NOTES

CATASTROPHE INSURANCE FUTURES CONTRACTS: A NEW JURISDICTIONAL QUESTION FOR REGULATORY AGENCIES?

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I. INTRODUCTION

The appropriate range of regulatory agencies' jurisdictional authority is not a new issue. The Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC) have traditionally been the main antagonists in a competition to regulate differing financial instruments.[1] Typically, in this competition, the instruments had both the attributes of futures, regulated by the CFTC, and securities, regulated by the SEC.[2] The jurisdictional competition between the CFTC and the SEC has

1. *See generally* Chicago Mercantile Exch. v. SEC, 883 F.2d 537 (7th Cir. 1989), *cert. denied*, 496 U.S. 936 (1990); Board of Trade v. SEC, 677 F.2d 1137, 1140 (7th Cir.), *cert. denied and judgment vacated as moot*, 459 U.S. 1026 (1982); S. REP. NO. 850, 95th Cong., 2d Sess. 20 (1978), *reprinted in* 1978 U.S.C.C.A.N. 2087, 2108.

2. In an early conflict in this competition, the Court of Civil Appeals of Texas wrote, "Under [7 U.S.C. § 2], the jurisdiction of the [CFTC] over futures is exclusive, and the [SEC] and state securities agencies are precluded from regulating commodity futures accounts." Birenbaum v. Bache & Co., 555 S.W.2d 513, 516 (Tex. Civ. App. 1977) (citing State v. Monex Int'l, Ltd., 527 S.W.2d 804, 806 (Tex. Civ. App. 1975)). The conflict often appeared as commodity versus security.

been largely resolved,[3] but financial innovation has continued to create new products.

A financial product, called the catastrophe insurance futures contract was recently launched on the Chicago Board of Trade. This product has the potential to create a new variety of jurisdictional dispute. The financial instrument has both the attributes of futures, regulated by the CFTC, and the attributes of an insurance product, regulated by the state insurance departments. A conflict may arise because both the CFTC and state insurance regulators have an arguable claim of federal statutory authority to regulate this innovative financial product. This Note does not address whether state insurance regulators have the authority to regulate the use of insurance futures by the insurance industry. Rather, this Note focuses on whether the CFTC or a state insurance regulator has the authority to regulate the financial instrument itself.

Before presenting the conflicting federal statutory authority that appears to grant exclusive jurisdictional authority to both the CFTC and state insurance regulators, this Note examines the composition of the catastrophe insurance contracts.[4] The discussion then turns to definitions of both futures contracts and the business of insurance.[5] These definitions delimit the areas each agency may regulate. The judicial definition of the financial instrument may determine whether the CFTC or state insurance regulators would be the appropriate regulator.[6] Finally, this Note examines the legislative intent and history of the regulatory spheres of the CFTC and state insurance regulators to provide some insight into the potential resolution of this issue.[7]

II. COMPOSITION OF THE CATASTROPHE INSURANCE CONTRACT

Before considering the regulatory authority surrounding catastrophe insurance contracts, a brief description of these financial instruments is necessary. The Chicago Board of Trade (CBOT) launched two insurance contracts on December 11, 1992.[8] Both are operationally similar and are only

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3. The United States Court of Appeals for the Seventh Circuit implicitly recognized the competitive nature of the CFTC and the SEC, and the negotiated settlement of these jurisdictional issues, when it wrote: "[T]he agencies [had] reached a pact, which the SEC call[ed] the Shad-Johnson Agreement and the CFTC call[ed] the Johnson-Shad Agreement. (John Shad was the SEC's Chairman at the time, and Phillip Johnson the CFTC's.) This Accord (as we shall call it to avoid offending either agency) provided that jurisdiction over options follows jurisdiction over the things on which the options are written." Chicago Mercantile Exch. v. SEC, 883 F.2d at 544.

4. *See infra* text accompanying notes 8-21.

5. *See infra* text accompanying notes 22-35.

6. *See infra* text accompanying notes 52-62.

7. *See infra* text accompanying notes 93-109.

8. 17 Ill. Reg. 154 (Dep't Ins. Jan. 4, 1993).

distinguishable by the scope of the relevant insurance pools, from which the contract valuation is determined.[9] One of the pools is national in scope, and the other is limited to the east coast.[10] The contracts are designed to reflect (1) the variable nature of catastrophic events on property, (2) the attendant impact on the insurance community, and (3) an accurate quantification of this property insurance risk.[11]

The actual contract value is determined by the losses reported to ISO DATA, Inc.[12] by the insurance companies in the quarter before the futures contract matures.[13] The reported losses are actually based on those losses occurring in the quarter four to six months prior to contract maturity.[14]

> For example, losses for the June 1993 contract must result from events that occur in the first quarter of 1993 and are reported to the reporting companies by the end of June 1993. These three extra reporting months are to allow for the time it typically takes for insureds to report losses to the companies; the majority of claims will be reported to companies within three months of the catastrophe.[15]

The ultimate value of the traded contracts is determined by totaling reported catastrophic losses.[16] This total is divided by the estimated property premium.[17] The "estimated property premium is based on the most recent statutory annual statements filed by the ISO reporting companies."[18] The estimated "premium amount is announced by the CBOT before the start of the trading of the relevant futures contract. This number is known and constant."[19] The ratio of total reported catastrophic losses to estimated

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9. CHICAGO BOARD OF TRADE, CATASTROPHE INSURANCE FUTURES & OPTIONS: A REFERENCE GUIDE 9 (1992) (on file with the *Drake Law Review*).

10. *Id.*

11. *See id.*

12. The Board of Trade publication states:

> The Insurance Services Office, Inc. (ISO) is a national membership association that gathers, stores, and disseminates statistical and actuarial information to regulators and insurers. . . . ISO DATA, Inc., a subsidiary of ISO, is responsible for collecting loss and premium data from the reporting companies and computing the final settlement value for each quarterly contract.

