasonably aligned with Speculators seeking to gain monopoly power. While (some) Speculators profit from price distortions, Hedgers benefit from efficient prices, which induce economic flows of commodities and informed production, storage, and transportation decisions.¹⁹³

Similar to the FASB's preference for Users, the new regulatory entity for commodities exchanges would explicitly favor the interests of Hedgers over Speculators. The same rationales apply: giving preference to Hedgers avoids the political task of balancing conflicting interests and aligns with the economics underlying commodity exchange regulation.¹⁹⁴ Thus, in theory, the new entity would be both independent and legitimate from a policy standpoint. Its mission would be to promulgate exchange rules that support transactions with economic grounds and promote market efficiency and integrity.¹⁹⁵

The LME's warehousing load-out rules provide an instance where market efficiency and integrity likely were not prioritized.¹⁹⁶ In particular, one warehousing rule explicitly favored the interest of metal owners to freely transfer their metal over general market efficiency, ultimately benefiting Speculators to the detriment of Hedgers.¹⁹⁷ Conversely, the new regulatory en-

without having a productive use for the raw materials. *See supra* Part I.C.

190. *See* Heakal, *supra* note 189 ("Hedgers want to minimize their risk no matter what they're investing in, while [S]peculators want to increase their risk and therefore maximize their profits.").

191. *See supra* Part I.C. It is possible, however, for Hedgers to inadvertently obtain market power and squeeze the market. *Self-Regulation, supra* note 12, at 147.

192. *See supra* Parts II.A.2–3.

193. *See supra* text accompanying notes 78–80.

194. *See supra* Part III.A.2.

195. *Cf. supra* text accompanying note 67 (showing a clear and present need for such a body).

196. *See supra* note 66 and accompanying text.

197. *See supra* note 66 and accompanying text (describing an LME rule that allows a metal owner to remove its metal from the warehouse only to immediately place it in a different warehouse owned by the same warehousing company in the same area); *see also* REP. ON BANK INVOLVEMENT WITH PHYSI-

tity's Hedger underpinning would better ensure the creation of rules that resist abusive warehousing practices.¹⁹⁸ By favoring Hedgers over Speculators, the new entity would be better able to deter manipulation and ensure market efficiency and integrity. Notwithstanding a common focus on the public interest, Subsection 2 discusses the new regulatory entity's narrow scope of responsibility as compared to FINRA and the NFA.

2. The New Entity's Position Relative to FINRA and the NFA

Similar to the new regulatory organization, FINRA and the NFA are public-oriented self-regulators.¹⁹⁹ FINRA is the "single self-regulator for all securities firms doing business with the public."²⁰⁰ It is responsible for surveillance, investigation, rule promulgation, and enforcement with respect to securities dealers and brokers.²⁰¹ Thus, FINRA mainly focuses on market integrity from the securities-firm level.²⁰² The NFA, in large part, is FINRA's counterpart for the futures industry, but with arguably fewer responsibilities.²⁰³

The new entity, on the other hand, would be operating one level removed from traders—concerned with the commodities

CAL COMMODITIES, *supra* note 57, at 207 (noting that Metro claimed to be merely respecting that "the LME has long recognized the right of the metal owner to decide what to do with free metal" by allowing loaded-out metal to be immediately stored in a different Metro warehouse). It would be counterproductive for a Hedger to engage in this type of activity, as the decision to load out metal would be based on production needs.

198. See REP. ON BANK INVOLVEMENT WITH PHYSICAL COMMODITIES, *supra* note 57, at 192 ("Goldman and Metro's use of the LME load-out rate as a maximum rather than minimum load-out rate has been targeted as an abusive practice in over a dozen class action suits."). For example, a Hedger-friendly rule would require warehouses to load out greater quantities if cancelled warrants reached a certain level. See *supra* Part I.C.

199. *About FINRA*, FINRA, <http://www.finra.org/about> (last visited Oct. 12, 2015); *Who We Are*, NFA, <https://www.nfa.futures.org/NFA-about-nfa/index.html> (last visited Oct. 12, 2015).

200. Jonathan Macey & Caroline Novogrod, *Enforcing Self-Regulatory Organization's Penalties and the Nature of Self-Regulation*, 40 HOFSTRA L. REV. 963, 964 (2012).

