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APPLYING *HOCHFELDER* IN COMMODITY FRAUD CASES

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The United States Supreme Court's decision in *Ernst & Ernst v. Hochfelder*¹ established that a private action for civil damages will not be allowed under section 10(b) of the Securities Exchange Act² or under rule 10b-5 of the Securities and Exchange Commission³ in the absence of an allegation of intent to deceive, manipulate, or defraud on the part of the defendant. This "scienter" requirement makes deficient any complaint under section 10(b) or rule 10b-5 that is based strictly on a negligence theory.

The Commodity Exchange Act contains an antifraud provision, section 4b,⁴ which, although not identical, has been analogized to section 10(b) of the Securities Exchange Act.⁵ This article will examine whether the requirement of "scienter" established by *Hochfelder*, is applicable to private damage actions brought under section 4b. After a brief review of the *Hochfelder* decision, the language of section 4b will be presented along with a discussion of the federal judicial and administrative decisions which have thus far interpreted that section. Using the analysis set forth by the Supreme Court in *Hochfelder*, the article will conclude that liability should not be imposed under section 4b absent a showing of scienter. This conclusion will be further supported by reference to the various policy considerations unique to the regulation of commodities transactions.

I. THE *HOCHFELDER* DECISION

In *Hochfelder*, the defendant, Ernst & Ernst, audited the books of First Securities Company of Chicago during a period when the principal owner defrauded a number of investors.⁶ In addition, Ernst & Ernst prepared an-

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¹ *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976).

² 15 U.S.C. § 78j(b) (1976).

³ 17 C.F.R. § 240-10b-5 (1978).

⁴ 7 U.S.C. § 6b (1976).

⁵ See, e.g., *Commodity Futures Trading Comm'n. v. J.S. Love & Associates Options, Ltd.*, 422 F. Supp. 652 (S.D.N.Y. 1976).

⁶ 425 U.S. at 288-89. A finding of securities fraud was made against First Securities in, *Securities and Exchange Comm'n. v. First Securities Co.*, 463 F.2d 981, 988 (7th Cir. 1972), cert. denied, 409 U.S. 880 (1972).

nual reports to the SEC and financial reports to the Midwest Stock Exchange on First Securities' behalf. A defrauded investor instituted suit in federal court alleging that Ernst & Ernst would have unearthed information leading to a discovery of the fraud but for the insufficiency of its accounting procedures. Although the complaint accused Ernst & Ernst of "aiding and abetting" the fraud, during discovery it became clear that the only real issue concerned negligent nonfeasance by Ernst & Ernst in the conduct of its audits.⁷ The district court rejected Ernst & Ernst's contention that negligence alone is insufficient to support a claim under section 10(b) or rule 10b-5.⁸ Nevertheless, the court granted summary judgment in favor of Ernst & Ernst, finding that Ernst & Ernst had not been negligent since it had adhered to generally accepted accounting procedures in its audits of First Securities.

On appeal, the United States Court of Appeals for the Seventh Circuit reversed and remanded, holding that one who breaches a duty of inquiry and disclosure owed another is liable in damages for aiding and abetting a third party's violation of rule 10b-5 if the fraud would have been discovered or prevented but for the breach.⁹ The "duty", according to the court, emanates from two sources: (1) a common law duty of inquiry arising from Ernst & Ernst's contract to audit First Securities; and (2) a statutory duty of inquiry under section 17(a) of the Securities Exchange Act and its corollary, SEC rule 17a-5, as preparer of First Securities' annual financial report to the SEC. The court of appeals further held that the defrauded investors of First Securities were within the class of persons intended to be protected by section 10(b) and rule 10b-5, so that they could maintain their action.¹⁰

The Supreme Court reversed the Seventh Circuit's decision holding that proof of "sciemer"—an intent to deceive, manipulate, or defraud—is necessary to sustain a claim under section 10(b) or rule 10b-5.¹¹ Thus even if public accounting firms owe a "duty of inquiry" and Ernst & Ernst had been negligent in fulfilling this duty, the complaint was still insufficient under section 10(b) and rule 10b-5 because Ernst & Ernst had no intent to defraud. The "starting point" in the Supreme Court's construction of section 10(b) was an analysis of the statutory language.¹² Section 10(b) makes it unlawful to "use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe . . ." The *Hochfelder* Court had no difficulty concluding that phrases such as "manipulative or deceptive" and "devices or contrivances" import more than mere neglect and connote the presence of knowing or intentional misconduct.¹³ In the Court's view; these are "terms that make unmistakable a congressional

⁷ 425 U.S. at 289-91.

⁸ *Id.* at 191.

⁹ *Hochfelder v. Ernst & Ernst*, 503 F.2d 1100, 1104 (7th Cir. 1974).

¹⁰ *Id.* at 1117.

¹¹ 425 U.S. at 199-201. The Court declined to rule on the question of section 10(b) liability for aiding and abetting. *Id.* at 192 n.7.

¹² *Id.* at 197.