Id. at 14.

13. *Id.* at 15.

14. *Id.*

15. *Id.*

16. *Id.*

17. *Id.*

18. *Id.*

19. *Id.* at 19 n. *.

property premiums is then multiplied by $25,000 to obtain the index value of the contract.[20]

With the popularity of stock index futures, this form of index-based, cash-settled contract has become a familiar feature in the financial community. However, "[u]nlike many other products traded on the CBOT there is no daily cash price series available to help individuals in deciding how to price the contract."[21] Thus, traders have no readily discernible value for the underlying index during the trading period of the contract.

III. CONFLICTING STATUTORY AUTHORITY FOR THE REGULATION OF FUTURES INSURANCE PRODUCTS

The jurisdictional conflict that arises between the CFTC and state insurance regulators results from regulatory authority granted to both regulators. Title VII of the United States Code provides, "The [CFTC] shall have exclusive jurisdiction . . . with respect to accounts, agreements . . . and transactions involving contracts of sale of a commodity for future delivery . . . ."[22] The apparent exclusive authority is not limited by the definition of a commodity. The Code states, "The word 'commodity' means wheat, cotton . . . and all

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20. *Id.* at 15. It will be necessary for the contract trader to make a subjective estimate as to the percentage of catastrophe losses that will be reported by the end of the reporting period. *See id.* at 19.

21. CHICAGO BOARD OF TRADE, A DISCUSSION OF INSURANCE FUTURES PRICING 1 (on file with the *Drake Law Review*).

22. 7 U.S.C. § 2(i) (Supp. IV 1992). The exclusive jurisdiction was granted except as provided in § 2(a). *Id.* § 2(a). Section 2(a) represents the resolution of the regulatory competition between the CFTC and the SEC. "[T]he [CFTC] shall have no jurisdiction to designate a board of trade as a contract market for any transaction . . . on one or more securities . . . ." *Id.* § 2(a)(i). Historically, the CFTC has regulated products that, although securities, were exempt from SEC regulation under the Securities Act of 1933. 15 U.S.C. § 77(c) (1988). CFTC regulatory authority may appear analogously appropriate in the case of an insurance futures contract because SEC regulatory authority was not granted to "[a]ny insurance or endowment policy or annuity contract or optional annuity contract, issued by a corporation subject to the supervision of the insurance commissioner . . . or any State . . . ." *Id.* § 77(c)(a)(8). This Note does not, however, question CFTC jurisdictional authority on the basis of whether it is a security-type contract that might be appropriately regulated by the SEC. Instead, this Note questions whether CFTC regulatory authority exists in the presence of regulatory authority granted to state insurance regulators with respect to the business of insurance. Additionally,

> [t]he McCarran Act does not . . . exempt the business of insurance from the coverage of all federal statutes which do not specifically state that their provisions are applicable to insurance. . . . To avail itself of the McCarran Act, [the state regulator] must show that the application of the Federal . . . Act would "invalidate, impair or supersede any law enacted by any State for the purpose of regulating the business of insurance."

Hamilton Life Ins. Co. v. Republic Nat'l Life Ins. Co., 408 F.2d 606, 611 (2d Cir. 1969) (quoting 15 U.S.C. § 1012(b) (1988)). For the purposes of this Note, the issue is not whether any impaired state laws exist, but whether the state regulatory laws would take precedence in the presence of attempted regulation by the CFTC.

services, rights, and interests in which contracts for future delivery are presently or in the future dealt in . . . ."[23] Thus, this exclusive authority appears to apply to any product that could be constructed and traded. This is a very broad and general grant of authority that would appear to extend regulatory power to the CFTC over catastrophe insurance contracts.

This exclusive authority is limited in that

> nothing contained in this section [granting exclusive jurisdiction] shall (i) supersede or limit the jurisdiction at any time conferred on the [SEC] or other regulatory authorities under the laws of the United States, or of any State, or (ii) restrict the [SEC] and such other authorities from carrying out their duties and responsibilities in accordance with such laws.[24]

This jurisdictional limitation appears to place CFTC regulatory authority of futures transactions ahead of the SEC or state insurance regulators, except insofar as both are allowed to continue concurrently with their regulatory activity.[25]

This exclusive authority may not exist, however, with respect to catastrophe insurance contracts because of the authority granted to the state regulators by the McCarran-Ferguson Act.[26] The McCarran-Ferguson Act provides, "The business of insurance, and every person engaged therein, shall be subject to the laws of the several states which relate to the regulation or taxation of such business."[27] This appears to be a broad grant of authority to the states to regulate the "business of insurance."[28] Further, "No Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance, or which imposes a fee or tax upon such business, unless such Act specifically relates to the business of insurance . . . ."[29] This grant of regulatory authority does not appear to allow regulatory activity by some regulatory agencies.

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23. 7 U.S.C. § 1(9) (Supp. IV 1992).

24. *Id.*

25. *See* Chicago Mercantile Exch. v. SEC, 883 F.2d 537, 550 (7th Cir. 1989), *cert. denied*, 496 U.S. 936 (1990). In *Chicago Mercantile Exchange*, the court recognized this limitation on this authority was nonexistent once exclusive jurisdiction was granted to the CFTC. *Id.* The opinion states:

> Although the [SEC's] jurisdiction continues "except as hereinabove provided", what is "provided" immediately above in § 2 is that "the [CFTC] shall have exclusive jurisdiction . . . with respect to . . . transactions involving contracts of sale of a contract for future delivery, traded or executed on a contracts market . . . or any other board of trade, exchange, or market". If IPs [or any other contract] are futures contracts, then the CFTC has exclusive jurisdiction, the "except" clause applies, and the remainder of the language on which the SEC now relies has no force.

Id.

