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PRECIOUS METALS TRADING—THE LAST FRONTIER OF UNREGULATED INVESTMENT

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The trading of precious metals, principally gold and silver bullion and coins, has long been a primary focus of investors worldwide and, indeed, has often been the yardstick by which the success of economies, currencies and even governments has been measured. Precious metals currently are offered to the public throughout much of the free world by banks, brokerage firms and cash metals dealers engaged in the business of metals trading. While many of these entities may be subject to Securities and Exchange Commission (SEC) or Commodity Futures Trading Commission (CFTC) jurisdiction through their other activities, their precious metals products are often completely beyond the authority of these agencies. Moreover, firms engaged exclusively in unregulated metals transactions may be subject to little or no federal regulatory controls whatsoever.

This article will first describe the nature of the precious metals markets and the manner in which metals products are offered to the public. The status of these metals and the instruments traded thereon will then be analyzed under the federal securities and commodities laws. Finally, the article will discuss the extent to which the trading of precious metals may become subject to SEC, CFTC or other forms of regulation in the future.

I. INTRODUCTION

In late 1983 and early 1984, federal and state authorities initiated a long-awaited crackdown on precious metals dealers operating fraudulent "boiler room" schemes across the country, which allegedly had bilked investors out of several hundred million dollars.¹ Indeed, in the two most celebrated of these

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1. See *Commodity Investment Fraud II, Hearings Before the Permanent Subcommittee on Investigations of the Senate Committee on Governmental Affairs*, 98th Cong., 2d Sess. 145-88 (1984) [hereinafter cited as *PSI Hearings*]; see also *War on Florida Boiler Rooms*, N.Y. Times, Nov. 14, 1983; *Regulating Bullion Dealers*, N.Y. Times, Oct. 31, 1983; *Senate to Study Gold Dealers*, N.Y. Times, Oct. 27, 1983; *Bullion Fraud: Who Protects the Investor?*, Chicago Tribune, Oct. 25, 1983. These "boiler room" schemes involved numerous types of commodity investment fraud schemes, including precious metals trading. *PSI Hearings, supra*, at 145-88. Most of the schemes, as discussed more fully below, were centered in Florida and Southern California. *Id.* at 149.

The nature of a "boiler room" operation previously had been reviewed in detail by the Senate Permanent Subcommittee on Investigations (PSI). *Commodity Investment Fraud, Report of the Senate Committee on Governmental Affairs Made by the Permanent Subcommittee on Investigations*, S. REP. No. 495, 97th Cong., 2d Sess. 10-13 (1982) [hereinafter cited as 1982 PSI REPORT]. The 1982 PSI Report concluded that more than \$200 million per year had been lost in commodity investment fraud schemes between 1975 and 1982, including "boiler rooms"

scandals alone, some 50,000 individuals nationwide lost more than \$100 million over the course of only a few months.² One firm, which sold "title" to \$60 million in gold while maintaining only \$2 million worth of the metal in its vaults, conducted a "pervasive radio blitz over New York's all news radio station WCBS extolling the safety of [its] storage facility which was reputed also to be the depository of the Mormon Church in the Wasatch mountains in Utah."³ Another firm, although "selling" millions of dollars of gold, had nothing in its vaults but old typewriters and wood bars painted to look like

selling precious metals, gems, oil and gas interests and other investments. The subcommittee characterized "boiler room" operations in the following terms:

In actuality, these "firms" usually consist of rented rooms crammed with desks and phones. Salesmen are hired for their brazen persistence alone; no actual knowledge of commodities is necessary. In fact, the less a salesman knows about a product the less restrictions are on him while speaking to customers. Consequently, salesmen receive little training and even less supervision. Salesmen learn to think of prospective customers as "mooches," holding money in their pockets which should be in the salesmen's pockets. As a result, they often make blatant oral misrepresentations and twist facts as they see fit, negating the importance of written representations later sent to the investor.

The key to selling a non-existent product to a perfect stranger is to build the excitement of the prospective sale to a feverish pitch. A very large sale is considered a great accomplishment, enhancing the status of the salesman in the eyes of his peers. There is a great deal of money involved. Salesmen's commissions can run as high as 50 percent of the sale. In this particular industry, a single sale of \$10,000 is common and sales as high as \$100,000 are not unheard of. Thus, one successful telephone call by a salesman can yield thousands of dollars. The use of stimulants, including amphetamines and cocaine, is prevalent. Salesmen are packed into these so-called "boiler rooms," shoulder-to-shoulder, in order to feed off the excitement of another salesman's successful sale. Often two or more salesmen will be on the phone with the same client in order to wear down any resistance the customer may offer. Prepared sales pitches are read, sometimes verbatim, and responses to customer objections are indexed to provide a prompt rebuttal. The best salesmen will be employed as "loaders" and will recall previous customers in order to try to sell even more of the worthless contracts.

Some boiler rooms even have multilingual capabilities. For example, PSI investigators got into the Boston telephone room of a registered commodity trading advisor (CTA) and found a salesman pitching a customer in Chinese.

High commissions, high telephone costs, flagrant misrepresentations, and the ever-present greed of the principals combine to ensure that little, if any, of the customers' money will actually be invested in commodity futures. The date the contract comes due—usually six months to one year after the sale—frequently corresponds closely to the time the company disappears. Meanwhile, the assets have been hidden, the sales staff has slipped away to other boiler room operations, and the principals have begun to devise new angles to old schemes, moving their operations to new havens. Customers will be extremely lucky to recover any part of their investment.

1982 PSI REPORT, *supra*, at 10-11.

2. *PSI Hearings, supra* note 1, at 14-51. See *\$100 Million Lost in Two Gold Failures*, Washington Post, Oct. 27, 1983.

3. *PSI Hearings, supra* note 1, at 125 (statement of Orestes J. Mihaly on behalf of New York State Attorney General Robert Abrams). Attorney General Abrams heard advertisements for a firm's gold sales program in his car on the way to his office and ordered a monitoring of the firm's operations. *Id.*

gold.⁴ Numerous other schemes of a similar nature have also been uncovered in recent months.⁵

These "boiler room" operations had their genesis in the "unfixing" of gold and silver prices by the United States government in the early 1970's, which permitted the trading of precious metals by the public for the first time in forty years, and spawned a host of speculative and non-speculative means of investing in these commodities.⁶ Individuals today may enter into precious metals investments in a multitude of forms. For example, investors may trade futures or option contracts on precious metals on organized exchanges regulated by the CFTC.⁷ In addition, they may purchase stocks in mining companies or other entities whose profitability will fluctuate with the value of precious metals.⁸

Investors may also engage in cash trading of precious metals, however,

4. *Id.* at 133-34 (statement of Earl Faircloth, International Gold Bullion Exchange Trustee). The gold bars, which numbered about 30, were auctioned for \$20 each. *See Bullion Reserve Funds Used to Buy Futures, Investigator Says*, Wall St. J., Feb. 28, 1984; *Tape by Late Owner of Bullion Reserve Tells of Client Losses*, Wall St. J., Feb. 29, 1984; *Defunct Gold Firm's Owners Face Charges of Theft, Other Crimes*, Wall St. J., Apr. 6, 1984; *International Gold Bullion Official in Dallas Is Found Guilty of Fraud*, Wall St. J., May 30, 1984.

5. *See PSI Hearings*, *supra* note 1, at 128, 152-53. *Commodity Salesman in New York Receives Two Year Prison Term*, Wall St. J., June 26, 1984; *see also LHW-A Tale of Two Victims*, Financial Times, May 5, 1984; *Another Metals Dealer Probed*, Santa Ana Register, Mar. 29, 1984.

6. *See G. GOLD, MODERN COMMODITY FUTURES TRADING 107-08 (1975); E. MALCA, EVERYBODY'S INVESTMENT BOOK 140-53 (1984)*. Until 1933, the price of an ounce of gold was fixed by the United States government at \$21. At that time, however, Congress prohibited the holding of gold bullion, in order to avoid excessive conversions of dollars into gold, and increased the price of gold to \$35 per ounce, where it remained for almost 40 years. In 1972, in response to mounting economic pressures on the value of the dollar, the United States raised the price of an ounce of gold to \$38 and, in 1973, to \$42.22. In 1973, the government gold pricing system was completely abandoned and, in 1975, United States residents were again permitted to purchase gold at a floating market price. The trading of silver has experienced a similar, although not identical, history.

7. "A futures contract is a legally binding commitment to deliver or take delivery of a given quantity and quality of a commodity at a price agreed upon" in as specified delivery month. Chicago Board of Trade, *COMMODITY TRADING MANUAL 8 (1982)*. Although futures contracts are the central instruments of the commodities trading industry, the Commodity Exchange Act provides no definition of the term. *See 7 U.S.C. §§ 1-24 (1982)*. A commodity option confers the right, but not the obligation, to make or receive delivery of a stated amount of a particular commodity, or of a futures contract thereon, for a fixed price up until a stated expiration date. *See Markham & Gilberg, Stock & Commodity Options—Two Regulatory Approaches and Their Conflicts*, 47 ALB. L. REV. 741, 756-59 (1983) (discussion of commodity options). Futures and options contracts are traded on regulated commodities exchanges, known as contract markets. *See generally Merrill Lynch, Pierce, Fenner & Smith v. Curran*, 456 U.S. 353, 357-61 (1982) (discussion of nature and purposes of commodity futures trading); H.R. REP. NO. 975, 93d Cong., 2d Sess. (1974) (same); CFTC, REPORT TO THE CONGRESS IN RESPONSE TO SECTION 21 OF THE COMMODITY EXCHANGE ACT. PUB. L. NO. 96-276, 2d Sess., § 7, 94 Stat. 542 (June 1, 1980) (same); CFTC, ECONOMIC PURPOSES OF FUTURES TRADING (1978) (same).

8. E. MALCA, *EVERYBODY'S INVESTMENT BOOK 152 (1984)*.

which can itself occur in a variety of forms. In its simplest terms, the trading involves the purchase of a stated amount of gold or silver for a fixed price with immediate delivery. For example, an individual might purchase 5,000 ounces of silver at \$10 an ounce, for a total purchase price of \$50,000, deliver a check to the seller and receive the actual silver. In the United States, broker-dealers, futures commission merchants (FCMs), banks or metals dealers may act as agents for their customers in effecting such cash transactions in precious metals. A brokerage firm or bank, for example, may purchase for their customers gold coins, such as Canadian Maple Leafs or South African Krugerrands, generally charging the customers a premium over the "spot" price of gold bars.⁹

In addition, a multitude of mechanisms exist through which customers may "buy" precious metals, many of which never involve actual delivery or possession of the physical metals or even the transfer of funds or property in payment. Under such a program a bank, broker or dealer may offer customers the opportunity to purchase bullion represented by a "certificate," for which they charge a "mark-up" or commission for their services. This approach allows the customer to take legal title to a specified quantity of gold or silver bars, which is stored for the customer in a vault or depository. Ownership is evidenced by a certificate or similar instrument issued to the customer setting out the type and quantity of metal purchased. One large bank will accept certificate orders over the telephone, through the customer's Visa or MasterCard, although physical certificates must be tendered for resale.¹⁰

In order to purchase certificates, a customer ordinarily will be required to post the full purchase price upon entering into the transaction, but the customer may be permitted to deposit a percentage of the purchase price with the balance due upon settlement two days later. At that time, the customer may either accept immediate delivery of the underlying metals, or receive a certificate entitling it to immediate or future delivery. The brokerage firm or dealer issuing the instrument will then segregate the physical commodity from within its own inventory, enter into a transaction itself to purchase the commodity in the cash market, "cover" its exposure through an offsetting transaction in the futures markets or leave itself exposed to the risk of the purchaser's demand for delivery upon settlement.¹¹

These transactions may represent *bona fide* purchases of precious metals, with actual payment and delivery effectuated at some point. Under such circumstances, the trading is indistinguishable from the offer or sale of other goods or products and is largely outside the scope of federal regulation. However, to the extent that certificates evidencing ownership of gold or silver are purchased for investment purposes, or for speculation on the price of these commodities, such certificates may very well be encompassed within the scope of one or more federal regulatory schemes.

9. Wall St. J., Apr. 23, 1984.

10. *Id.*

11. *See, e.g.*, SEC No-action letter to Mocatta Metals Corporation (Jan. 2, 1975).

II. INVESTIGATION OF PRECIOUS METALS SCANDALS

On October 26, 1983, the Senate Permanent Subcommittee on Investigations (PSI) announced the initiation of an investigation of precious metals trading in order to determine whether metals dealers fell within a "gap" in the federal regulatory system, which should be closed by Congress.¹² In March, 1984, the PSI subsequently conducted two days of hearings into the question of the proper locus of federal authority over metals dealers, if any, and is likely to issue recommendations in the near future regarding the need and scope of federal regulation in this area.¹³

The PSI's action was a direct result of several highly publicized scandals involving precious metals dealers, which had earlier led to investigations and prosecutions by the Attorney Generals of New York, Florida and other states. These state authorities revealed that a number of unregistered and unregulated precious metals dealers were involved in "boiler room" operations through which they made "cold calls" to unwitting customers and solicited accounts for metals trading. The dealers involved in such schemes generally offered customers the right to buy precious metals, which the dealers proposed to store for them, issuing a certificate evidencing ownership in the manner described above. In reality, however, such "boiler rooms" seldom, if ever, actually acquired the metals allegedly "owned" by the customer, but instead simply retained the customer's deposit and exposed themselves to the risk of the customer making a demand for delivery. In the event that a customer sought delivery, the firm could acquire the metals in the spot or futures markets or enter into a cash settlement with the customer. In many instances, the customer's "purchase price" was used by the unscrupulous dealer to fuel its own speculation in spot or futures trading.¹⁴

The two "boiler room" firms referred to above, Bullion Reserve of North America (Bullion Reserve) and International Gold Bullion Exchange (IGBE), and several others which have recently come to light, apparently operated for several years by soliciting customers through cold calls and building up enormous reserves of deposits but using only a small portion of the deposits, if any, to purchase metals for customers.¹⁵ The firms used a variety of "hard

12. *Regulating Bullion Dealers*, N.Y. Times, Oct. 31, 1984; *Senate To Study Gold Dealers*, N.Y. Times, Oct. 27, 1983; *Senate Committee Launches Probe Into Gold Bullion Cases*, PSI Press Release, Oct. 26, 1983.