¹³ *Id.*

intent to proscribe a type of conduct quite different from negligence."¹⁴ The Supreme Court expressly rejected the argument that suits under section 10(b) or rule 10b-5 are appropriate to redress negligent conduct in order to accomplish the Act's "remedial purposes."¹⁵ Furthermore, the Court attached no weight to portions of rule 10b-5 proscribing material misstatements or omissions since rule 10b-5 was promulgated pursuant to section 10(b) and must therefore be read to require scienter.¹⁶

Prefacing further inquiry with the statement that it may have been unnecessary,¹⁷ in light of section 10(b)'s plain language requiring scienter, the *Hochfelder* Court nevertheless proceeded to examine the legislative history of section 10(b). Although the Court cited a few supportive passages from testimony and reports, it found the legislative history of the 1934 Act "bereft of any explicit explanation of Congress' intent," with regard to the appropriate standard of liability. The Court also examined the "interdependence" between the various sections of the Securities Act in ascertaining congressional intent.¹⁸ The Court noted that wherever Congress created express private rights of action in the 1934 Act, the sections clearly specified whether recovery was to be premised on knowing or intentional conduct, negligence, or entirely innocent mistake.¹⁹ Moreover, in every section of the Act where negligence alone was made sufficient for a violation, Congress added special procedural restrictions not applicable under section 10(b).²⁰ If liability under section 10(b) were to be premised on mere negligence, the Supreme Court reasoned, causes of action intended to be brought under the carefully drawn procedural restrictions of other sections could be brought instead under section 10(b), thus frustrating congressional intent.²¹

¹⁴ *Id.* at 199.

¹⁵ *Id.* at 200.

¹⁶ *Id.* at 212-13.

¹⁷ *Id.* at 201.

¹⁸ *Id.* at 204-06.

¹⁹ *Id.* at 207.

²⁰ *Id.* at 210.

²¹ *Id.* at 210-11. Apart from the specific facts of *Hochfelder*, certain general characteristics of the controversy deserve isolation. First, the plaintiffs had to rely upon a judicially implied private right of action because § 10(b) does not contain express authority for private actions. *Id.* at 196. Nothing in the Supreme Court's opinion, however, suggests that a different interpretation would have been forthcoming if an express private remedy were contained in § 10(b). Second, the remedy sought was damages rather than prospective injunctive relief. The Supreme Court specifically refused to decide whether scienter is required in § 10(b) cases seeking injunctive relief, *Id.* at 194 n.12, although the dissent of Justices Blackmun and Brennan reached the sensible conclusion that the type of relief sought should not affect the determination of whether a violation of § 10(b) or rule 10b-5 has occurred. *Id.* at 217-18. Third, the action was initiated by private parties rather than by the SEC. Once again, however, the identity of the complainant should have no effect upon whether § 10(b) or rule 10b-5 has been breached. *Id.* Fourth, the defendant in the case was not cited as a perpetrator of the fraud but, rather, was accused merely of neglecting to unearth the true culprit through its audits. According to the Supreme Court, the same requirement—scienter—must be shown in suits of this nature as in actions against the actual perpetrator. Fifth, it is insufficient under § 10(b) merely to prove that a "duty"

In summary, the *Hochfelder* Court relied primarily on the statutory language in determining that scienter is required under section 10(b), and buttressed that conclusion by examining the legislative history of the 1934 Act. The next section of this article will attempt to apply the *Hochfelder* analysis to section 4b of the Commodity Exchange Act.

II. APPLYING *HOCHFELDER* TO COMMODITIES FRAUD

Using the approach set forth in *Hochfelder*, the "starting point" in determining whether scienter is necessary to prove commodities fraud is the language of section 4b of the Commodity Exchange Act. Since extensive reference will be made to the language of section 4b throughout the article, it is set forth in full below:

It shall be unlawful (1) for any member of a contract market, or for any correspondent, agent, or employee of any member, in or in connection with an order to make, or the making of any contract of sale of any commodity in interstate commerce, made, or to be made, on or subject to the rules of any contract market, for or on behalf of any other person, or (2) for any person, in or in connection with any order to make, or the making of, any contract of sale of any commodity for future delivery, made, or to be made, on or subject to the rules of any contract market, for or on behalf of any other person if such contract for future delivery is or may be used for (a) hedging

was breached that frustrated detection or correction of the fraud, even if that duty arises under the same federal statute that prohibits the underlying fraud. And, finally, negligent performance of a statutory or common law duty is not "aiding and abetting" a § 10(b) violation. Indeed, the Supreme Court has cast substantial doubt on whether "aiding and abetting" will hereafter exist at all as a claim under § 10(b) or rule 10b-5 unless scienter by the aider or abettor—"a mental state embracing intent to deceive, manipulate, or defraud"—is also shown. See note 8 *supra*.

²² 7 U.S.C. § 6b (1976). An exception to subsection (D) appears at the end of section 4b, authorizing the "crossing" or "matching" of orders held by a futures commission merchant or floor broker for execution at the prevailing market price under certain restrictions.