201. See *id.*; *What We Do*, FINRA, <http://www.finra.org/about/what-we-do> (last visited Oct. 12, 2015).

202. FINRA does perform market regulation functions for some securities exchanges. Macey & Novogrod, *supra* note 200. *But see* John McCrank, *NYSE To Take Back Policing Duties from Wall Street Watchdog*, REUTERS (Oct. 6, 2014), <http://www.reuters.com/article/2014/10/06/ice-nyse-regulations-idUSL2N0S12N020141006>. Commodities exchanges have largely retained their market regulation responsibilities. See, e.g., LONDON METAL EXCH., *supra* note 17; *Rulebooks*, CME GROUP, <http://www.cmegroup.com/market-regulation/rulebook> (last visited Oct. 12, 2015).

203. See *supra* text accompanying note 50.

exchanges themselves. Moreover, the organization's exclusive responsibility would be exchange rule promulgation. In other words, the new entity would fill a niche role that is currently occupied by for-profit, demutualized exchanges.²⁰⁴ In light of this narrow scope of responsibility, Section C outlines a few basic ideas for implementing such an entity and acknowledges challenges with doing so.

C. THE IMPLEMENTATION OF THE FASB FOR COMMODITIES EXCHANGES

Given the trend toward exchange demutualization, the Securities Industry Association (later renamed Securities Industry and Financial Markets Association) established guiding principles for evaluating different regulatory options: any regulatory structure should “foster investor protection; preserve fair competition; eliminate inefficiencies; encourage expert regulation; promote reasonable and fair regulatory costs; foster due process; and encourage industry participation and self-regulation.”²⁰⁵ A FASB-structured regulatory entity for commodities exchanges largely comports with these principles. It would be a group of independent, knowledgeable experts charged with the mission of promulgating rules that favor Hedgers, thus deterring manipulation and promoting market efficiency and integrity. Subsection 1 provides a basic structure for the new entity, and Subsection 2 proposes its regulatory focus. Subsection 3 briefly discusses challenges facing the new rule promulgator.

1. Organizational Structure of the New Entity

If the new entity is similarly situated to the FASB vis-à-vis its mission and stakeholders, then it is logical to also organize it in a similar manner in an effort to replicate the FASB's success.²⁰⁶ Following the blueprint of the FASB, the board of the new organization would be composed of three exchange representatives, two Speculator representatives, one Hedger representative, and an academic.²⁰⁷ It would vote on a simple majori-

204. The new entity would likely work closely with NFA, thus further likening NFA to FINRA with regard to the scope of its responsibilities. *See infra* note 212 and accompanying text.

205. Karmel, *supra* note 44, at 424; *accord* SEC. INDUS. ASS'N, *supra* note 138, at 3–4.

206. *See supra* Parts III.A–B.

207. The FASB is comprised of three Certified Public Accountants, two Preparer representatives, one User representative, and one academic. *See* Bratton, *supra* note 160, at 23; *see also* VAN RIPER, *supra* note 162, at 125–26.

ty basis.²⁰⁸ The new regulatory entity would also be publicly funded: the federal government would levy fees on institutional traders (formerly known as an exchange's members), and after the CFTC recognized the new entity as the authoritative promulgator of commodity exchange rules, it would be funded through those fees.²⁰⁹

A surrounding regulatory framework is necessary for the implementation of the new entity. It would benefit from an advisory council, similar to the FASAC, containing members representative of the constituent groups and possessing relevant skills and knowledge.²¹⁰ A high-ranking member of the CFTC would be part of the council.²¹¹ Another supporting piece is already in place. The NFA, playing the role of the Financial Accounting Foundation (FAF), would be responsible for the oversight, administration, and finances of the new regulatory organization.²¹² With a structure and surrounding framework similar to that of the FASB, the new entity would likely to be in

208. The FASB also operates on a simple four-to-three majority rule. See Bratton, *supra* note 160, at 23–24. Although “studies have looked for connections between the members’ votes and prior affiliations,” they have “found nothing significant.” *Id.* at 24; see John C. McEnroe & Stanley C. Martens, *An Analysis of the FASB’s Independence*, J. APPLIED BUS. RES., Winter 1996/1997, at 129, 131–32 (determining that the FASB’s members vote independently). Likewise, there have not been any significant voting coalitions between former auditors and Preparers. Bratton, *supra* note 160, at 24; see, e.g., D. Paul Newman, *An Investigation of the Distribution of Power in the APB and the FASB*, 19 J. ACCT. RES. 247, 261 (1981) (finding that auditor representative influence has not been dominant). The hope would be that the members of the new regulatory entity would vote in a similarly independent manner.