13. *PSI Hearings*, *supra* note 1, at 1-2. Numerous state and federal government officials testified at the PSI Hearings, including representatives of the Florida and California Securities Commissions, the New York State Attorney General's Office and senior officials of the SEC and CFTC. Precious metals industry representatives and victims of "boiler room" fraud operations testified as well.

14. See *PSI Hearings*, *supra* note 1 at 120-32, 147, 192-93; see also 1982 PSI REPORT, *supra* note 2, at 10-13; *Bullion Reserve Funds Used To Buy Futures, Investigator Says*, Wall St. J., Feb. 28, 1984.

15. See *PSI Hearings*, *supra* note 1, at 133-44 (statement of Earl Faircloth, IGBE Trustee); *id.* at 123-27, 150-51.

sell" techniques to lure unsuspecting customers and relied upon misrepresentations, outright falsehoods and promises of exaggerated returns to induce these customers to invest.¹⁶ In one instance, Bullion Reserve even hired a well known analyst of the metals markets to author a laudatory letter, praising the company's integrity and trading prowess and staking his personal reputation on the company's trustworthiness.¹⁷

IGBE also conducted a "far-flung advertising campaign with full page ads in newspapers in the larger cities of the country."¹⁸ The company's main offices "comprised four floors of a prestigious office building in downtown Fort Lauderdale" at an annual rent of \$1,116,000, and it maintained offices in Dallas and Los Angeles as well.¹⁹ IGBE induced customers to pay commissions of 1.5% to 3.5% per month until gold purchased was actually received by the customer, or to allow it to accept the gold on the customer's behalf and store it at a rate of 1.5% per month.²⁰

As early as 1981, as numerous instances of fraud regarding both IGBE and Bullion Reserve began to surface, the Federal Trade Commission (FTC) undertook to monitor the activities of these and other entities.²¹ By March, 1983, the FTC had compiled a list of some 200 alleged instances in which customers of IGBE had been unable to obtain the return of funds or the delivery of metals when requested.²² The FTC, in coordination with the SEC, CFTC and other authorities, launched a full scale investigation of IGBE in April, 1983.²³ Before that effort was substantially underway, however, IGBE, as well as Bullion Reserve, were forced into liquidation proceedings by state authorities, mooting the FTC's investigation.²⁴ IGBE alone left some 25,000 creditors in

16. *See id.*

17. *Advisor Got Fee To Plug Bullion Firm Before It Collapsed*, Chicago Tribune, Oct. 27, 1983. The advisor, Jerome F. Smith, authored a four-page letter sent to some 90,000 precious metal investors, including approximately 33,000 customers of Bullion Reserve, declaring in part: "I say unequivocally and without hesitation that you can trust Bullion Reserve of North America completely and without reservation. I put my name and reputation—and my future—on the line in saying this." *Id.* Smith, the author of a 1980 best-seller, *The Coming Currency Collapse* received \$5,000 from Bullion Reserve for the endorsement, and was promised an additional \$27,000 for 900,000 letters which were to have been sent out later in 1983.

18. *PSI Hearings*, *supra* note 1, at 133 (statement of Earl Faircloth, IGBE Trustee). As pointed out throughout the PSI Hearings, an extensive, coordinated mass media campaign is an integral part of all "boiler room" operations. Thus, these firms generally advertise nationwide in an aggressive fashion as part of their efforts to build a recognizable name and prepare the ground for telephone calls to unsuspecting investors. *See id.* at 148-49.

19. *Id.* at 134-35.

20. *Id.* at 133. This type of precious metal transaction is roughly analogous to the type of program operated by many banks and brokerage firms, described above, although in the case of IGBE and the other fraudulent schemes no precious metals were in fact ever available for delivery to customers.

21. *Id.* at 210-19 (statement of Amanda B. Pedersen, Federal Trade Commission). Jurisdiction of the Federal Trade Commission to combat precious metals and other commodity investment fraud, however, is extremely limited. *See infra* notes 185-92 and accompanying text.

22. *PSI Hearings*, *supra* note 1, at 214.

23. *Id.*

24. *Id.* at 214-16.

the wake of its collapse, with claims totalling more than \$75 million, although the trustee, as of March, 1984, had recovered only \$400,000 in assets.²⁵

The activities of IGBE and Bullion Reserve were also the subject of a series of actions by the Attorney General of New York in 1983 and 1984, resulting in the closing of "a number of fraudulent 'boiler room' operations that use unsolicited telephone calls to sell investments in often non-existent 'precious' or 'strategic' metals to an unwary public."²⁶ In 1981, New York prosecuted Mineral Resources Corp., a company which had fraudulently sold some \$1.4 million worth of a strategic metal known as Tantalum within a three month period.²⁷ Using an undercover operation, the state infiltrated Mineral Resources' "boiler room" and closed it down prior to the occurrence of any major customer losses.²⁸ The Attorney General's office also moved against a New York firm known as Empire State Metals Inc., which had been conducting business in a New York City suburb.²⁹ A related entity, United Precious Metals of Boca Raton, Florida, had been closed earlier by the CFTC after a raid by the Federal Bureau of Investigation.³⁰

In testimony before the PSI, however, the New York Attorney General's

25. *Id.* at 134. Upon liquidation of its operations, it was discovered that the principal asset of IGBE was an interest in a gold mine venture in Alaska. The two principals of the firm, William and James Alderdice,

Had used corporate funds to purchase this interest in a limited partnership engaged in the gold mine venture and, out of the operation, they would have received approximately thirty percent of the production of the gold mine. The venture was scheduled to begin operation in July 1983, but due to permit problems, lack of adequate financing and the weather, the operation did not succeed.

Id. at 135.

26. *Id.* at 120-32 (statement of Orestes J. Mihaly, on behalf of New York State Attorney General Robert Abrams).

27. *Id.* at 122-23.

28. *Id.* The state's infiltration of Mineral Resources resulted in the closing of the operation just before it allegedly was prepared to establish franchise boiler rooms all over the country, based upon the same methodology and approach. The state prosecuted Mineral Resources based upon the theory that it was engaged in the sale of unregistered securities by virtue of its marketing of "investment contracts." See *infra* notes 34-57 and accompanying text.

29. *PSI Hearings, supra* note 1, at 128.

30. *Id.* While the New York State Attorney General's Office was engaged in its investigation of Bullion Reserve, the head of Bullion Reserve, Alan Saxon, who was later identified as Alan Margolis, committed suicide leaving a tape detailing the fraud perpetrated by his company. See *Tape By Late Owner of Bullion Reserve Tells of Client Losses*, Wall St. J., Feb. 29, 1984. See also *PSI Hearings, supra* note 1, at 126.

The State of Florida also prosecuted a number of actions against precious metals dealers operating fraudulent "boiler rooms" in that State. *PSI Hearings, supra* note 1, at 107-15 (statement of E.C. Anderson, Florida Director of Securities). These included an injunctive action filed against IGBE in April, 1983 under the state's securities laws. Injunctive relief was granted, although IGBE's bankruptcy left the state without further recourse against the company. The State of Florida also brought cease and desist actions in 1983 against American Gold Alliance, Inc., Precious Metals Acquisitions, Inc., and First International Metals, Inc., all of which were engaged in the fraudulent sale of unregistered "investment contracts" for precious metals through unlicensed dealers. The State of Florida also brought an action against United Precious Metals, although this effort was curtailed by a bankruptcy filing on the part of the company. *Id.* at 112.

office noted that it and other state agencies were largely unable effectively to control the situation, which "cries out for federal regulation."³¹ It was asserted that federal law largely preempts state efforts in the area, "while federal authorities fail to take rigorous steps to police the industry."³² The Attorney General's office stated that many of these metals firms "claimed to fall between the 'regulatory cracks' since they were selling physicals for delivery, and not securities or futures contracts," although New York acted against these entities on the grounds that they were in fact offering investment contracts which should be regulated as securities.³³ The state requested congressional assistance in closing this regulatory "loophole," either by providing the SEC or CFTC with jurisdiction over metals dealers, or affording the states greater latitude in investigating and prosecuting their activities.³⁴

III. REGULATION OF PRECIOUS METALS TRADING UNDER THE FEDERAL SECURITIES LAWS

A. *The Securities Act of 1933*

The SEC has consistently taken the position that precious metals themselves are not securities and that their trading does not require registration under the federal securities laws. For example, in 1974, the SEC responded to two requests from registered broker-dealers seeking to offer their customers physical metals.³⁵ The first of these requests, submitted by Merrill Lynch, Pierce, Fenner

31. *PSI Hearings, supra* note 1, at 127-32; Press Release of New York Attorney General Robert Abrams (Oct. 26, 1983).

32. *PSI Hearings, supra* note 1, at 127-32; Press Release of New York Attorney General Robert Abrams (Oct. 26, 1983).

33. *See PSI Hearings, supra* note 1, at 129-30. The testimony offered by the Attorney General's Office identified several proposed steps contemplated by the State of New York, including enactment of a state commodities code, a step which has since been taken. *See infra* notes 214-17 and accompanying text. The Attorney General's Office also accused the federal agencies of a "leave it to others" attitude which had allowed many precious metals firms to slip through the cracks of the various regulatory schemes. The testimony of Florida's Director of Securities also pointed out that that state's inability to prosecute many precious metals firms aggressively was due to legislative impediments and the inability of federal regulatory agencies to take a leading role. *PSI Hearings, supra* note 1, at 113-15.

34. *PSI Hearings, supra* note 1, at 130-31.

35. *See* SEC No-action letter to E.F. Hutton & Co., Inc. (Dec. 31, 1974); SEC No-action letter to Merrill Lynch, Pierce, Fenner & Smith, Inc. (Dec. 26, 1974). The principal issue addressed in these letters was whether agreements pursuant to which customers purchased precious metals through the brokers could be deemed to constitute securities for purposes of the Securities Act of 1933 (Securities Act). The Securities Act defines the term "security" to include:

[A]ny note, stock, treasury stock, bond, debenture, evidence of indebtedness, profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting—trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, or, in general, any interest or instrument commonly known as a "security", or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

15 U.S.C. § 77b(1) (1982). Section 3(c)(10) of the Securities Exchange Act of 1934 provides a

& Smith, Inc. (Merrill Lynch), stated that Merrill Lynch would offer gold bullion to retail customers purchasing for their own accounts as well as to wholesale customers purchasing for resale. Merrill Lynch contemplated offer-

similar definition of security:

[A]ny note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit, for a security, or in general, any instrument commonly known as a "security"; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.

15 U.S.C. § 78c(a)(10) (1982).

In a landmark decision, the United States Supreme Court held that individual agreements could be deemed to constitute "investment contracts," and therefore securities, if there exists a "common enterprise" and investors are "led to expect profits solely from the efforts of a promoter or third party. . . ." *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946). In *Howey*, the Supreme Court found these elements to be present in the sale of units in a citrus grove development, by virtue of the commonality of interests among investors. 328 U.S. at 299-300. Indeed, even prior to the *Howey* decision, the Supreme Court had held that the scope of the Securities Act did not stop with the "obvious and commonplace," but extended as well to "exotic devices" exhibiting the characteristics of a security. *SEC v. Joiner Corp.*, 320 U.S. 344, 351-55 (1943). *See also* *United Housing Foundation v. Forman*, 421 U.S. 837 (1975), *rehearing denied*, 423 U.S. 884 (1975); *SEC v. Glenn W. Turner Enterprises Inc.*, 474 F.2d 476 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973).

In applying the *Howey* test to investments in commodities or commodity futures, a majority of courts have held that so-called "horizontal commonality" must be found, for example, a "common enterprise" among a number of similarly situated investors. *See Hirk v. Agri-Research Council, Inc.*, 561 F.2d 96, 99-101 (7th Cir. 1977); *Milnarik v. M-S Commodities*, 457 F.2d 274, 278-79 (7th Cir.), *cert. denied*, 409 U.S. 887 (1972). The Fifth Circuit Court of Appeals has held, however, that the requisite common enterprise may be found if so-called "vertical commonality" exists, that is when the broker has discretion over the customer's account, rendering the customer's success "contingent upon the sagacious investment counseling" of the broker. *SEC v. Continental Commodities Corp.*, 497 F.2d 516, 522-23 (5th Cir. 1974). *See also* *Peloso & La Bella, Determining if Discretionary Customer Accounts Are Securities*, 9 SEC. REG. L.J. 307 (1982); *White, Discretionary Commodity Accounts as "Securities": Applying the Howey Test to a New Investment Medium*, 67 GEO. L.J. 269 (1978); Note, *Federal Regulation of Discretionary Commodity Accounts*, 32 HASTINGS L.J. 871 (1981); Note, *Federal Definition of a Security—An Examination of the "Investment Contract" Concept and the Propriety of a Risk Capital Analysis Under Federal Law*, 12 TEX. TECH L. REV. 911 (1981); Note, *Discretionary Trading Accounts as Securities—Howey Revisited*, 16 TULSA L.J. 334 (1980); Note, *Discretionary Commodities Accounts: Are They Really Securities?*, 38 WASH. & LEE L. REV. 843 (1981); Note, *Discretionary Trading Accounts in Commodity Futures Are Not Securities Absent Horizontal Commonality*, 60 WASH. U.L.Q. 675 (1982).