Certain features of § 4b deserve careful examination. First, and perhaps most important, § 4b deals only with conduct of an agent in the performance of services for a principal. It applies primarily to futures commission merchants (and their salesmen) or floor brokers in the solicitation, handling or execution of commodities transactions for customers or investors. It does not encompass a fraud committed between two agents or between two principals, nor does it cover a fraud perpetrated by an agent against someone else's principal. The wrongdoing must be that of the agent and it must be against the person on whose behalf the agent is acting, namely, the agent's own principal.

Second, § 4b differentiates between cash or "spot" commodity transactions made on a contract market and futures contracts made there. Subsection (1), which relates to dealings in actual commodities on a contract market, prohibits fraud only if it is committed by a "member of a contract market, or . . . any correspondent, agent, or employee of any member" and, as is true throughout § 4b, only if the fraud is committed by the member against someone for whom he is acting. Subsection (2), which speaks of futures contracts made on a contract market, applies by its terms to "any person" who is agent for a principal in such transactions.

any transaction in interstate commerce in such commodity or the products or byproducts thereof, or (b) determining the price basis of any transaction in interstate commerce in such commodity, or (c) delivering any such commodity sold, shipped, or received in interstate commerce for the fulfillment thereof—

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

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

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

(D) to bucket such order, or to fill such order by offset against the order or orders of any other person, or willfully and knowingly and without the prior consent of such person to become the buyer in respect to any selling order of such person, or become the seller in respect to any buying order of such person.²²

Given the language of section 4b, it must be determined whether that language requires proof of scienter to establish a violation of its terms. Before taking the first step in the *Hochfelder* analysis, however, it is helpful to review prior judicial and administrative interpretations of section 4b and to consider the position of Commodity Futures Trading Commission on the proper standard of liability.

A. Prior Judicial and Administrative Decisions

Four years before *Hochfelder*, the United States District Court for the Eastern District of Louisiana determined that section 4b requires proof of more than negligence to establish a violation. In *McCurnin v. Kohlmeyer & Co.*,²³ a Kohlmeyer salesman bought cotton futures contracts at a price exceeding his customer's instructions, in the mistaken belief that the customer wished to enter the market even if a higher price had to be paid. Thereafter, the salesman misinformed the customer of his rights, not knowing that the customer could rescind the transaction. The customer brought suit under section 4b to recover his losses on the cotton futures transactions, even though the salesman "had not intention to mislead, cheat or defraud" the customer.²⁴ The district court, focusing on the language of section 4b, held that simple negligence is not a violation:

The C.E.A. [Commodity Exchange Act] does not use sweeping terms. Its pejoratives are simple and pointed: it uses the words "cheat" and "defraud" and "wilfully." By any definition these connote deliberate acts or a degree of negligence that is so gross as to

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

²⁴ 347 F. Supp. at 575.

approach wilfulness. This interpretation is strengthened by the fact that criminal penalties are attached to a violation of section 6b, 7 U.S.C. § 13. Such penalties are not usually attached to good faith actions merely because they are negligent or uninformed. Nor did Congress in the C.E.A. employ any general prohibitions against untrue statements of material fact or omissions to state material facts such as those found in the Securities Act of 1933.²⁵

The district court in *McCurnin* found that the Commodity Exchange Act's anti-fraud provision—section 4b—is much narrower in its scope than section 10(b) of the Securities Exchange Act and SEC rule 10b-5. The court noted that the Securities Exchange Act of 1934 “employs much broader language” and that there “is no counterpart of Section 10(b) in the C.E.A., nor any counterpart of Rule 10-b-5 in the Commodities Act regulations.”²⁶ Furthermore, the district court described the customer's attempt to expand section 4b's scope as “chopping it into fine pieces as part of a stew composed of mingled bits of the Securities Act of 1933, the Securities Exchange Act of 1934,” and other securities statutes.²⁷

More recently, in *Silverman v. Commodity Futures Trading Commission*,²⁸ the United States Court of Appeals for the Seventh Circuit was confronted with the issue whether the term wilfully in section 4b requires proof of evil motive. The court held that section 4b does not require proof of evil motive, but it is important to note that the facts showed “a pattern and program of [unauthorized] trading in large measure carried on over a period of years with many people in an intentional and calculated manner”²⁹ Thus, the offense clearly involved intentional violations of known duties.

In a second recent case, *Haltmier v. Commodity Futures Trading Commission*,³⁰ the United States Court of Appeals for the Second Circuit reaffirmed that evil motive is not a necessary element of a section 4b fraud. Nevertheless, the court found deliberate and intentional mishandling of a commodity customer's account:

Nor is it important that Haltmier may not have had an evil motive or an affirmative intent to injure his customer, or that he did not subjectively want to cheat or defraud Millet. It is enough that he acted deliberately, knowing that his acts were unauthorized and contrary to instructions. Such knowing, intentional conduct made his acts wilful, and therefore his violations of the statutory prohibition against cheating or defrauding the customer were wilful, in the accepted sense for infractions of this type.³¹

²⁵ *Id.* at 576.