26. 15 U.S.C. §§ 1011-1015 (1988).

27. *Id.* § 1012(a).

28. The phrase "business of insurance," used throughout this Note, is intended to denote its meaning under the McCarran-Ferguson Act.

29. 15 U.S.C. § 1012(b) (1988).

Arguably, the broad and general grant of exclusive jurisdiction given to the CFTC does not apply to the catastrophe insurance contract because the act granting the CFTC regulatory authority does not "specifically relate[] to the business of insurance."[30]

This conflict between the CFTC's exclusive authority over futures transactions and the state insurance regulator's jurisdiction over the business of insurance is a new jurisdictional issue. In *Chicago Mercantile Exchange v. SEC*,[31] the court attempted to resolve the ongoing regulatory turf war between the CFTC and the SEC. The court was able to refine the issue to a single question: "[I]s the instrument a futures contract? If yes, then the CFTC's jurisdiction is exclusive, unless it is also an option on a security, in which case the SEC's jurisdiction is exclusive."[32] With catastrophe insurance contracts, however, the question is more than just whether the contract is a futures contract. Even if a futures contract is deemed to exist, the CFTC may not be able to regulate the business of insurance because its statutory authority lacks any specific mention of the business of insurance. The McCarran-Ferguson Act states no federal law applies to the business of insurance unless it specifically relates to the business of insurance.[33]

To construe the applicability of these conflicting statutes, a court would have to determine whether the financial instrument was a futures contract, a product within the "business of insurance,"[34] or a combination of both. In *Chicago Mercantile Exchange v. SEC*, the issue presented was whether the contract was a futures contract or a security. The court stated, "Each of these terms has a paradigm, but newfangled instruments may have aspects of each of the prototypes. . . . We must decide whether tetrahedrons belong in square or round holes."[35] Determining whether the catastrophe insurance contract is a futures contract or an instrument within the business of insurance involves a similar analysis.

IV. IS THE INSTRUMENT A FUTURES CONTRACT?

In determining if the CFTC has jurisdiction over catastrophe insurance contracts, it must first be determined if the instrument is a futures contract. Although the definition of a "security" is an extensively litigated and codified term, the definition of "futures contract" has no such extensive history. The omission of a definition of "futures contract" in the act granting the CFTC

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30. *Id.*

31. Chicago Mercantile Exch. v. SEC, 883 F.2d 537 (7th Cir. 1989), *cert. denied*, 496 U.S. 936 (1990).

32. *Id.* at 545.

33. 15 U.S.C. § 1012(b) (1988).

34. The McCarran-Ferguson Act grants states the authority to regulate the "business of insurance." *Id.* §1012(a).

35. Chicago Mercantile Exch. v. SEC, 883 F.2d at 539.

jurisdictional authority over them has been recognized by the courts.[36] "The statute does not define either 'contracts . . . for future delivery' or 'option'—although it says that 'future delivery . . . shall not include any sale of any cash commodity for deferred shipment or delivery.'"[37] Because a statutory definition of the term "futures contract" is lacking, a definition must be discerned by other means.

Many traditional definitions of futures have focused on the future delivery of a commodity. A futures contract has been defined as "[a] present right to receive at a future date a *specific quantity of a given commodity* for a fixed price."[38] Cash-settled, index-based futures contracts, however, are not included within this definition because there is no delivery of a "specific quantity of a given commodity."[39] The catastrophe insurance contract also lacks this delivery process. The Court of Appeals for the Seventh Circuit has recognized many of the innovative futures contracts lack a delivery procedure.[40] The court stated:

> [A broad interpretive approach had been used] in redefining futures contracts to omit the delivery obligation. Recall the statutory scope of the CEA: contracts "for future delivery". Commodity futures contracts may be settled by delivery; financial futures contracts are settled exclusively in cash. One might have thought the prospect of "future delivery" the sine qua non of a "futures" contract. Yet no one, not even the SEC, doubts that a contract may be a futures contract even though it provides for cash settlement. If delivery is not essential, then the "traditional" elements of futures contracts are not invariable ingredients of the CFTC's jurisdiction.[41]

If the traditional elements are not necessary to establish CFTC jurisdiction, what are the appropriate elements necessary to define a futures contract?

In *Chicago Mercantile Exchange v. SEC*, the SEC promoted, and the court examined, the concepts of "futurity" and "bilateral obligation" as the ingredients of a futures contract.[42] "'Futurity means that value is set in the future . . . [and] 'bilateral obligation' means that the contract is executory on both sides until expiration or settlement . . . ."[43] The catastrophe insurance contract appears to have both elements. The value is set in the future, when

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36. *Id.*

37. *Id.* (quoting 7 U.S.C. § 2 (1988)).

38. BLACK'S LAW DICTIONARY 676 (6th ed. 1990) (emphasis added) (citing Clayton Brokerage Co. v. Mouer, 520 S.W.2d 802, 804 (Tex. Civ. App. 1975)).

39. *Id.*

40. Chicago Mercantile Exch. v. SEC, 883 F.2d 537, 549 (7th Cir. 1989), *cert. denied*, 496 U.S. 936 (1990).

41. *Id.*

42. *Id.* at 541, 545-46.

43. *Id.* at 541.

all of the claims have been totaled, so futurity exists.[44] Additionally, the contract appears to have the typical bilateral obligations of most futures contracts because obligations exist until expiration for selling either short or long.[45] Thus, under the concepts of futurity and bilateral obligations, it may be reasonable to conclude the catastrophe insurance contract is a futures contract.