A recent decision of the Ninth Circuit Court of Appeals held that a discretionary futures account was not a security because there was no shared enterprise between the broker and the customer—*i.e.*, the broker could profit even if the customer's investment was completely lost. *Mordaunt v. Incomco*, 686 F.2d 815 (9th Cir. 1982). The customer subsequently filed a petition for *certiorari* which, if granted, could resolve the split among the circuits on this issue. *See Mordaunt v. Incomco*, 686 F.2d 815 (9th Cir. 1982), *petition for cert. filed*, 52 U.S.L.W. 3921 (U.S. June 11, 1984) (No. 83-2025).

ing customers the choice either of accepting delivery or having the gold stored on the customer's behalf with a reliable custodian in London. Merrill Lynch, however, would not issue a certificate or receipt evidencing the customer's ownership of the gold, but instead would provide the customer with a confirmation as it would for any other commodity transaction. In addition, Merrill Lynch would issue a separate monthly or quarterly statement to those customers storing gold with the custodian.³⁶

Merrill Lynch proposed to offer to repurchase from its customers any gold purchased through it, contingent upon Merrill Lynch's ability to execute the order at the London fix³⁷ on the following day. Merrill Lynch's only function in connection with these transactions would be to execute purchase and sale orders as principal on the London or other cash market. Without elaborating as to the bases of its decision, the staff of the SEC concluded that these activities would not subject Merrill Lynch to the registration provisions of the Securities Act.³⁸

Almost simultaneously with its response to Merrill Lynch, the SEC staff, in a letter to E.F. Hutton & Co., Inc. (Hutton), stated that Securities Act registration would not be required if Hutton acted as agent for its customers in the purchase and sale of gold with recognized precious metals dealers.³⁹

36. See SEC No-action Letter to Merrill Lynch, Pierce, Fenner & Smith, Inc. (Dec. 24, 1974).

37. See *id.* The "London fixing price," relied upon in the Merrill Lynch letter is the standard price quotation for physical gold traded on the London Metal Exchange (LME). Trading on the LME is conducted in the "ring," an organized trading floor, in a manner similar to that engaged in on United States contract markets. Official prices are established each day by the quotation committee, selected from among the ring dealing members, based upon the last best bid and offer prevailing at the close of the ring. These are then announced as the day's official price for "spot" and "forward" metals.

The LME operates as a dealer market in "spot" transactions, requiring that purchasers and sellers enter into transactions as principals for their own accounts, and not as brokers for their customers. Nevertheless, through brokerage agreements with their customers, such firms are in practice able to do so in any event. In addition, the London market operates on the basis of "spot" or "forward" transactions, as opposed to futures trading. "Spot" trading in metals involves the actual purchase of physical metals, secured by a down payment, with payment of the full purchase price made upon settlement two days later. Forward transactions involve similarly binding obligations to purchase or sell on a stated date 30 to 90 days in the future. Unlike futures trading, however, a forward trader generally cannot offset his obligations and liquidate positions, and transactions are not margined. See *generally* T. TARRING & P. ROBBINS, *TRADING IN METALS* (1983) (discussion of metals trading in London market); WOLFF'S GUIDE TO THE LONDON METAL EXCHANGE (1980) (same).

38. SEC No-action Letter to Merrill Lynch, Pierce, Fenner & Smith, Inc. (Dec. 24, 1974).

39. SEC No-action Letter to E.F. Hutton & Co., Inc. (Dec. 31, 1974). Hutton proposed to charge its customers a price three to five percent over the London fixing price, depending upon the value of the gold purchased, which would include all storage, delivery, fabrication, and insurance and other costs. Purchases were to be made on a cash basis with full payment required within five business days after the order was executed. The gold certificates to be issued by Hutton were to be non-negotiable, although they would be assignable for a limited period of time. If the customer decided to resell the gold, Hutton proposed to offer to act as the customer's agent in reselling the gold to the London dealer at the next London fixing price less a charge of three percent depending upon the value of the gold sold. Hutton made no guarantees, however, as to resale price or the existence of a market for resale.

Hutton had stated that purchases would be made on a cash basis with full payment required within five business days after the order was executed. Hutton would arrange storage with one of a number of custodian banks at no additional charge for the first year. In contrast to the Merrill Lynch program, however, customers would receive a "gold certificate" which would entitle the customer to obtain delivery from the custodian, although the certificate would not designate a particular serial numbered bar. Nevertheless, all gold held would be segregated on behalf of the customer. Hutton stated that customers would have the right to assign their certificates for a limited period of time in order to facilitate resale, although Hutton claimed that no market for these certificates would be created.⁴⁰

Shortly after the Hutton letter, the SEC staff also took a no-action position on a request by the Mocatta Metals Corporation (Mocatta), an international precious metals dealer, to offer gold and silver bullion and coins to customers.⁴¹ The Mocatta plan would permit customers either to take physical delivery of the metals or to have the metals stored on their behalf, evidenced by one of three forms of non-negotiable instruments.⁴² One form of instrument would be a delivery order instructing a custodian charged with safekeeping of the physical commodity to deliver the item specifically described and identified in the order to or upon the order of the purchaser or in accordance with the purchaser's instructions. Such delivery orders would not be negotiable and would cover specific bars of silver or gold, designated by serial numbers, and stored in a warehouse or vault.⁴³ Storage of the metal thereafter would be maintained for the benefit of the customer, according to the terms of the delivery order. In addition, Mocatta offered to issue "confirmations" which, unlike orders or receipts, were not evidence of ownership but instead represented undertakings by the dealers involved to store the customer's metals and, at the customer's request, to arrange for delivery in accordance with its instructions. In the alternative, the dealer would offer the customer a "custodian's certificate," which is a written notification by a custodian confirming that the dealer has delivered commodities to the custodian which it holds for the buyer's account.⁴⁴

40. *Id.*

41. See SEC No-action Letter to Mocatta Metals Corporation (Jan. 2, 1975).

42. See *id.*

43. See *id.* This procedure is in fact somewhat similar to the making or acceptance of deliveries of precious metals under exchange-traded futures contracts. In such instances, what changes hands is most often not physical metals, but negotiable warehouse receipts evidencing ownership of the metal. The metal is stored in a vault or depository. The warehouse receipt is then endorsed over to the person accepting delivery. See G. GOLD, MODERN COMMODITY FUTURES TRADING 22, 48-49 (1975). In fact, Mocatta represented that each delivery order issued would be accepted by the custodian prior to its sale by Mocatta and will be treated for all practical purposes, under the applicable Uniform Commercial Code, as a warehouse receipt.

44. SEC No-action Letter to Mocatta Metals Corporation (Jan. 2, 1975). With respect to each of the types of instruments offered by Mocatta, customers were to have an undivided interest, to the extent of the quantity purchased, in specifically identified metals held by the custodian. Such metals were to be stored so as to assure that they were free from the claims of any

In any event, under the Mocatta plan, the certificates or other instruments representing the customer's interest generally were not negotiable, except with Mocatta, and could not be transferred to a third party except through Mocatta. In addition, Mocatta retained the right to assign the customer's metals for a limited period of time, generally not beyond thirty days. Further, while metals ordinarily were not margined in the same manner as commodity futures contracts, Mocatta proposed to allow some form of financing or margining arrangement.⁴⁵

Separately, Mocatta proposed to enter into a joint venture with Drexel Burnham & Co., Inc., pursuant to which Mocatta metals would be marketed to the public through Drexel Burnham's subsidiaries as well as other registered broker-dealers, along the lines of the Hutton agency plan described above.⁴⁶ The joint venture proposed to deal with customers in much the same way contemplated by Mocatta in its own capacity. Thus, customers would have the same options of delivery of the metals or of accepting a variety of certificates and would be able to trade subject to the same terms and conditions as the Mocatta plan. With respect to customers of Drexel Burnham, however, an approach such as that employed by Merrill Lynch was to be applied. Under this approach, Drexel Burnham would act not as principal but as a broker for the customer, undertaking no repurchase obligations and simply issuing confirmation and monthly statements rather than certificates or receipts.⁴⁷ The staff of the SEC also issued a no-action letter to Deak & Co., Inc., another established precious metals dealer, which marketed a program similar to that of Mocatta.⁴⁸

Similar programs, with slight variations, have been reviewed by the SEC staff as well. The staff gave clearance, for example, to a metals dealer to act as agent for the customers of banks and broker-dealers.⁴⁹ In that instance, the metals dealer proposed to allow these customers the options of taking delivery or receiving a storage receipt or purchase certificate. The former, a

creditors of Mocatta or the custodian, other than storage liens, but customers were not given title to specific bars.

45. *See id.* Mocatta also noted that it did not provide potential buyers of metals with investment advice.

46. *See* SEC No-action Letter to Drexel Burnham & Co., Inc. and Mocatta Drexel Burnham, Inc. (Jan. 2, 1975). The joint venture, designated Mocatta Burnham, had been established to sell gold bullion and coins to broker-dealers and financial institutions other than banks. Mocatta Burnham proposed to purchase metals exclusively from, and sell such metals to, Mocatta and Federal Coin and Currency, an affiliate of Mocatta, at the best price that Mocatta and Federal Coin and Currency were then selling or buying metals in substantially similar quantities from their other customers.

47. *See id.*

48. SEC No-action Letter to Deak & Co., Inc. (Nov. 3, 1975).

49. *See* SEC No-action Letter to American Gold Depository Corp. (Apr. 14, 1975). The dealer proposed to charge customers eight percent of the dollar value of the metal purchased on all sales of up to \$5,000 and a commission of seven percent on all sales in excess thereof. The commission was to be divided equally between the dealer and the banking institution or broker-dealer. Orders were proposed to be accepted at the first London fixing price on the morning following the day the order was received from the customer.

non-negotiable instrument, could neither be transferred nor redeemed by the dealer. To the contrary, a customer seeking to sell the metal represented by such a receipt would be required to take delivery of the metal. In contrast, a "purchase certificate" would grant the customer a ten-year option to purchase a specific quantity of metal identified by a serial number. These instruments could be redeemed by the dealer but could not be transferred to a third party. The SEC staff concluded that Securities Act registration would not be required.⁵⁰ The staff further provided a similar no-action position to a bank which proposed to act as the agent of its customers in effecting transactions in precious metals with a dealer, implementing the same type of program.⁵¹

The SEC staff, in its letters approving plans for the marketing of precious metals, never clarified the reasoning upon which it premised its conclusions. Moreover, in 1980, the SEC issued a release that stated that the staff would no longer respond to requests for no-action letters on the question of "whether esoteric commodity offerings involved securities," due to the "unique and unusual circumstances involved" in such transactions.⁵² As a result, the SEC has refused to respond to numerous requests since that time, and it is no longer possible to infer from the SEC's analysis the guidelines which must be adhered to in order to avoid Securities Act registration.

Nevertheless, based upon the facts that the SEC identified as relevant in these no-action letters and the recent testimony of John M. Fedders, Director of the SEC's Division of Enforcement before the PSI,⁵³ it is possible to draw certain conclusions as to the criteria that the SEC staff relied upon in approving the various plans. Principal among these elements has been the fact that metals dealers generally act only as the purchase or sale agents for their customers and do not provide additional services, such as investment advice.⁵⁴

50. *Id.* The "purchase certificate" was to be exercisable at any time during its term at an exercise price of one dollar. Each certificate was consecutively numbered, issued in the name of the customer and bore the serial number of the metal represented. It was stated, however, that neither the dealer nor anyone acting in his behalf had any obligation to repurchase the metal.

51. SEC No-action Letter to Security Pacific National Bank (Jan. 11, 1980).

52. SEC No-action Letter to North American Coin and Currency Ltd. (Sept. 14, 1981). See also SEC No-action Letter to American Board of Trade, Inc. (Aug. 18, 1981); SEC No-action Letter to Denver Gold and Silver Exchange (Nov. 28, 1980); SEC No-action Letter to Gold Bullion Funds (Oct. 15, 1980). The SEC staff did not provide any explanation in these letters as to why it would no longer pass upon the questions presented, other than the suggestion that the unique factual suggestions and somewhat exotic arrangements made generalized determinations on their regulatory status impossible.

53. See *PSI Hearings, supra* note 1, at 199-203 (statement of John M. Fedders, Director of the Division of Enforcement of the Securities and Exchange Commission).

54. See *id.*; see also SEC No-action Letter to Dreyfus Gold Deposits, Inc. (Jan. 4, 1978). In the SEC's letter to Dreyfus Gold Deposits, Inc., the SEC staff apparently relied in part upon the fact that no investment advice would be provided by the dealer in finding that a security was not created. Similarly, in other no-action letters, the SEC staff often pointed out as a significant factor the fact that no investment advice on precious metal trading would be provided to customers. See, e.g., SEC No-action Letter to Merrill Lynch, Pierce, Finner & Smith, Inc. (Dec. 26, 1974).

As a result, the SEC has not viewed the customer's trading as being dependent upon the efforts of a promoter or third party, since the agent performs "merely ministerial functions unrelated to the production of profits."⁵⁵ However, where the broker or dealer trades the customer's funds on a discretionary basis or offers investment advice in conjunction with the provision of other managerial services, a security may be found to exist.

Second, the absence of any pooling of customers' funds for the purpose of investment appears to be significant to a finding that no security exists. This view is supported by the fact that, in at least one instance, the staff of the SEC refused to grant no-action status to a proposal which contemplated, among other things, providing customers with a gold custodian depository slip which would represent an interest in "a segregated, pooled trust depository account."⁵⁶ Similarly, some metals dealers offer so-called "delayed delivery discounts," pursuant to which they agree to discount commissions according to the length of time that the customer agrees to delay delivery.⁵⁷ This allows the dealer to pool customers' funds, invest them, and earn profits up to the agreed upon delivery date. The SEC has stated that such an arrangement may involve the creation of a security.⁵⁸

In addition, the absence of a secondary market in the instruments evidencing metals ownership has also been found significant to the SEC in reaching the conclusion that no security is created through the operation of precious metals programs. For this reason, in those instances in which a no-action position was sought, the requesting party often stated that, although it might agree to repurchase gold or certificates as principal, the instruments themselves would be non-negotiable and would be subject to a prohibition on transferability.⁵⁹

55. *PSI Hearings*, *supra* note 1, at 201. Under the *Howey* line of cases, a customer cannot be deemed to have invested in a "common enterprise" the success of which is dependent solely upon the efforts of a third party, if the person offering the investment simply executes orders upon instructions of the customer as broker and does not manage the customer's account nor exercise input with respect to the account. If, on the other hand, the customer provides the broker with funds and authorizes it to invest those funds in precious metals on a discretionary basis, a security may very well be found to exist. *See id.* Under these circumstances, the broker likely will commingle the funds of all investors with respect to which it has been granted discretion, and provide a variety of managerial services, thereby creating a "common enterprise."

56. SEC No-action Letter to Commonwealth Silver Exchange, Inc. (July 9, 1975). In the SEC's letter to Commonwealth Silver Exchange, Inc., the SEC's staff specifically identified the existence of a margin requirement as evidence of a security. *Id.* The dealer proposed to margin customers transactions by allowing them to purchase gold on a down payment of no less than 35% of the purchase price within 24 hours of placing the order. *Id.* The balance of the purchase price was to be deferred under the terms of the customer's account contract up to a period of one year and renewable thereafter upon mutual consent of the parties for another year. *Id.* The customer would be required to maintain a 35% equity balance at all times in the account. *Id.* Although not made explicit, the SEC apparently was concerned that this element rendered the trading program a vehicle for speculation rather than bona fide purchases. *See id.*

57. *PSI Hearings*, *supra* note 1, at 203.