²⁶ *Id.*

²⁷ *Id.* at 575. See also, *Economou v. U.S. Department of Agriculture*, 494 F.2d 519 (2d Cir. 1974).

²⁸ 549 F.2d 28 (7th Cir. 1977).

²⁹ *Id.* at 31 (emphasis in original).

³⁰ 554 F.2d 556 (2d Cir. 1977).

³¹ *Id.* at 562.

Moreover, the court in *Haltmier* found that "[t]here is now no doubt" that unauthorized trading is a section 4b violation,³² thus inferring that the petitioner would have had no reason to believe in good faith that his intentional, deliberate conduct was lawful or proper.

The *Silverman* and *Haltmier* decisions seem to articulate a standard of proof for section 4b fraud that is at variance with the *Hochfelder* scienter requirement. Those decisions specifically reject the concept that the conduct in question must include an "evil motive" or even a subjective desire to cheat, defraud or injure the commodity customer. In contrast, *Hochfelder* requires "a mental state embracing intent to deceive, manipulate, or defraud"³³ before a violation is proven under section 10(b) of the Securities Exchange Act. Whether an actual conflict of standards exists, however, cannot be determined with certainty for several reasons. First, neither *Silverman* nor *Haltmier* expressly considered the *Hochfelder* precedent, so they cannot be said to have consciously rejected its scienter requirement. Second, the conduct in both *Silverman* and *Haltmier* was held to be knowing, deliberate and intentional, so that a finding of the "mental state" required by *Hochfelder* may be implicit in those decisions. And, third, it is clear in both *Silverman* and *Haltmier* that mere negligence was not present, and the decisions do not purport to decide that such negligence would be "fraud" under section 4b.

In contrast to the federal court's interpretation of section 4b, the Commodity Futures Trading Commission has expressed the view that fraud under section 4b should be construed broadly. On June 24, 1975—prior to the *Hochfelder* ruling—a CFTC release in the Federal Register adopted *special* antifraud rules³⁴ for commodity options,³⁵ leverage contracts,³⁶ and illegal off-exchange future transactions³⁷ which are patterned largely after SEC rule 10b-5 rather than section 4b. The release contained the following plea for broad interpretation of section 4b:

The Commission notes that at least two courts may have taken a restrictive view of the purpose of section 4b because of the requirement of willfulness in the statute [citing *McCurnin* and *Economou v. U.S. Department of Agriculture*].³⁸ The Commission does not believe these decisions should have continued vitality as applied to the Act as recently amended. It is appropriate—particularly in light of the Commodity Futures Trading Commission Act of 1974³⁹—that all provisions of the Commodity Exchange Act, as amended, be broadly

³² *Id.* at 560.

³³ 425 U.S. at 194 n.12.

³⁴ CFTC Regs. §§ 30.01, 30.02, 30.03; 17 C.F.R. §§ 30.01, 30.02, 30.03 (1978).

³⁵ Regulation of commodity options, including anti-fraud standards, is based upon § 4c(b) of the Commodity Exchange Act, 7 U.S.C. § 6c(b) (1976).

³⁶ Regulation of leverage contracts, including anti-fraud standards, is based upon § 19 of the Commodity Exchange Act, 7 U.S.C. § 15a (1976).

³⁷ Futures contract trading anywhere except through a contract market is illegal under § 4h of the Commodity Exchange Act, 7 U.S.C. § 6h, and is a felony under § 9 of the Act, 7 U.S.C. § 13 (1976).

³⁸ 494 F.2d 519 (2d Cir. 1974).

³⁹ Pub. L. No. 93-463, 88 Stat. 1389, amending 7 U.S.C. § 1 *et seq.*

construed to effectuate their remedial purposes [citing authorities]. The courts have frequently held in the context of remedial legislation that willfulness connotes no more than an awareness of an act or omission and not whether the act or omission is understood to be unlawful [citing cases].⁴⁰

The reasons cited by the Commission for broadly construing section 4b do not fully support its position. The significance of the reference to the CFTC Act of 1974 is unclear in view of the fact that section 4b was left untouched by those amendments to the Commodity Exchange Act, even though Congress was urged in 1974 to broaden the scope of section 4b.⁴¹ The Commission's other rationale—to "effectuate the remedial purposes" of the Commodity Exchange Act—was held in *Hochfelder* to be insufficient reason to disregard the plain language or legislative history of a statutory provision.⁴²

The Commission's leaning toward equating section 4b fraud with negligence has been manifested in reparations cases brought by complaining investors against Act registrants under section 14 of the Commodity Exchange Act.⁴³ Added by the CFTC Act of 1974, section 14 allows complainants to institute proceedings before the Commission itself for damages against persons required to be registered under the Act, and the Commission may award damages if it is proven that the respondent has violated the Act or any regulation or order thereunder. These cases are heard initially by an administrative law judge, and that decision is reviewable by the full Commission and, thereafter, by a United States Court of Appeals. To date, administrative law judges have sometimes ruled that a section 4b violation can be shown in reparations cases by evidence that the respondent was negligent in the performance of a "fiduciary duty" toward the complainant. None of these initial decisions, however, has yet been reviewed by the full Commission.