The catastrophe insurance contract, however, has one distinguishing feature from the other futures contracts. This distinction can be illustrated by what a futures contract is designed to accomplish. In *Chicago Mercantile Exchange v. SEC,* the court stated "futures are a means of hedging, speculation, and price revelation without transfer of capital. So one could think of the distinction between the jurisdiction of the SEC and that of the CFTC as the difference between regulating capital formation and regulating hedging."[46] The court also stated, "The legislature thought that this Accord would resolve things and restore a regime in which the SEC supervises capital formation and the CFTC hedging."[47] Thus, a futures contract is meant to be a hedging vehicle and not a capital formation vehicle. A futures contract is designed to establish the future value of some asset. Futures contracts are distinguishable from catastrophe insurance contracts because the former have an asset of value underlying the contract.[48] This asset represents a store of wealth for the contract trader.[49] A catastrophe insurance contract, although assisting in the quantification of insurance company liability, has no store of wealth underlying the contract. The underlying instrument in a catastrophe insurance contract does not represent a store of wealth. Rather, it is a wasting asset or a liability that may have to be honored. This distinction, between providing a future value of some underlying store of wealth or providing a future value of some future liability, may prove to be a philosophical distinction that could lead a court to find a catastrophe insurance contract is not a futures contract. Commodity futures originated with an underlying physical asset.[50] Financial futures were based on the value of a

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44. *See supra* text accompanying notes 7-10.

45. *See supra* text accompanying notes 11-16.

46. Chicago Mercantile Exch. v. SEC, 883 F.2d 537, 543 (7th Cir. 1989), *cert. denied*, 496 U.S. 936 (1990).

47. *Id.* at 544.

48. The Wall Street Journal lists futures contracts based on a store of units of account (Interest Rate, Currency, Stock Index) or based on a commodity used for processing (Grains and Oilseeds, Livestock and Meat, Food and Fiber, Metals and Petroleum). *Futures Prices*, WALL. ST. J., Mar. 31, 1993, at C12.

49. This is referred to as a store of wealth because all contracts are based either on some physical commodity or on a financial asset that could be traded for a physical commodity. All of the commodities or financial assets have a storage life and have no specified date in the future when value is zero.

50. *See* S. REP. NO. 850, 95th Cong., 2d Sess. 7 (1978), *reprinted in* 1978 U.S.C.C.A.N. 2087, 2095 (providing an overview of the history of commodity markets and market regulation in the United States).

financial asset.[51] To extrapolate further, however, may not be appropriate. A future may not exist with respect to a liability contingent on some natural disaster, because the catastrophe insurance contract lacks the store of wealth on which previous futures contracts have always been constructed.

A determination that catastrophe insurance contracts do not have the characteristics of a futures contract will prevent CFTC regulatory jurisdiction. Such a determination, however, will not necessarily preclude state regulatory authority. State insurance regulators may still have authority over this product, even if it is a futures contract, because states presumably regulate the business of insurance even when that business has futures characteristics.

V. IS THE INSTRUMENT WITHIN THE BUSINESS OF INSURANCE?

Regardless of whether or not the catastrophe insurance contract is defined as a futures contract, state regulators will only have authority to regulate it if it falls within the business of insurance. The definition of insurance can be used to determine whether the catastrophe insurance contract constitutes the business of insurance. Insurance is defined as:

> A contract whereby, for a stipulated consideration, one party undertakes to compensate the other for loss on a specified subject by specified perils. The party agreeing to make the compensation is usually called the "insurer" or "underwriter;" the other, the "insured" or "assured;" the agreed consideration, the "premium;" the written contract, a "policy;" the events insured against, "risks" or "perils;" and the subject, right, or interest to be protected, the "insurable interest." A contract whereby one undertakes to indemnify another against loss, damage, or liability arising from an unknown or contingent event and is applicable only to some contingency or act to occur in future. An agreement by which one party for a consideration promises to pay money or its equivalent or to do an act valuable to other party upon destruction, loss, or injury of something in which other party has an interest.[52]

Presumably, the business of insurance involves transactions in which a contract of insurance between an insurer and an insured, or an insurance policy, as defined above, would be effected. Interestingly, the definition of insurance could very well apply to the catastrophe insurance contract. It is a "contract whereby one undertakes to indemnify against loss . . . [on] some contingency or act to occur in the future."[53] Thus, the catastrophe insurance contract may not just be within the business of insurance, it may be an insurance policy.[54]

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51. *See supra* text accompanying notes 33-36.

52. BLACK'S LAW DICTIONARY 802 (6th ed. 1990).

53. *Id.*

54. The Board of Trade has started trading in an option on the catastrophe insurance contract. CHICAGO BOARD OF TRADE, CATASTROPHE INSURANCE FUTURES & OPTIONS: A

In *SEC v. National Securities, Inc.*,[55] the United States Supreme Court defined the business of insurance. The Court stated, "The relationship between insurer and insured, the type of policy which could be issued, its reliability, interpretation, and enforcement—these [are] the core of the 'business of insurance.'"[56] The Court recognized other activities of insurance companies would impact an insurance company's reliability to an extent that they too would be within the business of insurance.[57] "But whatever the exact scope of the statutory term, it is clear where the focus [is]—it [is] on the relationship between the insurance company and the policyholder. Statutes aimed at protecting or regulating this relationship, directly or indirectly, are laws regulating the 'business of insurance.'"[58] Thus, the relationship between the insurer and insured is of paramount importance.