58. *See id.* Such delayed-delivery discounts resemble "investment contracts" since any "profit" earned by the customer is dependent upon the dealer's pooling of the funds of its customers and earning a profit on the funds sufficient to provide a return.

59. *See, e.g.*, SEC No-action Letter to E.F. Hutton & Co., Inc. (Dec. 31, 1974); SEC No-action Letter to Merrill Lynch, Pierce, Fenner & Smith, Inc. (Dec. 24, 1974).

Accordingly, there could be no "market" for the receipts or certificates themselves, apart from actual ownership of the metals. In this regard, Mr. Fedders also noted in his Senate testimony that:

[B]uy-back plans which involved more sharing of risk between the dealer and purchaser might indicate a transaction constituting an 'investment contract'. For example, a transaction in which the dealer agreed to repurchase at a set price, or at a fixed percent of the original purchase price, or where the commodity was extremely illiquid due to a limited market, would be more indicative of a securities transaction.⁶⁰

B. *Investment Advisers Act Issues*

The Investment Advisers Act of 1940 (Advisers Act)⁶¹ requires registration as an investment adviser of any person who, for compensation or profit, has rendered opinions as to the advisability of investing in, investments in, or as to the value of, securities, to fifteen or more persons within a twelve-month period.⁶² The Advisers Act restricts the amount and form of compensation an investment adviser may receive, limits the adviser's affiliations with other entities and imposes a number of disclosure and recordkeeping requirements.⁶³ To the extent that account agreements or certificates evidencing ownership of metals are deemed to be securities, therefore, brokers, banks or dealers offering these instruments to customers may be required to consider whether they are subject to Advisers Act registration by virtue of their general advice or trading recommendations.

Since the SEC generally has found that precious metals programs will not be subject to the Securities Act if conducted in the manner described above, Advisers Act registration for the most part should not be necessary. It is significant to note, however, that in each of the requests for no-action letters cited

60. *PSI Hearings, supra* note 1, at 202. If the dealer and customer are in fact sharing the risk of an investment in precious metals, an investment contract may be found, since the profits of all investors are to an extent intertwined, and each customer's success in the investment is dependent upon that of the other customers, as well as the skill of the broker.

61. 15 U.S.C. §§ 80b-1—80b-21 (1982). The Advisers Act sets out a comprehensive scheme of regulation governing virtually all aspects of an adviser's business. See generally T. FRANKEL, *THE REGULATION OF MONEY MANAGERS* (1978); 2 L. LOSS, *SECURITIES REGULATION* 1396-1401 (2d ed. 1961).

62. 15 U.S.C. § 80b-2(a)(11) (1982). The questions of what constitutes "advice," and who should be counted as a recipient of such advice, have generated substantial controversy. See Lovitch, *Investment Advisers Act of 1940—Who Is An "Investment Adviser"?*, 24 KAN. L. REV. 67 (1975). With respect to the latter issue, for example, it is not clear whether the general partner to an investment limited partnership should be deemed, for purposes of Advisers Act registration, to be rendering advice to one "client" (i.e., the partnership) or to each of the limited partners. See, Hacker & Rotunda, *SEC Registration of Private Investment Partnerships After Abrahamson v. Fleschner*, 78 COLUM. L. REV. 1471, 1477-79 (1978).

63. 15 U.S.C. §§ 80b-5(1), 80b-6(3) (1982). The most significant prohibition imposed upon persons registered or required to be registered as investment advisers is the proscription against "performance based fees," such as a percentage of the profits earned for a client's account. See 2 T. FRANKEL, *THE REGULATION OF MONEY MANAGERS* Ch. XI § B18 (1978); see also Schultz, *Performance-Based Fees Under the Investment Advisers Act of 1940*, 39 BUS. LAW. 521 (1984).

above the requesting parties included specific representations that they would not provide customers with advice or consultation regarding their investments or regarding any other related matters.⁶⁴ Nevertheless, these entities generally did state that they anticipated offering their views on the future course of the metals markets to their customers.⁶⁵ The SEC staff did not object to the proposed activity, presumably due to the fact that neither the certificates nor the underlying commodities were deemed to constitute securities.⁶⁶

In at least one no-action letter, the SEC staff specifically addressed the Advisers Act issue pursuant to a request from Dreyfus Gold Deposits, Inc.⁶⁷ In that instance, a metals firm proposed to provide its customers with general information concerning: (1) the mining, fabrication, distribution and pricing of gold compared to that of other metals, and equivalent information about other commodities; (2) government sales of and other actions regarding gold as well as analyses of past events and reports on upcoming events; (3) the different methods of investing in gold and the comparison of these methods with its own services; and (4) the historical role of gold as an investment medium for the private investor.⁶⁸ It was not anticipated that customers would be provided with specific advice concerning the timing or size of particular transactions.⁶⁹

The SEC staff concluded that Advisers Act registration would not be required, but that its position was "subject to reconsideration if gold investments are offered and sold with the representation that economic benefits will inure to a purchaser through the managerial efforts of the seller or third party."⁷⁰ In its response, the SEC staff focused on the status of the instruments offered under the Securities Act and determined that, if no security was found, Advisers Act registration would not be necessary.⁷¹ Conversely, in his testimony

64. See, e.g., SEC No-action Letter to Dreyfus Gold Deposits, Inc. (Mar. 12, 1975); SEC No-action Letter to E.F. Hutton & Co., Inc. (Dec. 31, 1974); SEC No-action Letter to Merrill Lynch, Pierce, Fenner & Smith, Inc. (Dec. 26, 1974).

65. SEC No-action Letter to Dreyfus Gold Deposits, Inc. (Mar. 12, 1975); SEC No-action Letter to E.F. Hutton & Co., Inc. (Dec. 31, 1974); SEC No-action Letter to Merrill Lynch, Pierce, Fenner & Smith, Inc. (Dec. 26, 1974). The distinction apparently drawn by entities submitting requests for no-action letters, and presumably accepted by the SEC's staff in granting such requests, was between the offering of general advice as to market or economic trends, as opposed to recommendations with respect to specific transactions. The latter might be more likely to be characterized as "investment advice" rather than general economic forecasting.

66. SEC No-action Letter to Dreyfus Gold Deposits, Inc. (Mar. 12, 1975); SEC No-action Letter to E.F. Hutton & Co., Inc. (Dec. 31, 1974); SEC No-action Letter to Merrill Lynch, Pierce, Fenner & Smith, Inc. (Dec. 26, 1974). See Friedman, *The Applicability of the Investment Advisers Act to Advice Regarding Precious Tangibles and Futures*, 4 ALI-ABA COURSE MATERIALS, 25 (1980).

67. See SEC No-action Letter to Dreyfus Gold Deposits, Inc. (Jan. 4, 1978).

68. *Id.*

69. *Id.* With respect to the categories of advice proposed to be offered, Dreyfus further stated that it would provide charts of the market prices of gold over designated periods of time relative to those of other specified commodities, commodities indexes or standard indexes such as the cost of living or the Standard & Poor's 500.

70. *Id.*

71. *Id.* See also SEC No-action Letter to Merrill Lynch, Pierce, Fenner & Smith, Inc. (Dec.

before the Senate Subcommittee, Mr. Fedders noted that the rendering of significant investment advice by a metals dealer could result in the creation of a security.⁷² Thus, if the dealer advises the customer as to the particular metal to purchase or the timing of transactions, both Securities Act and Advisers Act registration may be required.⁷³

C. Investment Company Act Issues

If a precious metals program is structured in such a way as to render it subject to Securities Act registration, the Investment Company Act of 1940 (1940 Act)⁷⁴ may be applicable as well. The 1940 Act requires registration as an investment company of an entity engaged principally in the trading of securities whose participations are owned by 100 or more persons.⁷⁵ Accordingly, if individual customer accounts for the trading of precious metals or certificates of ownership of metals are found to constitute "securities," a metals dealer offering such instruments might be deemed to be an issuer engaged principally in the trading of securities, subject to registration as an investment company.⁷⁶

The definition of "security" under the 1940 Act, however, essentially tracks

2, 1974). In its request for a no-action letter, Merrill Lynch represented that it "will form an opinion as to whether or not a purchase of gold bullion is suitable for a particular customer. . . . The Merrill Lynch research department will prepare, and continually update, an opinion indicating its views on whether gold will increase or decrease in price in the future. This opinion will be made known to customers, but the choice of when, whether and at what price to purchase or sell gold will be made solely by the individual customer." *Id.*

72. See *PSI Hearings*, *supra* note 1, at 199-203. Specifically, Mr. Fedders stated that investment advice alone regarding precious metals might not be sufficient to cause the relationship between the customer and the dealer to be characterized as an "investment contract," since the metals are:

[F]ungible, and there are both a ready market for resale and many sources of information regarding the value of the metals. However, the offering of substantial investment advice regarding the metals would present a basis for an argument that the dealer was in fact offering an "investment contract" when the advice was coupled with other services that increased the customer's reliance on the dealer. The full realization of profits from the investment package would be dependent upon the dealer's investment advice. Although the customer could watch the market and sell at an appropriate point, he arguably would receive higher profits by purchasing and selling where instructed by the dealer.

Id. at 202.

73. See *id.*

74. 15 U.S.C. §§ 80a-1—80a-64 (1982). The 1940 Act, perhaps the most complex and extensive of all the federal securities statutes, establishes a detailed set of requirements for entities subject to its jurisdiction. Such entities must adopt a corporate structure according to a specific form, and must comply continuously with numerous reporting, recordkeeping, voting, proxy, disclosure and other requirements. See 1 T. FRANKEL, *THE REGULATION OF MONEY MANAGERS* Ch. IV (1978); 1 L. LOSS, *SECURITIES REGULATION* 144-53 (2d ed. 1961).

75. 15 U.S.C. §§ 80a-3(a)(1)-(3) (1982). In fact, even the definition of an "investment company" subject to the 1940 Act is substantially more complex than this characterization, involving numerical and other tests for determining the status of an entity under the statute.

76. See 15 U.S.C. § 80a-2(36) (1982). Compare 15 U.S.C. § 77b-1 (1982) with 15 U.S.C. § 80a-2(36) (1982).

that set out in the Securities Act, such that, if the instruments involved are found not to be "securities," the person offering them would not be considered an investment company.⁷⁷ In this regard, the SEC has proposed a rule pursuant to the 1940 Act which would create a "safe harbor" for exclusion from investment company registration for individuals or entities providing individualized investment management services.⁷⁸ This would require that customers be interviewed by the broker upon opening their accounts in order to determine their investment objectives and financial situation, and that their situations be reviewed periodically thereafter in order to modify trading strategies in accordance with any changes in circumstances.⁷⁹

As a result, under the SEC's proposal, it would be possible to trade customers' precious metals accounts on a discretionary basis, and even in a generally similar or parallel fashion, but only if each customer's situation is evaluated individually and periodically and any transactions executed for that customer are in accord with its needs and objectives. Otherwise, any pooling of customers' funds, metals or accounts could require 1940 Act registration.

D. SEC Regulation of Precious Metals Dealers

The SEC continues to maintain that, because the operation of a precious metals program generally does not involve the offer or sale of a "security,"

77. Investment Company Act Release No. 11391 (Oct. 10, 1980).

78. *Id.* The proposed rule would require that the investment manager: (1) furnish continuous advice to its customers based upon their particular needs and investment strategies; (2) conduct interviews with customers at least annually; (3) review the customers' financial situations at least quarterly in order to determine whether there has been any change in their status; and (4) provide customers at least quarterly with statements of their accounts. In addition, the SEC stated in proposing the rule that each customer must retain "to the extent reasonably practicable every indicia of ownership" of the funds in the account, and that the investment manager must be "available on a reasonable basis" for consultations or to answer questions. *Id.* The rule, proposed rule 3a-4 under the 1940 Act, has not been acted upon, although the SEC staff has provided several no-action letters to parties relying upon its terms and representing that they would abide thereby. See SEC No-action Letter to Shearson/American Express, Inc. (July 13, 1983); SEC No-action Letter to Paley & Ganz, Inc. (Dec. 6, 1982). In its no-action letter to Paley & Ganz, Inc., the SEC staff stated that 1940 Act registration would not be required if the entity traded separate accounts with a "high degree" of uniformity due to the similarity of customers' investment objectives, provided that each customer continued to be evaluated individually. SEC No-action Letter to Paley & Ganz, Inc. (Dec. 6, 1982).

79. SEC No-action Letter to Shearson/American Express, Inc. (July 13, 1983). In its letter requesting a no-action position from the SEC staff, Shearson/American Express proposed to manage individual customers' accounts on a discretionary basis, but to "group" orders for these accounts when it "determines that a particular security is a suitable investment for more than one client." *Id.* The firm represented that "there will be variations among the portfolios of the individual accounts as a result of the dates on which the accounts were opened, the size of the account, marketing conditions, the different securities deposited by clients into their accounts, the discretion retained by clients to exclude certain securities from their accounts and the discretion retained by clients to partially liquidate the securities in their accounts." *Id.* The staff concluded that the treatment afforded to customers was sufficiently individualized so that registration under the 1940 Act, and registration of accounts as securities under the Securities Act, would not be required.

it lacks jurisdiction to prosecute the allegedly fraudulent schemes of metals dealers such as IGBE and Bullion Reserve. In his testimony, Mr. Fedders stated that "unless a metals transaction involves an 'investment contract' or some other specified security the [SEC] has no jurisdiction over the transaction."⁸⁰ Mr. Fedders noted that the sale of metals as part of a "package" together with particular services provided by the dealer may constitute a "security," but concluded that, "where the seller agreed merely to store or insure the metals for the purchaser" this was not likely to be the case.⁸¹

For the most part, therefore, precious metals trading appears to be outside the jurisdiction of the SEC. The programs operated by metals dealers generally do not involve a "package" of services, but simply a facility for the purchase and sale of metals. As a result, it is difficult to construe a customer's investment as dependent on the efforts of a promoter or third party or as part of a common enterprise, as required by the "investment contract" test. Nevertheless, even slight variations in the manner in which these trading programs are structured could alter this conclusion. Thus, if the dealer offers investment advice in conjunction with brokerage and storage services, the customer may be much more strongly dependent on its efforts, and the customer's potential profits might be deemed to be more closely tied to those of other investors.