209. The FASB stopped collecting contributions and became publicly funded in 2002, receiving federal government funding collected from fees levied on reporting companies. Bratton, *supra* note 160, at 24; see Cunningham, *supra* note 184. *But cf. infra* Part III.C.3 (noting the challenge of the new entity gaining such approval).

210. The FASAC is a group of FASB constituents that “consults with the FASB on technical issues, project priorities, and other matters likely to concern the FASB.” *Facts About FAF*, FAF, <http://www.accountingfoundation.org/cs/ContentServer?c=Page&pagename=Foundation%2FPages%2FFAFSectionPage&cid=1176157790151> (last visited Oct. 12, 2015). The FASB’s founders created the FASAC in an effort to ensure that the FASB was responsive to constituent interests. See CHATOV, *supra* note 166, at 232–39; VAN RIPER, *supra* note 180, at 9, 17; Bratton, *supra* note 160, at 14–15. The FASAC helps the FASB “prioritize, set agenda items, and keep things moving.” Bratton, *supra* note 160, at 15; accord CHATOV, *supra* note 166, at 234.

211. The original FASAC contained the SEC’s Chief Accountant. CHATOV, *supra* note 166, at 15; Bratton, *supra* note 160, at 15.

212. The FAF is an independent, not-for-profit entity that is responsible for the oversight, administration, and finances of the FASB. *About Us*, FAF, <http://www.accountingfoundation.org/jsp/Foundation/Page/FAFLandingPage&cid=1175805317591> (last visited Oct. 12, 2015).

a strong position to carry out its mission.

The alignment of the new entity's mission with that of the CFTC would lead to a collaborative, positive relationship between the two organizations.²¹³ The existence of the NFA, combined with the CFTC's support, would ease the transition to a sole, authoritative rule maker for commodities exchanges.²¹⁴ Given the structure of the new entity, Subsection 2 broadly discusses the type of rules it would promulgate.

2. Regulatory Focus of the New Entity

Some have argued that ex-post regulation is more effective than ex-ante regulation with regard to preventing market manipulation.²¹⁵ "Given the myriad of factors that determine a market's vulnerability" to manipulation, it is difficult to promulgate ex-ante regulations that properly deter manipulation, as "restrictions are frequently more severe than necessary to prevent manipulation and demoralize legitimate uses of markets."²¹⁶ Ex-post deterrence, on the other hand, does not pose the same problems. Strict, harm-based sanctions are preferable because "the probability of detection of a market power manipulation is very high, and the probability of a mistaken conviction is very small."²¹⁷ The exchange can impose substantial financial punishments for market manipulation, as would-be manipulators likely have vast financial resources.²¹⁸

The new regulatory entity for commodities exchanges, therefore, would likely have a retrospective focus. Retrospective-based regulations would deter known types of manipulation from recurring, even though new types of manipulation would undoubtedly surface. The key to success would be responsiveness. If the new entity is to be effective, it must understand the operation of its rules and frequently adjust various categories so that they continue to align with the entity's mis-

213. See *supra* text accompanying notes 182–84.

214. See Karmel, *supra* note 44, at 427 ("The futures industry could perhaps move more easily to a sole self-regulator than the securities industry . . ."). The securities industry did largely move to a single self-regulator via FINRA. See *supra* notes 200–01 and accompanying text.

215. See, e.g., *Self-Regulation*, *supra* note 12, at 196–99 (suggesting that traders be "subject to penalties if they exploit market power during delivery periods," but less restricted in their actions beforehand); Steven Shavell, *The Optimal Structure of Law Enforcement*, 36 J.L. & ECON. 255, 256–66 (1993).

216. *Self-Regulation*, *supra* note 12, at 196–97.

217. *Id.* at 197.