With respect to policy risk hedging with insurance futures, such transactions would distinctly impact the reliability and enforcement of insurance policies. Thus, under the Supreme Court's definition of the business of insurance, regulation of futures transactions by insurance companies is appropriate to regulate the reliability of the insurance company.[59] This would represent regulation of the insurance company as an entity and is almost certainly within the business of insurance. Additionally, state regulation of the catastrophe insurance contract may well be appropriate to control the impact on the relationship between the insurer and the insured.[60] The Supreme Court's definition of the business of insurance, however, does not indicate whether state regulatory authority should end with mere regulation of use by insurance companies of futures contracts, or if state regulatory authority would extend to catastrophe insurance contracts. Although there is no statutory authority, it is conceivable a court could construe the catastrophe insurance contract as a national-type instrument, and, therefore, beyond individual state regulation. This is speculation, but it is based on the judiciary's tendency to limit state involvement in products requiring national uniformity.[61] Notwithstanding this tendency, the Supreme

REFERENCE GUIDE 41 (1992). An option has additional aspects similar to a catastrophe insurance contract. An option has a "writer" of the option as well as a purchaser of this price risk coverage. A "premium" is paid for the option, and options are often sold as insurance against some price movement. The vernacular surrounding an options transaction has the sound of a catastrophe insurance contract. With respect to the jurisdictional issue, however, the option contract is ignored because the CFTC is allowed jurisdiction over any option on a futures contract. 7 U.S.C. § 2(a)(ii) (1988). The initial question is whether or not the catastrophe insurance contract is a futures contract.

55. SEC v. National Sec., Inc., 393 U.S. 453 (1969).

56. *Id.* at 460.

57. *Id.*

58. *Id.*

59. *See supra* text accompanying notes 50-52.

60. *See supra* text accompanying note 53.

61. Justice Powell, dissenting in Foremost Insurance Co. v. Richardson, 457 U.S. 668 (1982), wrote of an expanding federal authority:

Court, in interpreting the McCarran-Ferguson Act, has stated, "Congress intended to declare, and in effect declared, that uniformity of regulation, and of state taxation, are not required in reference to the business of insurance by the national public interest . . . ."[62]

It is currently unresolved whether or not the catastrophe insurance contract is a futures contract. It is also uncertain whether catastrophe insurance contract regulation affects the insurance relationship enough to warrant state regulation within the business of insurance. If it is assumed the catastrophe insurance contract is a futures contract, and the regulation of the contract is warranted under the business of insurance, an examination of the legislative history of the McCarran-Ferguson and Commodity Exchange Acts may indicate which agency should prevail.

VI. HISTORY OF THE MCCARRAN-FERGUSON ACT

An examination of the history of the McCarran-Ferguson Act may determine if this statute should take precedence over the Commodity Exchange Act. This analysis is divided into two parts: an examination of congressional intent and an examination of historical judicial interpretation.

A. *Examination of Congressional Intent*

The House Committee on the Judiciary, commenting on the McCarran-Ferguson Act, recognized that "[f]rom its beginning the business of insurance ha[d] been regarded as a local matter, to be subject to and regulated by the laws of the several States."[63] The United States Supreme Court recognized this view for a period of seventy-five years prior to 1944.[64] In 1944, the Supreme Court decided "the business of insurance was commerce and, therefore, subject to the Sherman Act . . . and the Clayton Act."[65] This ruling created uncertainty about the constitutionality of state laws.[66] The McCarran-Ferguson Act was passed "to protect the continued regulation and

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> No trend of decisions by this Court has been stronger—for two decades or more—than that toward expanding federal jurisdiction at the expense of state interests and state-court jurisdiction. Of course, Congress also has moved steadily and expansively to exercise its Commerce Clause and preemptive power to displace state and local authority. Often decisions of this Court and congressional enactments have been necessary in the national interest. The effect, nevertheless, has been the erosion of federalism—a basic principle of the Constitution and our federal Union.

Id. at 677-78 (Powell, J., dissenting).

62. Prudential Ins. Co. v. Benjamin, 328 U.S. 408, 431 (1946).

63. H.R. REP. NO. 143, 79th Cong., 1st Sess. (1948), *reprinted in* 1945 U.S.C.C.A.N. 670, 670-71.

64. *Id.* at 671.

65. *Id.*

66. *Id.*

taxation of the business of insurance by the several States . . . . [T]he Congress propose[d] by this bill to secure adequate regulation and control of the insurance business."[67] The congressional comments specify:

> Section 2 [of the McCarran-Ferguson Act] provides that the insurance business, and all persons engaged in such business, shall be subject to State laws relating to the regulation and taxation of such business; and (b) that no act of Congress shall be construed to invalidate, impair, or supersede any State law which regulates or taxes the insurance business, unless such act specifically so provides.[68]

Although the McCarran-Ferguson Act reaffirmed the states' regulatory role over the business of insurance, Congress did not intend to grant any new powers to the states.[69] The states were to retain only those powers held prior to the Supreme Court's ruling the Clayton and Sherman Acts applied to insurance as commerce.[70]

The congressional comments provide that state regulation is always subject to the decisions of the Supreme Court, which hold "a State does not have power to tax contracts of insurance or reinsurance entered into outside its jurisdiction by individuals or corporations resident or domiciled therein covering risks within the State or to regulate such transactions in any way."[71] Based on this congressional comment, a CFTC claim that the contract was actually a foreign insurance or reinsurance product covering risks within the state—and, therefore, beyond state regulatory action—would have some support in the regulatory history of the McCarran-Ferguson Act. In *Connecticut General Life Insurance Co. v. Johnson*,[72] cited by the House Committee on the Judiciary, the Supreme Court struck down a California tax on foreign reinsurance transactions of California policy liability as violative of the Due Process Clause.[73] The Court stated:

> Apart from the facts that appellant was privileged to do business in California, and that the risks reinsured were originally insured against in that state by companies also authorized to do business there, California had no relationship to appellant or to the reinsurance contracts. No act in the course of their formation, performance or discharge, took place there. The performance of those acts was not dependent upon

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67. *Id.*
68. *Id.* at 672.
69. *Id.* at 671.
70. *Id.*
71. *Id.* at 670-71 (citing Connecticut Gen. Life Ins. Co. v. Johnson, 303 U.S. 77 (1938); St. Louis Cotton Compress Co. v. Arkansas, 260 U.S. 346 (1922); Allgeyer v. Louisiana, 165 U.S. 578 (1897)).
72. Connecticut Gen. Life Ins. Co. v. Johnson, 303 U.S. 77 (1938).
73. *Id.* at 81-82.