Similarly, a dealer's offer to attempt to resell the customer's metals at the "spot" price would not in itself appear to constitute the formation of a secondary market in certificates or other instruments evidencing ownership. However, if this feature involves a sharing of risk between the dealer and customer, for example, through the former's agreement to guarantee a certain resale price or a percentage thereof, a secondary market might be created and the characterization of the transactions could be altered. Moreover, to the extent that financing arrangements provided to customers could be deemed to involve the margining of purchases and sales, this element of a securities transaction may exist as well. Because many precious metals firms successfully have charted a zigzag course around the respective spheres of the federal agencies, however, they have been able to carve out a regulatory gap while operating perilously close to the jurisdiction of the SEC, CFTC and other authorities.

IV. REGULATION OF PRECIOUS METALS TRADING UNDER THE COMMODITY EXCHANGE ACT

Under the Commodity Exchange Act (CEA),⁸² the CFTC is granted exclusive jurisdiction over the regulation of futures contracts, option contracts

80. *PSI Hearings*, *supra* note 1, at 201.

81. *Id.* at 201-02.

82. 7 U.S.C. §§ 1-24 (1982). The CEA sets out a comprehensive scheme of regulation governing virtually all aspects of commodity futures trading on regulated contract markets, as well as certain off-exchange activities. See Horwitz & Markham, *Sunset on the Commodity Futures Trading Commission: Scene 2*, 39 BUS. LAW. 67 (1983). The CEA requires that futures and commodity option contracts be traded exclusively on designated contract markets, which are subject to con-

and leverage contracts, but this authority specifically does not extend to "deferred" or "forward" delivery contracts which are essentially cash transactions providing for later delivery of the underlying commodity.⁸³ As a result, it is the CFTC's position that, unless an entity is offering one or more of these types of instruments, it lacks the authority to regulate the entity's conduct.⁸⁴ This section of the article will explore the extent to which cash trading in precious metals can be construed as involving the sale of off-exchange futures contracts, options or leverage contracts, thereby triggering the CFTC's regulatory authority. Additionally, the scope of the CFTC's jurisdiction over cash transactions pursuant to the commodity trading advisor and anti-manipulation provisions of the Commodity Exchange Act will be examined.

A. Regulation of Precious Metals Transactions as Futures Contracts

The CEA prohibits, except through a "registered contract market," "any contract of sale of any commodity for future delivery."⁸⁵ The CEA does not define what is meant by a contract for "future delivery," although it does state that "the term 'future delivery' . . . shall not include any sale of any cash commodity for deferred shipment or delivery."⁸⁶ To the extent that the purchase or sale of precious metals through banks, brokerage firms or dealers represents *bona fide* cash transactions in metals, which simply provide for delayed delivery of the items purchased, therefore, they are exempt from the prohibition against off-exchange futures contracts. Indeed, unregulated precious metal dealers presumably have proceeded up to this point based upon their conclusion that the instruments offered are deferred delivery contracts, rather than futures contracts.

Because the distinction between forward and futures contracts is not articulated in the CEA or CFTC regulations, but instead has been defined informally based upon the respective characteristics of the two types of instruments, it is possible that a transaction designated as a cash or "forward" trade could nevertheless be construed as a futures contract if it sufficiently evidences the various elements thereof. In this regard, the Office of General Counsel of the CFTC has stated in an internal memorandum that:

stant CFTC surveillance. In addition, the CEA requires registration of all commodity professionals, as futures commission merchants, introducing brokers, associated persons, commodity trading advisors, commodity pool operators or floor brokers. In addition, each of these categories of registration carries with it a set of ongoing regulatory requirements. See 1 P. JOHNSON, COMMODITIES REGULATION 101-74 (1982).

83. 7 U.S.C. § 4 (1982). See *infra* notes 84-90 and accompanying text (discussion of futures versus forward contracts).

84. See *PSI Hearings*, *supra* note 1, at 204-09 (statement of Dennis Klejna, Director of CFTC Division of Enforcement).

85. 7 U.S.C. § 2 (1982).

86. *Id.* The purpose of this provision was to exclude from the coverage of the Commodity Exchange Act any *bona fide* transactions in physical commodities which simply provided for delayed or deferred delivery thereof, but did not allow for price speculation.

(1) Congress intended generally to prohibit any public marketing of contracts for the future delivery of commodities—in the plain and literal meaning of that phrase—except through the facilities of a designated contract market, and (2) this complete prohibition was intended to be subject to an exemption solely for the benefit of persons involved in a commercial cash commodity business, which would allow them to effect cash sales of the commodity, contemplating actual delivery as a matter of course, but in which shipment or delivery of the commodity might be deferred for purposes of commercial convenience or necessity.⁸⁷

Accordingly, a transaction will likely be deemed a permitted forward contract if it is part of a commercial cash commodity business and the delayed delivery mechanisms are employed for the purpose of commercial convenience and not for speculation.

The CFTC subsequently amplified this conclusion in *In re Stovall*,⁸⁸ holding that the deferred delivery exemption of the CEA “was intended to cover only contracts for sale which are entered into with the expectation that delivery of the actual commodity will eventually occur through performance on the contracts.”⁸⁹ In addition, the CFTC in *Stovall* identified four “classic” elements of futures contracts which, although not strictly required in every case, evidence the existence of such an instrument: (1) the existence of standardized contracts; (2) instruments “directly or indirectly offered to the general public”; (3) transactions that are “generally secured by earnest money, or ‘margin’ ”; and (4) “transactions . . . that are entered into primarily for the purpose of assuming or shifting the risk of change in value of commodities, rather than for transferring ownership of the actual commodities. . . .”⁹⁰

87. Internal Memorandum of the CFTC Office of General Counsel, *reprinted in* [1977-1980 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 20,772 (Exhibit 1) (1978).

88. [1977-1980 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 20,941 (1979). Despite the centrality of the definition of “futures contract” to the regulatory scheme imposed by the CEA, even CFTC interpretations of the definition have never set out a list of exclusive criteria, nor identified any determinative characteristics of such instruments.

89. *Id.*

90. *Id.* at 23,777-79. The CFTC and the courts have addressed the issue of what constitutes a futures contract in numerous contexts and situations. For example, the CFTC’s Office of General Counsel has determined that a dealer in contracts for deferred delivery of Government National Mortgage Association (GNMA) certificates was not engaged in the sale of futures contracts, since each transaction was individually negotiated and there was no general public participation in the program. CFTC Interpretive Letter No. 77-11, [1977-1980 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 20,466 (Aug. 17, 1977). *Cf.* Precious Metals Assocs. Inc. v. CFTC, 620 F.2d 900 (1st Cir. 1980); CFTC v. National Coal Exch., [1980-1982 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 21,424 (W.D. Tenn. 1982); CFTC v. Commercial Petrolera Internacional, S.A., [1980-1982 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 21,222 (S.D.N.Y. 1981); CFTC v. Co Petro Mkt. Group, Inc., 502 F. Supp. 806 (C.D. Cal. 1980), *aff’d*, 680 F.2d 573 (9th Cir. 1982). The CFTC has noted, however, that these elements are not an “exhaustive catalogue of factors in determining whether an instrument is a futures contract.” CFTC v. Comercial Petrolera Internacional S.A., [1980-1982 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 21,222 at 25,098 (S.D.N.Y. 1981). To the contrary, the CFTC and the courts have repeatedly held that, like the approach of the

The CFTC has recently brought several administrative or enforcement actions against precious metals dealers which it alleged were engaged in the offering of illegal futures contracts, not cash forward contracts, under the definition set out above. In *In the Matter of First National Monetary Corporation*,⁹¹ the CFTC found that the "forward" contracts offered by two precious metals dealers were "of standardized form, providing for delivery of a given quantity of precious metals at a date in the future at a fixed price at the outset of the transaction."⁹² In addition, customers could take long or short positions with the dealers acting as principal in every transaction. The initial deposit made by the customer, which represented a percentage of the total purchase price, was variable at the dealer's discretion and, if the equity in the customer's account fell below a specific maintenance level, additional funds could be required.⁹³

After reviewing in detail the characteristics of futures contracts developed in the decisions cited above, the CFTC concluded that the precious metals forward contracts were futures contracts sold in violation of the CEA.⁹⁴ The CFTC based this conclusion upon the fact that: (1) the contracts contained standardized terms regarding initial margin payments, method of delivery and the date by which a customer must notify the firm of its intention to accept or make delivery; (2) the price of the contracts was agreed upon at the time they were made; (3) the contracts provided an opportunity for the customer to avoid delivery through an offsetting transaction or by "rolling over" its position; and (4) the contracts were offered for the purpose of providing customers with an opportunity to assume the risks of price changes in the underlying commodity and thus were for speculation.⁹⁵

Similarly, in *Golden v. First National Monetary Corporation*,⁹⁶ a CFTC administrative law judge found that a metals firm's denomination of instruments as cash forward contracts was contradicted by the fact that the

courts in determining the existence of a "security," the identification of a futures contract depends upon a review of all of the circumstances of a particular case. See *In the Matter of First Nat'l Monetary Corp.*, [1982-1984 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 21,707 (1983). In addition, the labels applied to an instrument by the offeror clearly are not dispositive of its characterization. *Id.*

91. [1982-1984 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 21,707 (1983).

92. *Id.*

93. *Id.* In fact, certain of the characteristics of the contracts offered, such as the discretion vested in the offeror, not only distinguish them from forward contracts, but from futures contracts as well. For example, the CFTC noted in its decision that "although it may appear to the unsophisticated that the risk of profit or loss under these agreements is dependent upon the price movement of the commodity, this is simply not the case. Monex and FNMC reserve the right to arbitrarily alter crucial provisions of the agreements governing forwards. . . . In summary, a forward customer has no unqualified right to a profit even though the market moves favorably to his position." *Id.* As a result, customers were not speculating only against the price of the underlying commodity but against the dealer's ability and willingness to fulfill its obligations as well.

94. *Id.*

95. *Id.*

96. [1980-1982 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 21,749 (1983).

contracts were traded on margin and customers could "roll" their positions. As a result, it was found that the instruments were in fact prohibited off-exchange futures contracts.⁹⁷

B. Regulation of Precious Metals Transactions as Commodity Options

In addition to its regulation of futures contracts, the CEA also prohibits or controls the trading of a number of other related instruments. Principal among these are commodity options, defined to include options on physical commodities as well as options on futures contracts. Unlike a futures contract, an option conveys the right but not the obligation to purchase or sell the underlying commodity.⁹⁸ The person granting or "writing" the option thus offers the purchaser the right to purchase (a "call" option) or sell (a "put" option) a fixed amount of a given commodity at a fixed price at any point up until a stated expiration date.⁹⁹ The purchaser pays a "premium" in order

97. *Id.* See also Jackson v. American Gold Dealers Association, [1982-1984 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 21,956 (1983). In *Jackson*, the complainant maintained a "cash forward contract" account with a dealer in gold. The complainant alleged misrepresentations by the dealer in assuring him that there would never be any margin calls but nevertheless making such calls. The CFTC hearing officer found "many characteristics which are inherent in a single 'futures contract' and should be deemed as such. Futures contracts must be traded on or subject to the rules of a designated contract market to be legal. The determination that these 'cash forward contracts' were in effect 'futures contracts' not designated on a commodity exchange, makes the resulting transactions in this complaint illegal and in violation of Section 4(a)(1)(2) of the Commodity Exchange Act." *Id.* Recently, the CFTC also initiated actions, in conjunction with the Federal Bureau of Investigation, against the operators of a network of precious metals boiler rooms, alleging that the firms were actually involved in the sale of illegal, off-exchange futures contracts. See, *Boiler Room Charges Filed*, Ft. Lauderdale Sun-Sentinel, Sept. 1, 1984; *FBI Busts Ring, Seizes Records of Metals Dealers*, Miami Herald, Sept. 1, 1984.

98. See Lower, *The Regulation of Commodity Options*, 1978 DUKE L. J. 1095, (1978); Markham & Gilberg, *Stock and Commodity Options—Two Regulatory Approaches and Their Conflicts*, 47 ALB. L. REV. 741, 757 (1983).

99. Lower, *The Regulation of Commodity Options*, 1978 DUKE L.J. 1095 (1978); Markham & Gilberg, *Stock and Commodity Options—Two Regulatory Approaches and Their Conflicts*, 47 ALB. L. REV. 741, 757 (1983). Unlike a futures contract, therefore, a commodity option offers relatively limited risk to the option holder, and, therefore, is often more popular among small investors. Because the option can be permitted to lapse, the holder can limit losses to the initial price of the option premium. The writer of the option, however, cannot so limit its risk, since it is liable for delivery of the commodity regardless of any adverse price changes. As a result, serious losses can result for the writer of the option if the option is uncovered or "naked"—that is where the writer does not own the commodity or an offsetting futures contract. See Long, *The Naked Commodity Option Contract as a Security*, 15 WM. & MARY L. REV. 211 (1973). The risks of naked options were outlined by a House report at the time of the creation of the CFTC in 1974:

Under the theory of [commodity] options trading . . . the customer does not buy or sell a contract for future delivery of a commodity as most hedgers or speculators in regulated commodities take. Instead, he or she purchases the "right" to purchase or sell a contract in the future, paying a premium for someone else to actually guarantee to provide the actual contract at a specified price. Because there are no margin calls,

to obtain this right. Options have therefore been distinguished from futures contracts on the basis of the existence of a non-refundable premium, rather than initial or maintenance margins, the absence of a fixed obligation to make or receive delivery, and an opportunity for profit only if the price of the commodity rises enough to cover the initial premium.¹⁰⁰

Even if precious metals transactions do not constitute the offering of off-exchange futures contracts, they may be subject to CFTC regulation if they in fact exhibit the features of commodity options. In this regard, the payment of an initial premium, although delivery may never take place, potentially could render the types of precious metals trading described above subject to such a characterization.