218. See *id.*; *infra* note 228 and accompanying text.

sion of favoring Hedgers, thus deterring manipulation.²¹⁹

Although constant revision of rules entails substantial costs, they are preferable to open-ended standards. Rules provide roadmaps for both compliance as well as the identification of noncompliance.²²⁰ Courts, for example, are currently poorly equipped to deter manipulation because “the existing federal statutes that proscribe manipulation are poorly crafted and vague.”²²¹ Moreover, broad standards would require both the exchange and would-be manipulator to “make a judgment respecting a law-to-fact application,” and the “good faith with which they apply the principle will be unverifiable ex-post.”²²² Thus, standards would work against the goal of ex-post regulation: to punish those who are later determined to have manipulated the market. Given the expertise and independence of the new regulatory entity, it would be able to draft precise and relevant rules, thus giving compliance monitors better roadmaps and enhancing the deterrent effect of ex-post sanctions.²²³ Although a structure based on the FASB combined with an emphasis on ex-post regulation provides a solid foundation, Subsection 3 addresses some of the challenges the new rule promulgator will face.

3. Challenges Facing the New Entity

The first obstacle would be achieving acceptance of the new entity’s rules. Commodities exchanges have maintained their market regulation responsibilities and have no apparent reason to relinquish them. While the CFTC oversees rulemaking, it

219. See Bratton, *supra* note 160, at 40; *cf. supra* note 72 and accompanying text (noting the LME reacted too late in changing a warehousing rule). The NFA could be given monitoring responsibilities in conjunction with the exchanges and provide regular feedback to the new regulatory entity. In addition, the new entity would be open to receiving complaints from traders. Nonetheless, some commentators have deemed the regulatory process confusing and circular, leading to many dead ends. See Nicholas R. Bednar, Note, *Social Group Semantics: The Evidentiary Requirements of “Particularity” and “Social Distinction” in Pro Se Asylum Adjudications*, 100 MINN. L. REV. 353, 392 n.254 (2015); Maxwell Mensinger, Note, *Remodeling “Model Aircraft”: Why Restrictive Language That Grounded the Unmanned Industry Should Cease To Govern It*, 100 MINN. L. REV. 405, 430 n.160 (2015).

220. See Bratton, *supra* note 160, at 40–41.

221. *Self-Regulation*, *supra* note 12, at 198–99 (explaining how the poorly crafted laws have led to several legal decisions that allow a manipulator “to squeeze a market during the delivery period as long as he does not acquire his position with the intent to do so”).

222. See Bratton, *supra* note 160, at 44.

223. See *Self-Regulation*, *supra* note 12, at 198.

owes a degree of deference to the exchanges.²²⁴ Thus, some sort of legislation would likely be needed to allow the CFTC to designate the new entity as the recognized rule maker for commodities exchanges.²²⁵ Although this may seem like an unlikely proposition, it is achievable.²²⁶

A second challenge would be enforcement. Just as auditors verify that Preparers properly apply the FASB's standards, commodities exchanges are responsible for monitoring compliance with trading rules. Demutualization potentially incentivizes exchanges to disregard noncompliance.²²⁷ However, exchanges can levy fines on firms that violate its rules, thus providing a revenue stream.²²⁸ Because the new entity would be focused on creating rules that allow for ex-post detection of manipulation,²²⁹ the benefits of stringent enforcement would likely outweigh those of permitting noncompliance. The commodities exchanges, therefore, would be properly incentivized to enforce its public-oriented rules.

Moreover, the new entity would be required to promulgate rules for a vast array of futures products across numerous commodities exchanges.²³⁰ It would undoubtedly be an ambitious undertaking, but a recent, analogous project shows that it is viable. The Sustainability Accounting Standards Board (SASB), similarly structured to the FASB, develops and distributes "sustainability accounting standards that help public corporations disclose material, decision-useful information to

224. See 7 U.S.C. § 7a-2(c)(2), (c)(4)(A), (c)(5) (2012) (listing requirements for CFTC oversight of exchange rulemaking).

225. Cf. *supra* note 158 and accompanying text (noting the SEC's recognition of the FASB).

226. See Brush, *supra* note 18 ("Congress may be forced to pass legislation on the issue [of exchange regulation]."). Moreover, the Dodd-Frank Act expanded the CFTC's authority. See *supra* text accompanying note 141.