> any privilege or authority granted by it, and California laws afforded to them no protection.[74]

Thus, because the futures contract may be perceived as a form of reinsurance, state insurance regulators may not have jurisdiction over a futures transaction if the parties have no connection to the state or if the formation, performance, or discharge of the transaction lacks any contact with the state.

If a court determines state regulators are not allowed to regulate a foreign reinsurance contract, and if the catastrophe insurance contract is construed as a reinsurance activity, the McCarran-Ferguson Act may not grant regulatory authority.[75] Nevertheless, this does not resolve the jurisdictional issue because every state has a domestic insurance regulator who may desire to regulate the catastrophe insurance contract. For instance, the Illinois Department of Insurance may choose to assert authority over the catastrophe contract on the Board of Trade. The Board of Trade reinsurance activity would not be a foreign activity from this perspective. Further, additional states may attempt to create an insurance contract identical to the Board of Trade contract. Conceivably, these contracts could be created under the aegis of the state insurance regulator. Theoretically, another state's insurance regulator could be the supervising authority over this futures activity. Therefore, whether or not the foreign reinsurance activity is regulable by state insurance regulators, the jurisdictional authority of the remaining state insurance regulators is unresolved. Because the congressional comments do not resolve this jurisdictional issue, the judicial interpretation of the McCarran-Ferguson Act may define the extent of jurisdictional authority.

B. *Examination of Historical Judicial Interpretation*

The Supreme Court articulated its view of the McCarran-Ferguson Act when it stated:

> Suffice it to say that even the most cursory reading of the legislative history of this enactment makes it clear that its exclusive purpose was to counteract any adverse effect that this Court's decision in United States v. South-Eastern Underwriters Association might be found to have on state regulation of insurance.[76]

Thus, the Court recognized Congress intended to have states regulate insurance.

Additionally, courts have examined different insurance company activities to determine if the activity falls within the business of insurance, or falls under federal statutory authority. Three of these activities—insurance com-

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74. *Id.* at 81.
75. *See supra* text accompanying notes 66-69.
76. Maryland Casualty Co. v. Cushing, 347 U.S. 409, 413 (1954) (citations omitted).

pany mergers, insurance policy financing, and insuring the lives of mortgage recipients—are detailed.

In *SEC v. National Securities, Inc.*,[77] the Court held the McCarran-Ferguson Act applied in that conflict concerning the merger of two insurance companies.[78] The McCarran-Ferguson Act did not preempt SEC regulation of that insurance company merger because the applicable state regulation "focused its attention on stockholder protection; it [was] not attempting to secure the interests of those purchasing insurance policies. Such regulation [was] not within the scope of the McCarran-Ferguson Act."[79] The Court went on to state, "Different questions would, of course, arise if the Federal Government were attempting to regulate in the sphere reserved primarily to the States by the McCarran-Ferguson Act."[80] In effect, *SEC v. National Securities, Inc.* extended federal regulatory authority to a securities transaction—an insurance company merger—that is distinguishable from insurance contract regulation.

Courts have also addressed the business practice of requiring mortgage recipients to buy life insurance.[81] In *Dexter v. Equitable Life Assurance Society*,[82] the Court of Appeals for the Second Circuit stated, "If the meaning of 'regulate' is properly understood, Connecticut law at all relevant times did regulate the business of insurance, with particular reference to unfair methods of selling policies."[83] Therefore, it appears insurance sales practices are within the business of insurance.

Cochran v. Paco, Inc.[84] held "premium financing by an independent premium finance company does not constitute the 'business of insurance' for purposes of the McCarran Act."[85] It was not within the business of insurance because "[p]remium financing has little—if any—effect on an insurance company's ability to pay claims or on the nature of the policies it issues."[86] The Fifth Circuit has also written that "[t]he appropriate focus[, in determining if an activity is within the business of insurance,] is thus the nature of the activity itself, not the type of business that is conducting it."[87]

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77. SEC v. National Sec., Inc., 393 U.S. 453 (1969).

78. *Id.* at 463-64.

79. *Id.* at 460.

80. *Id.* at 463.

81. *See* Dexter v. Equitable Life Assurance Soc'y, 527 F.2d 233 (2d Cir. 1975); Addrisi v. Equitable Life Assurance Soc'y, 503 F.2d 725 (9th Cir. 1974), *cert. denied*, 420 U.S. 929 (1975).

82. Dexter v. Equitable Life Assurance Soc'y, 527 F.2d 233 (2d Cir. 1975).

83. *Id.* at 236. In Addrisi v. Equitable Life Assurance Society, 503 F.2d 725 (9th Cir. 1974), *cert. denied*, 420 U.S. 929 (1975), the Ninth Circuit Court of Appeals also found state law dealt with any unfair practices concerning the tying of mortgages to life insurance policies. *Id.* at 728.

84. Cochran v. Paco, Inc., 606 F.2d 460 (5th Cir. 1979).

85. *Id.* at 467.

86. *Id.* at 466.

87. Perry v. Fidelity Union Life Ins. Co., 606 F.2d 468, 470 (5th Cir. 1979), *cert. denied*, 446 U.S. 987 (1980).

Securities regulation and premium financing are not within the business of insurance because neither activity has the nature of insurance activity. Federal statutes prevail in these areas. State regulation of the insurance company sales methods is appropriate because they involve insurance activity. Judicial recognition that the nature of the activity defines whether something is within the business of insurance must place catastrophe insurance contracts squarely within this category.[88] Further, the comments of the House Committee on the Judiciary support control of the business of insurance by state regulators.[89] The Supreme Court has recognized this congressional intent.[90] Thus, state regulatory authority over catastrophe insurance contracts would be appropriate. The only possible limitation on this authority appears to be a prohibition on regulation or taxation of foreign insurance or reinsurance activity. A prohibition on foreign reinsurance regulation, however, does not end the jurisdictional conflict, because domestic state regulators may wish to regulate the trade. CFTC regulatory authority may not seem appropriate because (1) the Supreme Court has determined the business of insurance does not require national uniformity,[91] and (2) there is no specific mention of the business of insurance in the CFTC's exclusive regulatory authority over futures.[92] Nevertheless, this examination of congressional and judicial interpretation of the McCarran-Ferguson Act is not conclusive because an interpretive examination of the Commodity Exchange Act may bring another perspective to light.