The characterization of metals transactions as commodity options would be at least as significant to the operation of precious metals programs as a finding that they involved futures trading, since the CEA contains a ban on all commodity options trading, subject to certain limited exemptions.¹⁰¹ This prohibition came about as a result of the fact that many, if not most, of the early scandals plaguing the commodities industry related to options trading.¹⁰² Many "boiler room" operations were discovered in the early part of this century through which unscrupulous traders offered customers the ostensible opportunity to trade in commodity options. Customers were solicited by mass

and the degree of exposure is fixed, it initially appears more attractive to the small investor.

However, because some individuals will seek opportunities to exploit any given system, the high cost of "hedging" the options, as must be done to protect both the customer and the options merchants, has proved forbidding to many merchants seeking option customers so they write so-called "naked options," which are not hedged or covered in any way. The good faith and solvency of the broker is all that is securing a transaction.

It has been documented that, in some of these firms, customers who desire the proceeds of their transactions in these options were actually paid in many instances from other customer's accounts, and eventually a pyramid structure created, where one customer's account is robbed to pay another, collapses. Because there is no requirement on the options merchant to segregate customer's funds, as the law now requires for the trading of futures and regulated commodities, the investments of the customers are usually lost.

H.R. REP. NO. 975, 93d Cong., 2d Sess. 37-38 (1974). See also 120 Cong. Rec. 10,740 (1974).

100. See *United States v. Bein*, [1982-1984 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 22,004 (2d Cir. 1984). The decision in *Bein* actually relied heavily upon a district court decision handed down several years earlier. See *CFTC v. United States Metals Depository*, 468 F. Supp. 1149 (S.D.N.Y. 1979). In *Metals Depository*, the same set of criteria had been applied to determine the existence of a commodity option contract in metals contracts offered by a dealer. *Id.*

101. See 7 U.S.C. § 6c (1982).

102. Markham & Gilberg, *Stock and Commodity Options—Two Regulatory Approaches and Their Conflicts*, 47 ALB. L. REV. 741, 767 (1983). This was true, to a great extent, due to the fact that commodity options ostensibly could be marketed to the public as involving limited risk, unlike futures contracts. In fact, however, many off-exchange commodity option transactions involved substantially greater risk, since the options offered might be uncovered and the holder might therefore be subject to the risk of the dealer's ability and willingness to pay any profits earned.

telephone calls directed at unsophisticated and unwitting individuals. The callers would promise enormous profits and claim that their customers had actually been earning spectacular returns on very small investments. In fact, however, many of these schemes did not involve any options or futures trading whatsoever. To the contrary, the "brokers" would simply solicit funds, pay off investors with the deposits of later customers and attempt to keep the scheme running as long as possible. Inevitably, as customer demands outpaced deposits, the "trading" would collapse and the "brokerage firm" would be put out of business.¹⁰³

As a result of these events, the original CEA, enacted in 1936, imposed a flat prohibition on the trading of any options or on the commodities then enumerated under the statute.¹⁰⁴ Because the CEA purported to regulate trading on only a limited number of agricultural commodities, however, the options ban did not extend to options on so-called "world" commodities, such as silver, platinum and coffee. As a result, a number of firms or individuals began operating "boiler rooms" for the trading of options on such commodities, following the established pattern of solicitation of unsophisticated individuals. In the early 1970's, therefore, a new wave of scandals began to arise as traders seized upon this loophole.¹⁰⁵

In 1974, Congress created the CFTC and granted it exclusive jurisdiction over a broad range of transactions in futures contracts and related instruments.¹⁰⁶ In order to close the loopholes under which the "boiler room" firms had operated, the 1974 amendments to the CEA extended its coverage

103. See *id.* at 756-61. The most celebrated of these scandals involved a firm known as Goldstein-Samuels, operated by a 26 year old trader named Harold Goldstein. Goldstein offered naked options on a number of internationally traded commodities and earned huge profits in the early 1970's. As large price increases in these commodities began to occur, however, Goldstein became unable to pay customers and by 1973 he was out of business, leaving behind some \$85 million in unpaid "options." Goldstein-Samuels was thereafter put into involuntary receivership by the California Corporation Commissioner and declared bankrupt. See Lower, *The Regulation of Commodity Options*, 1978 DUKE L. J. 1095, 1105-08 (1978), citing, Stipulation of Relevant Facts, SEC v. Goldstein-Samuels, Inc., No. 73-472 RFK (C.D. Cal. Oct. 11, 1973); *In re Goldstein-Samuels, Inc.*, No. 7303131 (C.D. Cal. Mar. 29, 1973); *In re Goldstein-Samuels, Inc.*, [1971-1978 Transfer Binder] BLUE SKY L. REP. (CCH) ¶ 71,095 (Okla. Dept. Sec. Commn., Feb. 23, 1973).

104. Commodity Exchange Act, ch. 545, 49 Stat. 1491 (1936) (codified as amended at 7 U.S.C. §§ 1-26 (1982)). The statute provided that:

No person shall offer to enter into, or confirm the execution, of any transaction . . . involving any commodity regulated under this chapter . . . which is of the character of, or is commonly known to the trade as, a "privilege", "indemnity", "bid", "offer", "put", "call", "advance guaranty", or "decline guaranty". . . .

Id. See Biderman, *New Trading Vehicle—Commodity Options Are Growing in Popularity*, Barron's, Jan. 8, 1973, at 11, col. 1.

105. Biderman, *New Trading Vehicle—Commodity Options Are Growing in Popularity*, Barron's, Jan. 8, 1973, at 11, col. 1. It was this "loophole" which permitted the operation of Goldstein-Samuels and other fraudulent commodity option schemes.

106. Commodity Futures Trading Commission Act of 1974, Pub. L. No. 93-463, 88 Stat. 1389 (1974). The CFTC's exclusive jurisdiction is conferred by § 2 of the 1974 legislation. 7 U.S.C. § 2 (1982).

to all previously unregulated commodities, but did not similarly expand the options ban, although it gave the CFTC plenary authority to regulate such transactions.¹⁰⁷ As a result, extensive options fraud continued even after the creation of the CFTC.

The CFTC's authority over options trading was enhanced when, in 1982, the chairmen of the CFTC and SEC entered into a jurisdictional agreement, the "Shad/Johnson Accords," which allocated jurisdiction over options and other derivative instruments between the two agencies.¹⁰⁸ As a result of the Shad/Johnson Accords and their subsequent enactment into law through congressional amendments to the relevant statutes, the CFTC currently has clear and exclusive authority over the regulation of options on precious metals.¹⁰⁹ The CEA's options ban, however, remains in effect such that, unless precious metals options are encompassed within one of the narrowly delineated exemptions to the ban, offer or sale of the options is prohibited. The principal exemption to the options ban, as noted, is the CFTC's "pilot program" for exchange traded commodity options.¹¹⁰ Because the precious metals programs described above are conducted exclusively off-exchange, this exception would not be available to most banks, brokerage firms and metals dealers.

The CEA and CFTC regulations also include an exemption from the

107. See 7 U.S.C. §§ 2, 6c (1982). The amendments to the CEA included a "catchall" provision, extending the CFTC's jurisdiction to "all other goods and articles . . . and all services, rights, and interests in which contracts for future delivery are presently or in the future dealt in." 7 U.S.C. § 2 (1982).

108. *Joint Explanatory Statement of the Securities and Exchange Commission and the Commodity Futures Trading Commission, reprinted in* [1980-1982 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 21,332 (Feb. 2, 1982). The Shad/Johnson accords were in fact intended to resolve a number of long-standing and extensive disputes between the SEC and CFTC over jurisdiction on certain financial instruments. In particular, the two agencies had, since 1975, contested authority over approval of futures and option contracts on GNMA certificates. At that time, the CFTC approved an application of the Chicago Board of Trade (CBT) for designation as a contract market in the trading of GNMA futures. That action was challenged by the SEC, which claimed that it alone had jurisdiction over regulation of GNMA and secondary instruments thereon. *SEC-CFTC Jurisdictional Correspondence*, compiled at [1975-1977 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 20,117 (1975). Thereafter, in 1981, the SEC granted approval to the Chicago Board Options Exchange (CBOE) to trade options on GNMA certificates. See Securities Exchange Act Release No. 17,577 (Feb. 26, 1981), 46 Fed. Reg. 15242 (1981). That action was then challenged by the CBT in a suit commenced in the Seventh Circuit. See *CBT v. SEC*, 677 F.2d 1137 (7th Cir.), *vacated as moot*, 459 U.S. 1026 (1982). With the enactment of the Shad/Johnson accords into law, however, the jurisdictional dispute, at least with respect to the instruments then under discussion, was alleviated, since the accords granted the CFTC exclusive jurisdiction over futures contracts on securities and indexes of securities as well as options on such futures contracts.

109. See 15 U.S.C. § 77b(1) (1982); 7 U.S.C. § 6c (1982). The SEC retains exclusive jurisdiction only with respect to options on individual securities and options on foreign currency traded on a national securities exchange. *Id.*

110. See U.S.C. § 6c (1982); 17 C.F.R. pt. 33 (1984). The "pilot program" is organized in much the same way as exchange-traded futures contracts. Thus, a contract market seeking to trade a particular option contract must apply to the CFTC for approval and must establish specific trading criteria and limitations and submit to constant CFTC surveillance. At present, several option contracts on precious metals are offered by contract markets, most notably those on gold and silver offered by the Commodity Exchange, Inc. (Comex) in New York. See, e.g., Comex Brochure, Options on Comex Gold Futures (undated).

options ban for so-called "dealer options," pursuant to which a producer or processor of a physical commodity may offer options thereon, subject to a number of specifically defined conditions.¹¹¹ Such options, however, may be offered only by a person who, on May 1, 1978, was both in the business of granting options on a physical commodity and in the business of buying, selling, producing or otherwise utilizing that commodity.¹¹² Moreover, the grantor of the option must have a net worth of at least \$5 million, undertake joint and several liability with any person selling its options for damages sustained by a customer in connection with their offer or sale, segregate daily all money, securities or property belonging to customers, and prepare a number of particular records.¹¹³

Several firms, such as Mocatta and Monex International Ltd., have been included under the "grandfather" provision of the dealer options exemption and, through compliance with the remaining limitations of the rule, have been permitted to offer off-exchange options on precious metals. These options convey the right, but not the obligation, to make or receive delivery of a stated amount of bullion or coins.¹¹⁴ For a non-refundable fee paid by the customer in full at the outset (the "premium"), the dealer will provide the customer with the right to purchase (a "call" option) or sell (a "put") a fixed amount of a given metal for a specified price (the "strike price") at any point up to a stated date in the future. There is no secondary market in such options and they cannot be traded subsequent to their initial sale. The dealer may, however, offer to liquidate the physical commodity on behalf of customers purchasing "call" options, subsequent to their exercise of the option. In addition, a "call" option may be convertible into a "margin" account in "spot" metals, or the customer may actually take delivery and store the metals with the dealer or a custodian.¹¹⁵

Similarly, with respect to "put" options, customers might exercise the option and sell the commodity to the dealer at the "strike price" or, in some circumstances, convert the option into a "short" position in a margin account maintained with the dealer. Dealers may offer to purchase options from the customer as well, in which case the dealer pays the premium. In addition, if the option requires the customer to deliver metals to the dealer, the dealer may require the posting of margin funds as security for the customer's obligations.¹¹⁶

111. See 7 U.S.C. § 6c (1982); 17 C.F.R. § 32.12 (1984). Interestingly, dealer options have often been known alternatively as "Mocatta" options, after the Mocatta Metals Corporation, which initiated the plan. See Jarecki, *Mocatta Options: Forerunner of a Boom Market?*, COMMODITIES, Apr. 1977, at 31. See also 1 P. JOHNSON, *COMMODITIES REGULATION* § 1.67 (1982); *infra* notes 127-30 and accompanying text.

112. 17 C.F.R. § 32.12 (1984).

113. *Id.*

114. The elements of the option programs offered by these entities are described in brochures and prospectuses that they distribute. See, e.g., Monex Gold & Silver Options, Offering Statement (Dec. 1, 1983).

115. *Id.*

116. *Id.*

This procedure, however, obviously would not be available to a majority of banks, brokers or dealers who either are not engaged in the actual business of producing or processing the underlying metals, or were not involved in such business as of 1978. Moreover, an entity selling dealer options on behalf of the dealer will be subject to registration with the CFTC as an FCM, and therefore will become subject to a host of regulatory obligations.

CFTC regulations also include an exemption for "trade options," which are offered through a person whom the grantor has a reasonable basis to believe is a commercial user of, or a merchant handling, the commodity which is the subject of the commodity option transaction.¹¹⁷ In contrast to the dealer option exemption, this provision allows the sale of options on any commodities regardless of the status of the offeror. Thus, a bank, broker or dealer would be permitted to offer options on metals to any qualified purchaser. The purchaser, however, must be regularly and actually exposed to the risk of price movements in the underlying commodity and must purchase the option solely for a non-speculative purpose intended to reduce its risk exposure incurred as the result of such fluctuations. This exemption clearly does not envision the offer or sale of such options to the general public for speculation.¹¹⁸

Unless one of these exemptions is available, the sale of options on precious metals is flatly prohibited. Moreover, as is true with respect to the status of precious metals transactions as futures contracts, such trading may involve the offering of commodity options regardless of the manner in which they are denominated. Thus, in several instances, the courts have found that "deferred delivery" contracts were in fact illegal option contracts and were prohibited by the CEA.¹¹⁹

In *CFTC v. Preferred Capital Investment Company*,¹²⁰ an investment labelled as a "deferred delivery" contract was found to constitute a commodity option, since it involved a non-refundable premium, the customer's loss was limited to the original premium, and the purchaser of a contract could profit from its ultimate resale only if the price of the commodity rose enough to cover the initial premium.¹²¹ Moreover, although the contracts entitled the purchaser to take physical possession of the underlying metals, they did not

117. See 17 C.F.R. § 32.4 (1984). The so-called "trade option" exemption was originally intended to apply to purchasers of agricultural options entering into such transactions for the purpose of hedging risks associated with the underlying agricultural commodity. As a result, the exemption is not clearly applicable to many transactions in financial instruments, although the CFTC has been adopting interpretations intended to so apply it. See 43 Fed. Reg. 54,220 (1978). See also CFTC Division of Trading and Markets, Interpretive Letter No. 84-7, [1982-1984 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 22,025 (Feb. 22, 1984) (foreign currency options may qualify for "trade option" exemption); CFTC Division of Trading and Markets, Interpretive Letter (July 3, 1984) (silver option may qualify for trade option exemption).