227. See, e.g., REP. ON BANK INVOLVEMENT WITH PHYSICAL COMMODITIES, *supra* note 57, at 189–90 (reporting that the LME has the "authority to investigate" and can "impose additional load-out requirements" on warehouses that intentionally create queues, but it has failed to do so).

228. See, e.g., Jed Horowitz & Aaron Lucchetti, *NYSE Levies Fine Against Lehman for Trading Tactic*, WALL ST. J. (Nov. 3, 2005), <http://www.wsj.com/articles/SB113093824717486284>; see also *About FINRA*, *supra* note 199 (noting FINRA levied \$134 million in fines in 2014). But see Macey & Novogrod, *supra* note 200, at 965 (noting FINRA's "difficulty [in] enforcing its own rules" and that it "does not have explicit statutory authorization to bring private rights of action in court to enforce the penalties it assesses against members"). Thus, the commodities exchanges would likely need to be given explicit authority to collect the fines it levies.

229. See *supra* Part III.C.2.

230. However, the entity would not have to start from scratch—it could begin by assessing the operation of existing exchange rules.

investors.”²³¹ Founded in 2011, the SASB expects to have completed issuing reporting standards for eighty-eight industries across ten economic sectors by early 2016.²³² Effective communication and collaboration between the exchanges, the new regulatory entity, and the NFA would smooth the process of rule promulgation.²³³

Finally, the CFTC heavily defers to the futures industry,²³⁴ and the risk of regulatory capture is ever-present.²³⁵ Thus, the success of the new FASB-structured regulatory entity for commodities exchanges will depend on the organization’s ability to stay true to its public-oriented mission as well as attract qualified talent. It must be able to develop the prestige needed to draw not only the best and the brightest, but also those inclined to perform public service. Adequate funding and public awareness of the entity, therefore, will be important issues. However, if the FASB is any indication, the creation and sustainability of such an entity for commodities exchanges is both feasible and highly desirable.

CONCLUSION

Commodities exchanges are currently SROs with CFTC oversight. They are not, however, properly incentivized to deter manipulation and promote market efficiency and integrity, as they do not fully internalize the costs associated with such manipulation. Moreover, demutualization of exchanges has exacerbated the issue. Shareholders with profit-maximizing incentives may govern the exchange and prioritize earnings or the interests of certain shareholders over regulatory norms. With

231. SUSTAINABLE ACCT. STANDARDS BOARD, <http://www.sasb.org> (last visited Oct. 12, 2015).

232. Michael Peltz, *Climate Change and the Years of Investing Dangerously*, INSTITUTIONAL INV. (Apr. 7, 2014), <http://www.institutionalinvestor.com/article/3327752/investors-endowments-and-foundations/climate-change-and-the-years-of-investing-dangerously.html>.

233. See *supra* note 183.

234. See, e.g., *supra* note 140. While the SEC wields the power to set financial accounting standards if it is unsatisfied with the FASB’s performance, the CFTC does not have the same level of rulemaking authority. For further discussion, compare *supra* text accompanying note 184 with *supra* note 224 and accompanying text.

235. Regulatory capture refers to “agencies deliver[ing] regulatory benefits to well organized political interest groups, which profit at the expense of the general, unorganized public.” Steven P. Croley, *Theories of Regulation: Incorporating the Administrative Process*, 98 COLUM. L. REV. 1, 5 (1998); see also text accompanying note 156 (noting the difficulty in finding directors who are truly independent).

respect to the United States aluminum market, evidence suggests that this potential for manipulation became a reality. Through its ownership of Metro warehouses and the LME, Goldman Sachs was able to corner the market, thus imposing significant costs on other parties.

Notwithstanding its shortcomings, exchange self-regulation has its benefits. Exchanges can leverage their industry expertise to adopt rules that enhance efficiency and organization. SROs are also unencumbered by bureaucratic processes. Nevertheless, fundamental reform is needed to concentrate commodities exchanges' rulemaking efforts on the public interest. The creation of a FASB-structured regulatory entity with an explicit preference for Hedgers would preserve commodity exchange self-regulation but ensure the promulgation of public-oriented rules. With guidance from the FASB's blueprint (combined with hard work and a little luck), commodities exchanges could transition to a sole, authoritative rule maker that better deters manipulation and promotes market integrity and efficiency.