VII. HISTORY OF THE COMMODITY EXCHANGE ACT

The Commodity Exchange Act, which has evolved since its initial enactment as the Grain Futures Act of 1922,[93] was substantially revised in 1974.[94] The 1974 revision provided the CFTC with exclusive jurisdiction to regulate futures trading, "thereby preempting any State regulatory laws."[95] The following congressional comments indicate the intended supremacy of the CFTC as a futures regulator.

> "The *Senate* amendment retains the provision of the *House* bill but adds three clarifying amendments. The clarifying amendments make clear

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88. A catastrophe insurance futures contract, even with respect to its name, is not easily distinguishable from insurance activity.

89. *See supra* text accompanying notes 58-63.

90. *See supra* text accompanying note 71.

91. *See supra* text accompanying note 57.

92. *See supra* text accompanying note 28.

93. S. REP. NO. 850, 95th Cong., 2d Sess. 7 (1978), *reprinted in* 1978 U.S.C.C.A.N. 2087, 2095 (providing an overview of the history of commodity markets and market regulation in the United States).

94. *Id.* at 2098.

95. H.R. REP. NO. 565, 97th Cong., 2d Sess. 44 (1982), *reprinted in* 1982 U.S.C.C.A.N. 3871, 3893.

> that (a) the Commission's jurisdiction over futures contract markets or other exchanges is exclusive and includes the regulation of commodity accounts, commodity trading agreements, and commodity options; (b) the Commission's jurisdiction, where applicable, supersedes State as well as Federal agencies; and (c) Federal and State courts retain their respective jurisdictions."[96]

Additionally, "'[i]n view of the broad grant of authority to the Commission to regulate the futures trading industry, the Conferees do not contemplate that there will be a need for any supplementary regulation by the States.'"[97]

Courts have also interpreted the Act as extending exclusive jurisdiction.[98] "The language [of the Commodity Future Trading Act] seems to . . . express a clear intention to vest exclusive jurisdiction of the regulation of commodity options [and futures] in the [CFTC] and to supersede the jurisdiction of all state and federal agencies."[99]

According to both Congress and the judiciary, the CFTC is to regulate futures trading. Nevertheless, congressional and judicial statements do not indicate whether insurance futures are covered by this exclusive jurisdiction. An examination of previous competition between the CFTC and the SEC may aid in determining the appropriate extent of CFTC jurisdiction.

The creation of the CFTC and the expansive definition of futures contracts created the jurisdictional struggle between the CFTC and the SEC. The broad definition of a futures contract includes services, rights, and interests in which contracts for future delivery could be dealt.[100] Many subsequent futures contracts had a future interest on a financial instrument.[101] These futures appeared, in some respects, as a security, and the SEC resisted CFTC regulation.[102] Although there was no intent to allow the CFTC to regulate securities activity, the definitional line between security and futures activity was not clear enough to prevent conflict.[103] Congress drew a distinct line with the inclusion of section 2(a) in Title VII of the United States Code.[104] "The new subparagraph provide[d] that the [CFTC] shall have no jurisdiction to

96. SEC v. American Commodity Exch., 546 F.2d 1361, 1368 (10th Cir. 1976) (quoting H.R. CONF. REP. NO. 1383, 93d Cong., 2d Sess. (1974), *reprinted in* 1974 U.S.C.C.A.N. 5894, 5897).

97. Hofmayer v. Dean Witter & Co., 459 F. Supp. 733, 737 (N.D. Cal. 1978) (quoting H.R. CONF. REP. NO. 1383, 93d Cong., 2d Sess. (1974), *reprinted in* 1974 U.S.C.C.A.N. 5894, 5897).

98. *See* Chicago Mercantile Exch. v. SEC, 883 F.2d 537 (7th Cir. 1989), *cert. denied*, 496 U.S. 936 (1990).

99. International Trading, Ltd. v. Bell, 556 S.W.2d 420, 423 (Ark. 1977), *cert. denied*, 436 U.S. 956 (1978).

100. S. REP. NO. 1131, 93d Cong., 2d Sess. (1974), *reprinted in* 1974 U.S.C.C.A.N. 5843, 5870.

101. *See supra* text accompanying notes 33-36.

102. *See supra* note 18.

103. *See generally* S. REP. NO. 1131, 93d Cong., 2d Sess. (1974), *reprinted in* 1974 U.S.C.C.A.N. 5843, 5863, 5870-71.

104. 7 U.S.C. § 2(a) (Supp. IV 1992).

designate a board of trade as a contract market for any transaction whereby any party to such transaction acquire[d] any option on one or more securities as defined in [the Securities Acts]."[105] The SEC was prevented, however, from regulating the business of insurance, a securities-type transaction, by its own statutory exemption of insurance products.[106] Ultimately, the CFTC was allowed to regulate futures products based on those securities exempted from SEC regulation under the Securities Act of 1933.[107] Thus, regulatory authority over insurance futures was assumed by the CFTC in this "hand-me-down" fashion. If the SEC could not regulate a security, the CFTC was willing to do so. In this futures regulator versus securities regulator conflict, no specific attention was ever provided to the insurance industry and insurance regulators. Thus, the judicial history of the Commodity Exchange Act has always focused on the SEC and securities issues. The jurisdictional competition between the CFTC and the SEC has refined the definition of the CFTC's exclusive jurisdiction with respect to SEC regulatory authority. There are few guideposts to determine how the Commodity Exchange Act affects the business of insurance, state regulators, or state insurance.