The principal reparations case equating section 4b fraud and negligence is *Gordon v. Shearson Hayden Stone, Inc.*⁴⁴ There, the respondents had persuaded the complainant to engage in a "spread" transaction that incurred substantial losses. The administrative law judge held, first, that "a broker/agent has, by definition, a fiduciary relationship to his customer"⁴⁵ and that "acts in violation of the fiduciary duties of an agent are regarded as fraudulent, and hence violative of Section 4b."⁴⁶ Turning to the facts, the judge concluded that the spread transaction was not "unsuited" to the complainant, an experienced and affluent businesswoman, and that no misrepresentations had been made to her. However, the judge found that the complainant had not been fully informed of the risks of commodity trading as a result of respondent's

⁴⁰ 40 Fed. Reg. 26504, 26505 n.2 (June 24, 1975).

⁴¹ *Hearings on H.R. 13113 et al., before the Senate Committee on Agriculture and Forestry*, 93d Cong., 2d Sess. 716, 729 (May 22, 1974) (testimony of Prof. Jerome P. Weiss).

⁴² 425 U.S. at 199 & n.19, 200.

⁴³ 7 U.S.C. § 18 (1976).

⁴⁴ 2 CCH Comm. Fut. L. Reg. ¶ 20,427 (June 14, 1977).

⁴⁵ *Id.* at ¶ 21,731.

⁴⁶ *Id.*

mistaken belief that the spread transaction did not create high risk. The respondent contended that his omission was innocent and lacked the intent to defraud that is required by the *Hochfelder* and *McCurnin* decisions. The judge rejected that argument on the ground that *McCurnin* has been "undermined" by later decisions, including *Haltmier* and *Silverman*. As noted earlier, however, neither *Haltmier* nor *Silverman* involved purely negligent conduct, and neither ruled that negligence alone constitutes section 4b fraud. The judge also relied upon *Commodity Futures Trading Commission v. J.S. Love & Associates Options, Ltd.*⁴⁷ In *J.S. Love* the district court denied defendants' motion for summary judgment holding that a violation of the CFTC anti-fraud rule could be established absent evidence of willful misconduct.⁴⁸ The court also held that, on the facts, a preliminary injunction was not warranted.⁴⁹ The decision in *J.S. Love* however, did not involve section 4b but rather the special language of CFTC regulation 30.01, prohibiting fraud in options, that is far broader than section 4b.⁵⁰

In the *Gordon* reparations proceeding, the respondent also urged the administrative law judge to adopt and apply the "scienter" requirement of *Hochfelder*. The judge refused to do so, noting that section 4b does not contain the same words as section 10(b), that breach of a fiduciary duty may constitute "a form of intentional conduct for purposes of imposing liability" under section 4b even if it would be insufficient under section 10(b), and that a "willful" standard—even if appropriate where civil damage remedies are judicially implied—is not necessary when an express right to damages (as provided by section 14) exists under the Act.⁵¹ A strong argument can be made, however, that the "cheat" and "defraud" pejoratives of section 4b and its express "willfulness" requirement impose a scienter requirement no less strong than section 10(b). Moreover, the initial decision in *Gordon* identifies no public policy why the negligent act of a commodities broker should constitute fraud while the same act by a securities broker is not fraud unless scienter is proven.

In sum, no court has ruled that negligence alone constitutes section 4b fraud. Although the CFTC and the *Gordon* reparations case support a broad construction of section 4b, the next section of this article will demonstrate that this construction contradicts the approach the *Hochfelder* Court used in interpreting section 10(b) of the Securities Exchange Act.

B. The *Hochfelder* Approach

1. Statutory Language

Turning to the language of section 4b, it is necessary to examine each subsection, (A) through (D), just as the Supreme Court in *Hochfelder* studied

⁴⁷ 422 F. Supp. 652 (S.D.N.Y. 1976).

⁴⁸ *Id.* at 659-60.

⁴⁹ *Id.* at 661.

⁵⁰ CFTC Reg. § 30.01, 17 C.F.R. § 30.01 (1978). For example, section 30.01 contains no "willfulness" requirement. The District Court in *J.S. Love*, quoting the CFTC itself, observed that "the Commission has not used the concept of willful behavior [in § 20.01], which is reflected in the statutory language [of § 4b]." 422 F. Supp. at 659.