118. CFTC Interpretive Letter No. 84-6, [1982-1984 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 22,024 (Feb. 22, 1984).

119. See *CFTC v. United States Metals Depository*, 468 F. Supp. 1149 (S.D.N.Y. 1979); *CFTC v. Crown Colony Commodity*, 434 F. Supp. 911 (S.D.N.Y. 1977).

120. [1982-1984 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 21,770 (N.D. Tex. 1983).

121. *Id.* at 27,114.

obligate the purchaser to do so. To the contrary, the contracts specifically provided a means of delivery of the goods if desired, but allowed the purchaser the "right to cancel up to the time of delivery."¹²² On this basis, the court found that the contracts exhibited all of the required elements of option contracts and were subject to the CEA ban.¹²³ The same conclusion was reached in *CFTC v. International Bullion Clearing Corporation*,¹²⁴ where purchasers were offered investments in gold and silver under which a net profit could be realized only if the value of the underlying metal rose above its initial value by an amount greater than the fees charged by the offering company.¹²⁵ Customers acquired a right, but not an obligation to purchase a commodity on the specific future date at a pre-determined price and their sole risk was the loss of the non-refundable "acquisition fee."¹²⁶

The CFTC has adopted this approach to distinguish between permitted deferred delivery contracts and prohibited options. In *In re Precious Metals Associates Inc.*,¹²⁷ a metals dealer offered "limited risk forward contracts" on various metals.¹²⁸ Despite the label applied by the dealer, however, the contracts involved a non-refundable fee, a large part of which represented the dealer's commission, and granted the customer the right to buy or sell a specific amount of silver, copper or coffee at a fixed price on or before a fixed date in the future.¹²⁹ The CFTC had little trouble determining that such transactions constituted commodity options trading.¹³⁰

C. Regulation of Precious Metals Programs as Leverage Contracts

On February 21, 1984, the *Wall Street Journal* reported that the CFTC's regional office in Los Angeles had initiated its anticipated "crackdown" on the "nest" of allegedly illegal leverage dealers operating in southern California.¹³¹ Immediately thereafter, the CFTC initiated a number of actions against precious metals dealers located in the southwestern United States either by itself or in conjunction with state authorities.¹³² These actions signaled the

122. *Id.* at 27,114-15.

123. *Id.* at 27,115.

124. [1982-1984 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 21,675 (W.D. Tex. 1982).

125. *Id.*

126. *Id.* The Court in *CFTC v. International Bullion Clearing Corp.* held that the defendants had been required to register as commodity trading advisors, by virtue of the fact that they were rendering advice with respect to the trading of commodity option contracts. *Id.* at 26,594. The Court rejected the defendants' arguments that the contracts should be characterized as cash or "leverage" contracts. *Id.* at 26, 594; see *infra* notes 131-61 and accompanying text. (discussion of leverage contracts). The court imposed a number of penalties, including injunctive relief. *CFTC v. International Bullion Clearing Corp.*, [1982-1984 Transfer Binder] COMM. FUT. L. REP. ¶ 21,675 at 26,596-98 (W.D. Tex. 1982).

127. [1977-1980 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 20,882 (C.F.T.C. 1979).

128. *Id.* at 23,597.

129. *Id.* at 23,598.

130. *Id.* at 23,601.

131. Wall St. J., Feb. 21, 1984.

132. See, e.g., *Metals Firm That Sold Leveraged Contracts Is Ordered Liquidated*, Wall St.

use by the CFTC of a third method of control over unregulated metals transactions.

A leverage contract has been defined as a standardized long-term contract for the purchase or sale of a specified quantity of a given commodity involving, among other things, payment of a percentage of the spot price at the outset, periodic payment of a carrying charge or fee on the unpaid balance and repurchase of the contract from the customer upon the customer's demand.¹³³ A leverage dealer acts as principal in all transactions with its customers and acts as a "market maker," although a leverage dealer does not guarantee a repurchase market and it reserves the right to cease operating as principal or broker for its customers.¹³⁴ Leverage dealers may hedge their

J., May 3, 1984, at 44, col. 6; *Court Closes Metals Trading Corporation*, Phoenix Gazette, Feb. 18, 1984; *Premex Told to Halt Business*, Chicago Sun-Times, Feb. 4, 1984.

133. S. REP. No. 850, 95th Cong., 2d Sess. 26 (1978). A leverage contract was defined in the report as a standardized long-term contract for the purchase or sale of a specified quantity of a given commodity involving, among other things, payment of a percentage of the spot price at the outset, periodic payment of a carrying charge or fee on the unpaid balance and repurchase of the contract from the customer upon the customer's demand. A leverage dealer acts as principal in all transactions with its customers and acts as a "market maker," although it does not guarantee a repurchase market and reserves the right to cease operating as principal or broker for its customers. Leverage dealers may hedge their commitments to their customers in the futures or forward markets or by physical inventory, although the latter may be encumbered by bank loans. See *Matthews v. Monex Int'l. Ltd.*, [1977-1980 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 20,791 (C.F.T.C. 1979); *Report of the Advisory Committee on Market Instruments to the CFTC on Recommended Policies on Futures, Forward and Leverage Contracts and Transactions*, [1975-1977 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 20,192 (1976). Like futures contracts and options contracts, "leverage contract" is nowhere defined under the CEA or CFTC regulations. The CFTC's proposed regulations governing leverage transactions, however, attempt for the first time to posit a comprehensive definition. Thus, the regulations would define the term "leverage contract":

[T]o mean a standardized contract for the long-term (10 years or longer) purchased by a customer of a commodity which provides for: (1) the initial and maintenance payments of a percentage of the spot-price value of the commodity, (2) periodic payment of a carrying charge or a fee on the unpaid balance, (3) delivery of a commodity in an amount and form which can be readily resold in normal commercial or retail channels, (4) delivery of the underlying commodity after satisfaction of the balance due on the contract by the customer, (5) repurchase of the contract by the person or firm who sold the contract to the customer upon demand by the customer and (6) determination of the contract purchase and repurchase price by the person or firm who sold the contract and who acts as a principal in every contract.

49 Fed. Reg. 5498, 5499 (1984). Because leverage trading does not occur on organized contract markets, the volume of such trading cannot be easily ascertained. Nevertheless, as of June 1, 1978, it was reported that the value of outstanding leverage transactions was estimated to be approximately \$100 million. 42 Fed. Reg. 23,729, 23,730 (1978).

134. S. REP. No. 850, 95th Cong., 2d Sess. 26 (1978). The Senate Report described a leverage contract as:

[A]n agreement for the purchase or sale of a contract for the delivery at a later date of a specified commodity in a standard unit and quality, for the close-out of the contract by an offsetting transaction. The principal characteristics of the contract include: (1) standard units, quality, and terms and conditions; (2) payment and maintenance of 'margin'; (3) close-out by an offsetting transaction or by delivery, after payment in full; and (4) no right or interest in a specific lot of a commodity.

Id.

commitments to their customers in the futures or forward markets or by physical inventory, although the latter may be encumbered by bank loans.¹³⁵

In addition to its limitations upon the trading of futures and option contracts, the CEA and CFTC regulations also substantially restrict the extent to which a person may offer leverage contracts on physical commodities.¹³⁶ In fact, similar to the history of commodity options, the CFTC and Congress at various times have considered complete prohibitions on the trading of leverage transactions or regulation of such instruments as futures contracts.¹³⁷ In addition, in 1978 the CFTC adopted a moratorium on the trading of leverage contracts, although entities already engaged in the business of offering leverage contracts in 1978 were permitted to continue to do so under a "grandfather" clause of the regulations.¹³⁸

In its 1982 reauthorization process, the CFTC again sought to obtain a congressional suspension of leverage trading, but Congress refused to do so.¹³⁹

135. *Id.* The origins of leverage contracts on precious metals have been traced to the disparity between the prices of silver coins minted by the United States government and the market price of silver bullion in the late 1960's and early 1970's. Greenstone, *Leverage Transactions: On Creating a Regulatory Theme*, 27 EMORY L.J. 909, 910-11 (1978). For example, in 1971, a bag of pre-1975 United States silver coins bearing a face value of \$1,000 could be purchased for as little as \$1,100. Since the customer could obtain a bank loan of \$1,000 using the coins as collateral, an investor could profit from any change in price of the coins for a cash outlay of only \$100. A 10% increase in the value of the silver coins could therefore provide the investor with a 100% return on his investment. *Id.* at 911. With the advent of a highly inflationary economy in the United States in the 1970's, this trend was accelerated, since leverage investments in metals, which could be expected to increase in value, became highly favored. *Id.*

136. See 7 U.S.C. § 23 (1982); 17 C.F.R. § 31.1-31.24 (1984). Specifically, the CEA prohibits the trading of leverage contracts on any commodity specifically enumerated under the statute prior to the 1974 amendments. In addition, it provides that no person may "offer to enter into, enter into or confirm the execution of any transaction for the delivery of silver bullion, gold bullion or bulk silver coins or bulk gold coins, under a standardized [leverage] contract . . . contrary to any rule, regulation, or order of the [CFTC] designed to ensure the financial solvency of the transaction or prevent manipulation or fraud. . . ." 7 U.S.C. § 23(b) (1982). The CEA also includes a mandate, directing the CFTC to adopt regulations governing leveraged contracts on precious metals. See *infra* notes 139-41 and accompanying text.

137. See Greenstone, *Leverage Transactions: On Creating a Regulatory Theme*, 27 EMORY L.J. 909 (1978). The legislative and regulatory history of authority over leverage trading is marked by continuing attempts on the part of Congress and the CFTC to regulate leverage contracts as futures contracts or to promulgate a separate regulatory scheme. In addition, the SEC at one point attempted to assert jurisdiction over leverage trading by defining a leverage transaction as an "investment contract" under the analysis discussed above and requiring its registration as a security. See SEC v. Monex Int'l. Ltd., Civ. No. 74-3634 (C.D. Cal. 1974); SEC Litigation Release No. 6638 (Dec. 12, 1974). In the 1974 amendments to the CEA, Congress rejected attempts to regulate leverage contracts as futures contracts, but directed the CFTC to regulate them separately under its delegated authority. See H.R. REP. NO. 1383, 93d Cong., 2d Sess. 39 (1974). The CFTC, however, did not choose to regulate leverage contracts although it did promulgate a separate anti-fraud rule for leverage contracts in 1975. See 40 Fed. Reg. 18,187 (1975).

138. 43 Fed. Reg. 23,729 (1978). See 17 C.F.R. §§ 31.1-31.2 (1984) (CFTC's regulations imposing moratorium); see also 44 Fed. Reg. 55820 (1979) (adoption of moratorium on leverage transactions).

139. See H.R. REP. NO. 964, 97th Cong., 2d Sess. 51 (1982). Congress indicated that it did not object to the CFTC's moratorium, provided that the CFTC would be able "quickly" to adopt a comprehensive regulatory scheme governing leverage trading. Congress also noted

To the contrary, Congress directed the CFTC to promulgate regulations governing leverage transactions, and not to prohibit such transactions.¹⁴⁰ Congress also repealed the provision of the CEA which authorized the CFTC to find that leverage contracts should be treated as futures contracts, but permitted it to prohibit leverage contracts in any commodity if such contracts were not being lawfully offered and sold in December, 1982.¹⁴¹

On February 13, 1984, the CFTC issued its "interim" final rules establishing "a comprehensive regulatory scheme designed to govern the offer and sale to the public of leverage transactions for the purchase of silver bullion, gold bullion, bulk silver coins, bulk gold coins, copper, platinum . . ." and foreign currencies.¹⁴² Acting pursuant to its congressional mandate, the CFTC has imposed a host of registration, recordkeeping and financial requirements upon leverage transactions merchants (LTMs) although, because the temporary moratorium on leverage trading has been maintained, the full effect of the rules will not be felt immediately.¹⁴³ As adopted, the regulations require registration of persons engaged in leverage transactions along the lines of the parallel registration schemes established for FCMs.¹⁴⁴ In addition, "leverage com-

that it did not wish to adopt the moratorium by statute, since its grandfather provisions "are inherently anti-competitive and thus contrary to the fundamental objectives of economic competition and the free marketplace." *Id.* See also *End The Commodity Shuffle*, N.Y. Times, Aug. 31, 1984.

140. H.R. REP. NO. 964, 97th Cong., 2d Sess., 50 (1982).

141. *Id.* at 51. The conference committee further stated that it was not "limiting or circumscribing the [CFTC's] authority to take appropriate action under any other provision of the Commodity Exchange Act against transactions masquerading as 'leverage' contracts." *Id.*

142. 49 Fed. Reg. 5498 (1984). The CFTC's release noted that while it was adopting final rules, such rules were deemed to be "interim" for two reasons. First, the CFTC had maintained its moratorium with respect to the regulated leverage business until it had an opportunity to evaluate the efficacy of its rules. In addition, the CFTC indicated its intention to solicit additional comments on whether leverage transaction merchants should be permitted to offer customers the opportunity to take "short" positions in leverage contracts as well.