Apart from the need to resolve the conflict between the McCarran-Ferguson Act and the Commodity Exchange Act, the jurisdictional scope of the Commodity Exchange Act may be limited simply because the statutory construction is too extensive. Under the Commodity Exchange Act, the exclusive grant of futures regulatory authority extends to all services, rights, and interests[108] and may be sufficiently overbroad to require judicial attention. Such a broad grant of authority appears almost infinite. Theoretically, one could imagine a contract used to hedge the financial risk inherent in heart by-pass operations or organ transplants. Additionally, perhaps a futures contract could be established to provide a hedging tool for probate costs or inheritance taxes.[109] Such imaginative futures contracts highlight the broad jurisdictional authority granted to the CFTC, but also serve to indicate the jurisdictional range could become extended to any conceivable future interest. This infinite grant of authority, therefore, is likely to be limited by a court in some logical fashion. The principle limiting the Commodity Exchange Act, therefore, may emanate from a constricting definition of futures contracts.

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105. H.R. REP. NO. 565, 97th Cong., 2d Sess. 80 (1982), *reprinted in* 1982 U.S.C.C.A.N. 3871, 3929.

106. *See* 15 U.S.C. § 77(c)(a)(8) (1988).

107. H.R. REP. NO. 565, 97th Cong., 2d Sess. 39 (1982), *reprinted in* 1982 U.S.C.C.A.N. 3871, 3888 (providing chart depicting the intended jurisdiction of the CFTC and SEC).

108. *See supra* text accompanying note 19.

109. The Board of Trade does intend to launch a health insurance futures and option. CHICAGO BOARD OF TRADE, CBOT INSURANCE FUTURES: HEALTH INSURANCE FUTURES & OPTIONS 13 (1992).

VIII. CONCLUSION

The catastrophe insurance contract is certainly an innovative product. Apart from establishing a new risk management tool, it has also created a multi-faceted jurisdictional issue. Although superficially the contract appears to be a futures contract, the philosophical question whether a futures contract can exist on a wasting asset, which lacks any semblance of a store of wealth, needs to be addressed. Additionally, insurance company use of catastrophe insurance contracts is almost certainly within the range of the business of insurance. Contracts of this nature would have a significant effect on the business of insurance—the relationship of the insurer and the insureds. It is possible, however, for a court to construe regulation of the catastrophe insurance contract outside the scope of state regulation of the business of insurance.

The legislative histories of the McCarran-Ferguson and Commodity Exchange Acts do not articulate a clear preference for the authority of one over the other. Judicial analysis of the interplay between these two Acts is nonexistent. It is difficult to determine which act should dominate. Both acts appear to extend regulatory authority. As the legislative history indicates, it makes sense to facilitate trade through the establishment of a single regulator of futures products. For the past century, however, it has also made sense to have states regulate the business of insurance. To resolve this issue, perhaps a court would simply defer to the interpretation given to the contract by either of the potential regulators. In *Chicago Mercantile Exchange v. SEC*, the court acknowledged a desire to extend deference to the agencies' determinations.[110] The court was unable to determine, however, to which agency it was to defer.[111] In this situation, deference affects the balance of federal versus state rights. Appearing sensitive to this balance, the Court of Appeals for the Seventh Circuit has stated, "Delegation to agencies is not without its costs to the separation of powers; holding agencies within their delegated scope is an important task in maintaining constitutional structure."[112] Additionally, in *Transnational Insurance Co. v. Rosenlund*,[113] the United States District Court for the District of Oregon held it was appropriate to construe the McCarran-Ferguson Act liberally to give state statutes regulatory effect.[114] The court stated:

> [S]ince the Congressional intent and purpose behind passage of the McCarran-Ferguson Act was to throw the whole weight of its vast power

110. Chicago Mercantile Exch. v. SEC, 883 F.2d 537, 547 (7th Cir. 1989) (citing Chevron U.S.A. v. Natural Resources Defense Council, 467 U.S. 837 (1984)), *cert. denied*, 496 U.S. 936 (1990).

111. *Id.*

112. *Id.* at 548.

113. Transnational Ins. Co. v. Rosenlund, 261 F. Supp. 12 (D. Or. 1966).

114. *Id.* at 28.

> behind existing and future state systems for regulating and taxing the business of insurance, it is the Court's duty to liberally construe the 1947 enactments and, if possible, give them a construction as to place [state] legislation within the exemption under the Act.[115]

This passage indicates that deference to state legislative action is appropriate and is one basis on which to grant state regulatory authority before federal authority, but it is hardly conclusive.

Overall, this jurisdictional issue may be moot because the CFTC may acquire regulatory authority by default. State regulators have not asserted their potential authority. If any state regulatory authority is asserted, the Seventh Circuit Court of Appeals has stated a resolution of this type of issue is a "'task [that] should not reflect a value judgment as to which of the competing agencies is best equipped to regulate these [products].'"[116] This is a worthy sentiment that, when coupled with the court's determination that a national, uniform regulation of the business of insurance is not a necessity,[117] indicates a "realpolitik" assumption of CFTC jurisdictional prevalence is not necessarily appropriate.

Scott L. Hippen

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115. *Id.*

116. Chicago Mercantile Exch. v. SEC, 883 F.2d 537, 549 (7th Cir. 1989) (quoting Board of Trade v. SEC, 677 F.2d 1137, 1161 (7th Cir. 1982)), *cert. denied*, 496 U.S. 936 (1990).

117. *See supra* text accompanying note 56.