⁵¹ 2 CCH Comm. Fut. L. Rep. ¶¶ 20,427; 21,733-34.

the specific words of section 10(b) of the Securities Exchange Act. In subsection (A), it is an offense for an agent to "cheat" or to "defraud" his principal, or to attempt to do so. The common understanding⁵² of these words is that the agent's conduct is intentional and deliberate rather than inadvertent or merely negligent. The word "cheat" is defined as "to deprive of something valuable *by the use of deceit or fraud*."⁵³ The term "defraud" connotes the same meaning.⁵⁴ "To attempt" something is "to make an effort to do, accomplish, solve or effect."⁵⁵ Nowhere in the standard reference works are those terms equated with accidental, inadvertent, or merely negligent conduct.

Subsection (B) of section 4b prohibits an agent from making any "false report or statement" to, or to create any "false record" for, his principal if that conduct is "willfully" done. A "false" report, statement or record might be inadvertently or negligently made,⁵⁶ without an intent to convey false information. Subsection (B) eliminates that possible interpretation, however, by limiting the offense to the "willful" making of a false report, statement or record by the agent to his principal. The term "willful" means "intentional" or "done deliberately" in common parlance.⁵⁷

The modifier "willfully" appears again in subsection (C) which makes it a section 4b offense for the agent "to deceive or attempt to deceive" his principal "by any means whatsoever" in regard to "any act of agency" performed for the principal involving a commodities order or contract. The term "deceive" connotes a deliberate purpose to mislead,⁵⁸ as contrasted with more passive characterizations such as "to misinform" or "to give inaccurate information." And, since the deception must be "willful" under subsection (C) in order to be actionable, misinformation*conveyed by accident, inadvertence, or mere negligence would seem to be clearly exempted from that provision.

Subsection (D) of section 4b describes practices that depart somewhat from classic concepts of fraud but are intended to assure the open, competitive execution of orders in the market. For example, subsection (D) prohibits the "bucketing" of orders received by the agent from his principal. Bucketing has been described in the following terms: "To bucket an order is for the receiver of the order to cover it himself without making a contract with some-

⁵² In *Hochfelder*, The Supreme Court cited standard dictionary meanings in reaching its decision that the language of § 10(b) did not extend to merely negligent action. 425 U.S. at 199 & n.20.

⁵³ WEBSTER'S NEW COLLEGIATE DICTIONARY 189 (1973) (emphasis added).

⁵⁴ *Id.* at 298.

⁵⁵ *Id.* at 72.

⁵⁶ Webster's New Collegiate Dictionary gives as the first definition "not genuine" while relegating to second meaning "intentionally untrue." *Id.* at 413. The Random House Unabridged Dictionary of the English Language defines the term "false" as "not true or correct, erroneous" as the primary meaning and cites "false statement" as an example of that usage. RANDOM HOUSE UNABRIDGED DICTIONARY OF THE ENGLISH LANGUAGE 513 (1966).

⁵⁷ WEBSTER'S NEW COLLEGIATE DICTIONARY 1341 (1973); RANDOM HOUSE UNABRIDGED DICTIONARY OF THE ENGLISH LANGUAGE 1634 (1966).

⁵⁸ RANDOM HOUSE UNABRIDGED DICTIONARY OF THE ENGLISH LANGUAGE 374 (1966) ("To mislead by a false appearance or statement; delude").

one else or clearing⁵⁹ the transaction.”⁶⁰ In other words, the agent pretends to execute the order in the open market, but instead simply “books” it. A variation on this practice is where the order reaches the marketplace but is not offered competitively, such as where the transaction is privately concluded.⁶¹ The customer has a “rightful expectation” that his order will be transmitted to the marketplace for competitive execution at the best possible price.⁶² The remainder of subsection (D) describes other forms of noncompetitive handling of principals’ orders: (1) where the agent simply matches or “crosses” orders in his possession between buying principals and selling principals, and (2) where the agent, without the principal’s prior consent, willfully and knowingly “takes the other side” of the principal’s orders. In each instance, the agent deliberately handles the order in a noncompetitive way that is different from the principal’s understanding and expectation. None of the forms of conduct described in subsection (D) can occur through mere negligence; each is an intentional, deliberate course of action by the agent.

To summarize, the plain meaning of the words in each subsection of section 4b require intentional, deliberate conduct by the agent. This plain meaning should be given effect in cases brought under section 4b so that liability will not be imposed under the section in the absence of proof of scienter. Correspondingly, the CFTC position that negligence alone constitutes section 4b fraud should be abandoned.

2. Congressional Intent

The second step taken by the *Hochfelder* Court in construing section 10(b) of the Securities Exchange Act was to review the legislative history. This review was conducted to ascertain whether it was the “intent” of Congress to include unintentional, negligent conduct within that section. The Supreme Court concluded that Congress had revealed no such intent, but rather, as the text of section 10(b) suggested, meant to reach only intentional acts of fraud.⁶³

Section 4b of the Commodity Exchange Act was added to the original statute in 1936⁶⁴ and has remained unchanged since that date. The Report of the House Agriculture Committee⁶⁵ spoke of section 4b in terms of morally reprehensible conduct. It observed that “[a]s to those provisions of the bill

⁵⁹ All commodity futures transactions are “cleared” on the day of execution by the contract market or an appointed clearing agency. Clearing consists of matching the trade with the records of the opposite party and, thereafter, paying or collecting each day an amount equal to the change in market price.

⁶⁰ HIERONYMUS, *ECONOMICS OF FUTURES TRADING*, 86-87 (1971).

⁶¹ CFTC Reg. § 1.38, 17 C.F.R. § 1.38 (1978).

⁶² *Nichols & Co. v. Secretary of Agriculture*, 136 F.2d 503 (1st Cir. 1943). But where the principal knows of and consents to a non-competitive or “bucketed” trade, he may be barred from invoking subsection (D). *Garnac Grain Co., Inc.*, 8 A.D. 224 (1949).

⁶³ 425 U.S. at 201-06.

⁶⁴ Pub. L. 675, 79 Stat. 1943 (June 15, 1936).

⁶⁵ H.R. REP. NO. 421, 74th Cong., 1st Sess. (March 18, 1935).

which impose penalties for *cheating* and *sharp practices* there can be no objection except from those who desire freedom from all restraint in these matters."⁶⁶ The nexus of "fraud" throughout section 4b was also acknowledged:

Section 4b makes it unlawful for members of contract markets, and correspondents, agents, and employees thereof, in connection with orders to make or the making of contracts of sale of any commodity in interstate commerce to cheat, defraud or deceive the customer, or to bucket the order. The section also prohibits such *fraudulent practices* in futures contracts in connection with orders made on or subject to the rules of any contract market.⁶⁷

During the floor debates on the 1936 amendments in the Senate, a proposal was made to exempt cotton futures from one prohibition of section 4b and, in that context, Senator Robinson characterized his view of section 4b as "not to penalize an honest transaction but to give the fullest possible freedom to any fair business transaction, and at the same time do everything that is reasonable and necessary to prevent the *crooks* that sometimes operate on the market from influencing it."⁶⁸

In sum, a review of the 1936 legislative history discloses no intent of Congress to equate mere negligence with the "cheating" and "fraud" that Congress consistently explained as the target of section 4b. This assessment of Congressional intent is buttressed as well by the fact that, in the same 1936 amendments, Congress made it a *crime* to violate section 4b, punishable by a \$10,000 fine and one year imprisonment.⁶⁹ In 1974, the criminal fine for violation of section 4b was increased ten-fold to \$100,000,⁷⁰ and in 1978 a "knowingly" violation of section 4b was made a felony punishable by up to a \$500,000 fine and five years imprisonment.⁷¹ These harsh criminal penalties would seem inappropriate and quite excessive if mere negligence constitutes a section 4b fraud.

In *Hochfelder*, the Supreme Court also examined sections of the Securities Exchange Act other than section 10(b) to determine whether Congress intended to require scienter under section 10(b).⁷² Under the Commodity Exchange Act, as amended in 1974, a second anti-fraud section was adopted—section 40⁷³—applicable to commodity trading advisors and commodity pool operators. In pertinent part, section 40 bears an unmistakable similarity to section 10(b) and SEC rule 10b-5:

⁶⁶ *Id.* at 3 (emphasis added).

⁶⁷ *Id.* at 5 (emphasis added).

⁶⁸ CONG. REC., S7845, 7872 (May 25, 1936) (emphasis added).

⁶⁹ Pub. L. 675, 49 Stat. 1491, 1501 (1936).

⁷⁰ Pub. L. 93-463, 88 Stat. 1389, *amending* 7 U.S.C. § 13.

⁷¹ Pub. L. 95-405, 92 Stat. 865, *amending* 7 U.S.C. § 13. Use of the term "knowingly" is a requirement for felony conviction *in addition to* proof of "willfulness." Note that, in section 4b(D), both terms are used in conjunction with respect to the "crossing" of orders. Thus, the new "knowingly" language does not infer that innocent error or negligence would otherwise suffice, since "willfulness" remains to be proven.

⁷² 425 U.S. at 206-11.

⁷³ 7 U.S.C. § 60 (1976).

(1) It shall be unlawful for any commodity trading advisor or commodity pool operator, by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly—

(A) to employ any device, scheme, or artifice to defraud any client or participant or prospective client or participant; or

(B) to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or participant or prospective client or participant.⁷⁴

The similarity between section 40 and rule 10b-5 strongly suggests a congressional intent in section 40 to apply securities fraud concepts to the conduct of commodity trading advisors and commodity pool operators. Under the *Hochfelder* analysis, if negligence alone is not "fraud" on the part of commodity trading advisors or commodity pool operators under section 40 of the Commodity Exchange Act, it would seem incongruous for negligence to be "fraud" when other fiduciaries under the Act are involved, unless a clear congressional intent to make such a distinction exists. It does not.

III. POLICY CONSIDERATIONS

Having concluded that neither the language of section 4b nor its legislative history encourage, let alone compel, the equating of negligence with fraud, it remains to be determined whether *Hochfelder* should be bypassed because of public policy reasons applicable to commodities regulation that do not apply to the securities markets. In part, the answer resides in the relative *potential* for fraud in the two industries.

There can be no doubt that commodity futures trading involves a high degree of risk. Indeed, it has been stated that "[r]isk is synonymous with commodity futures trading."⁷⁵ That risk, however, inheres primarily in the leverage available to commodity traders due to low margin requirements that are frequently less than ten percent of the contract value. Market price movements, although volatile at times, are not likely to be greater on a percentage basis than some active equity securities. The price of soybean futures contracts, for example, underwent a 400 percent increase in price during 1973, an extremely dramatic price movement by commodity futures standards. By contrast, many equity securities experience price movements of that magnitude each year. In any event, risk, even leveraged risk, is not "fraud", nor is it *created* by fraud. Rather, the risk emanates from the ebb and flow of free market forces.⁷⁶

The potential for fraud is often *greater* in securities transactions than in commodity trading. Each issue of equity securities is unique in some respects,

⁷⁴ *Id.*

⁷⁵ *Gordon v. Shearson Hayden Stone, Inc.*, 2 CCH Comm. Fut. L. Rep. ¶ 20,427 (June 14, 1977) (initial decision).

⁷⁶ Tampering with free market forces—manipulation—is a violation of the Commodity Exchange Act *separate from* the anti-fraud provision of section 4b. See sections 6(b) and 9 of the Act, 15 U.S.C. §§ 9, 13.

so that the prospective investor must receive or review different information for each investment decision. Commonly, that information comes initially from the issuer who is eager to distribute the security, or from the underwriters or broker/dealers who profit from speedy distribution or sale. Clearly the risk of material misstatements or omissions is great in such an environment, and the reliance of the potential investor upon that information is nearly absolute. In sharp contrast, commodity trading involves a relatively limited number of standardized contracts written by the impartial commodity exchanges, approved in every material detail by the Commodity Futures Trading Commission, and codified in published rulebooks.

Another possible area of fraud is in misrepresenting the value of a potential investment. Here, once again, the problem is far more acute in securities than in commodities. While securities prices are governed solely by the collective judgment of securities traders, the value of commodities is dependent ultimately on the prices paid *outside* the futures market by merchants, processors or exporters of the commodities themselves. Thus, whether a particular security is "over-priced" or a "bargain" is purely a matter of opinion among similarly situated investors, while the price of commodity futures can be readily compared with "cash" market transactions. The ability to misrepresent the true worth of a futures contract, therefore, is highly restricted.

Fraud can also surface when an investor needs information necessary to judge an investment's future prospects. In securities, for example, investors make purchasing or selling decisions on the basis of the issuer's expected future growth and profitability, and they need accurate information about the issuer's products, markets, management skills, and other characteristics to make those decisions. Misrepresentation is both possible and highly injurious in those circumstances. For commodity trading, however, future prospects depend largely upon supply, demand, weather, and other factors that are widely published (often from government sources) and that do not originate with directly interested persons.

The potential for fraud can also be related to the size or sophistication of existing or potential investors. By that test, securities investors require greater protection than commodity traders. First, the number of securities investors is estimated at approximately 20-25 million while the number of commodity traders is probably below 200,000. Second, the composition of commodity traders, at least on the largest exchange, consists roughly of seventy-five percent commercial or professional traders and only about twenty-five percent avocational public investors. Third, the typical commodity trader is likely to be fairly sophisticated and affluent. As the Chairman of the House Agriculture Committee observed in 1973, "While securities markets attract the small speculator, with a limited exposure to loss, futures speculation is normally limited to the more venturesome and solvent speculator."⁷⁷

As a general rule, therefore, it would seem that the opportunities for fraud, deceit and cheating may well be more plentiful in securities than in commodities simply due to differences in their inherent nature. Accordingly,

⁷⁷ 119 CONG. REC. H41, 335 (1973).

there seems to be no identifiable feature of commodity trading that compels a definition of "fraud" more expansive than in the regulation of securities.

CONCLUSION

While opinions may vary on the wisdom of *Ernst & Ernst v. Hochfelder*, it is nevertheless the controlling law with respect to securities fraud under section 10(b) of the Securities Exchange Act. This article has examined whether the *Hochfelder* analysis would support a "scienter" requirement under section 4b of the Commodity Exchange Act. Because the words used in section 4b seem tailored to intentional or deliberate misconduct, because the Congress seems to have adopted section 4b to get the "crooks" in the industry, and because the potential for victimization through fraud seems no greater, and perhaps less, in commodity trading than in securities, section 4b should properly be interpreted as requiring scienter. To blur the traditional and common sense distinction between fraud and negligence would simply remove the intended sting of a fraud finding or unfairly equate human carelessness with dishonesty. Neither result seems to constitute a proper "remedial purpose" of the Commodity Exchange Act. Moreover, abundant remedies for merely negligent conduct will still exist for injured investors at common law.