143. See *id.* The regulations set forth for the first time a comprehensive definition of leverage contracts. See 17 C.F.R. § 31.4(w) (1984) (codification of regulations). In response to comments it received on its proposed regulations, the CFTC amended its proposed definition of "leverage contracts" by permitting either the periodic payment by the leverage customer or the accrual by the LTM of a carrying charge or fee on the unpaid balance of the price of the contract. In addition, the CFTC eliminated the portion of the proposed definition requiring repurchase of leverage contracts by the LTM upon demand by the customer. 49 Fed. Reg. 5498, 5499 (1984). One controversial aspect of the definition, however, was maintained by the CFTC. Under the proposed as well as the final regulations a leverage contract must be for a term of 10 years or more, based upon the CFTC's contention that "leverage contracts as commonly known to the trade have traditionally been long-term contracts of at least this duration." *Id.*

144. See 17 C.F.R. § 31.6 (1984). The regulatory scheme adopted for LTMs and leverage trading is substantially similar to that imposed upon FCMs and other regulated commodities professionals. For example, LTMs must become registered with the CFTC and any employees engaged in the solicitation or acceptance of customer accounts, or in the supervision of persons so engaged, must become registered as associated persons. 17 C.F.R. §§ 3.17, 3.18 (1984). In addition, LTMs are subject to recordkeeping and reporting requirements roughly analogous to those established with respect to FCMs. See 17 C.F.R. §§ 31.14, 31.15 (1984). Further, LTMs must maintain a minimum adjusted net capital of \$2.5 million, plus 20% of the market value

modities" upon which leverage contracts are based, also must be registered with the CFTC.¹⁴⁵ Further, net capital, segregation, reporting and recordkeeping requirements similar to those imposed upon FCMs are made mandatory for LTMs.¹⁴⁶

LTMs are also governed by specific antifraud rules under CFTC regulations,¹⁴⁷ and the CFTC as well as the courts have provided relief to private customers found to have been defrauded by leverage dealers.¹⁴⁸ Indeed, numerous decisions in recent years have found violations of these rules by leverage merchants offering precious metals and have resulted in an industry reputation for "boiler room" operations conducted through allegedly

of the physical commodities subject to uncovered leverage contracts. 17 C.F.R. § 31.7 (1984). LTMs are also subject to the CFTC's financial "early warning" system, under which FCMs and LTMs must provide notice whenever their net capital falls below a certain specified amount. 17 C.F.R. § 31.7 (1984). For LTMs, this figure has been established as 120% of the minimum net capital requirements. *Id.* One financial requirement which has been created for LTMs but not imposed upon FCMs is the mandate that an LTM cover 90% of its obligations on leverage contracts, 25% of which must be covered by physical commodities. *Id.*

Several other provisions of the LTM regulations, however, represent significant departures from the regulatory scheme governing FCMs. First, LTMs are required to distribute to customers and file with the SEC a comprehensive disclosure document, similar to the disclosure document required to be prepared by commodity trading advisors. 17 C.F.R. § 31.11 (1984). This requires provision of a lengthy risk disclosure statement, the content of which is prescribed by the regulations, an explanation of the business background of the LTM and its principals, detailed explanations of the terms of the leverage contracts, disclosure of leverage trading engaged in or intended to be engaged in by the LTM or its principals, any material actions against the LTM or its principals and other information. *Id.* Second, the regulations require LTMs to obtain CFTC approval, through a registration process, for any "leverage commodities" on which a leverage contract is to be offered. 17 C.F.R. § 31.6 (1984). Because futures contracts may be traded only on registered contract markets, no registration process analogous to SEC registration of securities has existed in the commodities markets. The registration of leverage commodities thus represents a departure from this practice. In addition, the CFTC has defined the term "leverage commodity" in terms of certain specific characteristics: (1) the nominal size of the delivery pack and range of tolerable weights; (2) the composition of the delivery pack and tolerances as to its components; (3) the nominal bar weights and range of tolerable weights; (4) the minimum guaranteed quality; (5) a list of deliverable refiners; (6) the required packaging of bars; (7) the method of pricing; (8) the locations of delivery facilities; and (9) the transportation and registration arrangements. As a result, "2,000 ounces of silver is a different leverage commodity from 1,000 ounces of silver and . . . would require separate registration." 49 Fed. Reg. 5498, 5500 (1984); *see* 17 C.F.R. § 31.4 (1984). Finally, unlike futures or options trading, the regulations governing leverage trading contain a mandatory rescission provision that allows first-time customers to rescind a leverage transaction within the first three days of entering into such transaction, except that the customer may be assessed actual price losses accruing to its position as a result of market movements. *See* 17 C.F.R. § 31.23 (1984).

145. *See* 17 C.F.R. § 31.6 (1984).

146. *See* 17 C.F.R. §§ 31.7-31.17 (1984).

147. *See* 17 C.F.R. § 31.3 (1984).

148. *See generally* Adoption of Antifraud Rules, [1975-1977 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 20,049 (June 17, 1975) (release adopting antifraud regulation governing leverage trading). *See also* CFTC v. Premex, Inc., [1980-1982 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 21,229 (7th Cir. 1981); Thielker v. Bonaire Trading Corp., [1980-82 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 21,404 (C.F.T.C. 1982).

fraudulent promotional schemes. In *Moreira v. First National Monetary Corp.*,¹⁴⁹ for example, a CFTC administrative law judge (ALJ) found that a leverage dealer and its employees had failed to advise a customer of the risks of loss and of reinstatement of a position, and had engaged in improper liquidations.¹⁵⁰ Similarly, in *Campbell v. International Precious Metals Corp.*,¹⁵¹ an ALJ held that an associated person had made misrepresentations concerning the status of a customer's account and future margin calls and, therefore, had breached its fiduciary duty.¹⁵² In *Mitchell v. Premex, Inc.*,¹⁵³ the CFTC determined that a leverage firm had violated its antifraud rule by soliciting investments from inexperienced investors without disclosing that they could lose their entire investment, that a front-end load would be imposed, that margin calls might be made, and that the firm could close out the customer's account at will.¹⁵⁴ Moreover, it was found that the merchant had permitted debit balances to occur in the customer's account without the customer's knowledge, and later demanded satisfaction of the balance.¹⁵⁵

149. [1982-1984 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 21,914 (C.F.T.C. 1983).

150. *Id.* at 27,960-61. The administrative law judge in *First National Monetary* noted that "it is well established that a commodity professional who gives advice on the purchase or sale of commodities to a person pursuant to a standardized contract such as a margin contract has a fiduciary relationship with such person. . . . In such relationships the commodity professional is required to provide all facts relevant to the transaction in question to which a reasonable person would attach importance in reaching an investment decision." *Id.* at 27,961.

151. [1982-1984 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 21,816 (C.F.T.C. 1982).

152. *Id.* at 27,390-91. The complainant in *International Precious Metals* had purchased seven bags of silver initially and sold three at a profit. She then received a margin call and sold one bag at a loss to cover the loss to cover the margin. Because she failed to object to the margin call at that time, however, she was found by the ALJ to have ratified the sale of the one bag of silver and the satisfaction of the margin call. *Id.* at 27,391. Nevertheless, the account executive was found to have breached a duty to the complainant by failing to keep her apprised of market conditions and the status of her account, and by telling her that her account was "fine" when in fact it was in a loss position. *Id.* at 27,391.

153. [1982-1984 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 21,678 (C.F.T.C. 1983).

154. *Id.* at 26,606-07.

155. *Id.* at 21,607. The ALJ in *Mitchell v. Premex, Inc.*, in fact found a number of egregious antifraud violations on the part of the leverage firm, which was registered as an FCM. In particular, it was found that the firm had encouraged the complainants to invest their children's trust funds in the leverage trading, and took advantage of the complainants' lack of sophistication or knowledge concerning such trading. *See id.* at 21,607. Thus, it was held that the account executive:

[D]eliberately and fraudulently omitted any of the risks involved in the transaction. He deliberately led the [complainants] to believe that Premex would purchase the metal in question, and set it aside for [them]. That was patently untrue . . . it is appalling to me that a respondent could knowingly and willingly solicit and dissipate the funds of children in a venture of this nature, knowingly and wilfully browbeat such unwitting people as the [complainants] into sending in more money to allegedly salvage a disastrous investment, permit a so-called debit balance to develop on the account, and then hound the victims for the debit balance.

Id. at 21,606-07. *See also* Jackson v. Premex, Inc., [1982-1984 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 21,618 (C.F.T.C. 1982) (FCM and its agent violated CFTC's antifraud regulation for leverage transactions by failing to comply with customer's instructions to sell leverage contract in silver at time when silver was selling at particularly high price).

The CFTC, as noted, has recently undertaken increased enforcement efforts against a number of leverage dealers engaged in fraudulent or otherwise illegal operations. One such firm, Smythe-Wheatley Ltd., was charged in a suit filed jointly by the CFTC and the Arizona Attorney General's Office in early 1984 with running a "boiler room" scheme through which employees made cold call solicitations for leverage trading.¹⁵⁶ According to the CFTC, neither Smythe-Wheatley nor its employees were registered with the CFTC or state authorities in any capacity, despite the fact that they were offering leverage contracts and the firm was simply "gambling with customers' money."¹⁵⁷ Indeed, the company allegedly diverted some \$450,000 in customer funds for the purchase of luxury cars, real estate and a sixty-foot yacht, before being ordered to cease its operations by a federal district court.¹⁵⁸

At approximately the same time, the CFTC initiated actions against Premex, Inc., a leverage dealer registered as an FCM.¹⁵⁹ Based upon the CFTC's allegations that Premex had insufficient capital to meet obligations to customers, a district court froze the company's assets pending a determination on its condition.¹⁶⁰ In addition, the CFTC revoked Premex's FCM registration and denied its application for commodity trading advisor registration, as a result of alleged inaccuracies in materials filed with the CFTC and other improprieties.¹⁶¹

156. *State of Arizona v. Smythe-Wheatley, Ltd.*, [1982-1984 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 22,034 (D. Ariz. 1984). See *Metals Firm Has Folded, Court Is Told*, The Arizona Republic, Feb. 23, 1984; "Squeaky Clean" *Scottsdale Metals Firm Is Being Victimized by U.S., Lawyer Says*, The Arizona Republic, Feb. 22, 1984; *Court Closes Metals-Trading Corporation*, The Phoenix Gazette, Feb. 18, 1984.

157. See *Court Closes Metals-Trading Corporation*, The Phoenix Gazette, Feb. 18, 1984. The United States District Court for the District of Arizona immediately enjoined Smythe-Wheatley from conducting business in the sale of leverage contracts in any form. *State of Arizona v. Smythe-Wheatley, Ltd.*, [1982-1984 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 22,034 at 28,635 (D. Ariz. 1984).

158. See "Squeaky Clean" *Scottsdale Metals Firm Is Being Victimized By U.S., Lawyer Says*, The Arizona Republic, Feb. 22, 1984. The firm allegedly took in some \$4 million in "leverage contracts" from at least 816 clients in Arizona and California. *Id.* At the time the action was initiated, it was reported that more than \$2 million had been seized in company bank accounts in the two states. *Metals Firm Has Folded, Court is Told*, The Arizona Republic, Feb. 23, 1984.

159. See *CFTC v. Premex Inc.*, [1982-1984 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 22,061 (S.D. Cal. 1984); *CFTC v. Premex, Inc.*, [1982-1984 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 22,035 (S.D. Cal. 1984).

160. See *CFTC v. Premex, Inc.*, [1982-1984 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 22,061 (S.D. Cal. 1984); *CFTC v. Premex, Inc.*, [1982-1984 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 22,035 (S.D. Cal. 1984).

161. See *CFTC v. Premex, Inc.*, [1982-1984 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 22,061 (S.D. Cal. 1984); *CFTC v. Premex, Inc.*, [1982-1984 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 22,035 (S.D. Cal. 1984). The company and its affiliates were prohibited from acting in any manner inconsistent with the orderly wind-down of their trading operations. The court order required Premex to provide the CFTC with full access to all of its books and records and to liquidate its operations by a specific date. [1982-1984 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 22,035 at 28,637. In addition, a temporary equity receiver was appointed and directed to establish a receivership account to take control of all of the firm's assets. [1982-1984

D. Commodity Trading Advisor Issues

Any person rendering advice as to the value of, or the advisability of trading in, commodity futures contracts, commodity option contracts, or leverage contracts, as part of a regular business, is required to register with the CFTC as a commodity trading advisor (CTA).¹⁶² Similar to the Advisers Act, however, such registration is not required if the person renders advice to no more than fifteen persons in the course of any twelve month period or if the person offering advice is not compensated, directly or indirectly, therefor.¹⁶³ In addition, the CEA excludes from the definition of a CTA any FCM, associated person, bank or publisher if the provision of advice on commodity trading is "solely incidental" to the conduct of that person's business.¹⁶⁴

Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 22,061 at 28,705. See also *Premex's Assets Frozen By Judge*, Barron's, Feb. 20, 1984; *Premex Ordered to Shut Down*, Barron's, Feb. 6, 1984; *Premex Registration Is Revoked by CFTC, Official Fined \$215,000*, Wall St. J., Feb. 6, 1984; *Premex Told to Halt Business*, Chicago Sun-Times, Feb. 4, 1984.

162. 7 U.S.C. § 2 (1982). That provision of the CEA provides:

[T]he term 'commodity trading advisor' shall mean any person who, for compensation or profit, engages in the business of advising others, either directly or through publications, writings or electronic media, as to the value of or the advisability of trading in any contract of sale of a commodity for future delivery made or to be made on or subject to the rules of a contract market, any commodity option authorized under section 6c or any leverage transaction authorized under section 23, or who, for compensation or profit, and as part of a regular business, issues or promulgates analyses or reports concerning any of the foregoing.

Id. Registration of CTAs is required under § 4m of the CEA. 7 U.S.C. § 6m (1982). In addition, CTAs registered or required to be registered are subject to a host of recordkeeping and reporting obligations and, if they manage customers' discretionary accounts, to extensive and detailed disclosure requirements. See 17 C.F.R. pt. 4 (1984). See also Mitchell, *The Regulation of Commodity Trading Advisors*, 27 EMORY L.J. 957 (1978).

163. 7 U.S.C. § 6m (1982). In contrast to the state of the law under the Advisers Act, however, the CFTC and the courts have adhered to a "pass through" doctrine, pursuant to which an adviser rendering trading advice to only one entity may be subject to registration, if its advice is ultimately received by more than 15 persons. See *CFTC v. Savage*, 611 F.2d 270, 279-81 (9th Cir. 1979). As a result, it may be significantly easier for an adviser inadvertently to become subject to CTA registration than to Advisers Act registration.

164. 7 U.S.C. § 2 (1982). The CFTC has stated that the applicability of the "solely incidental" standard cannot be determined according to any numerical criteria, but only through evaluation of "the context of the business concerned and the factual situation in which the services are rendered." CFTC Interpretive Letter No. 76-1, [1975-1977 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 20,135 at 20,906 (Feb. 26, 1976). Under this approach, the CFTC generally has held that an FCM publishing periodic advice is most likely exempt from CTA registration. In contrast, however, an associated person of an FCM forwarding written recommendations or advice to existing or prospective customers may be more likely to be subject to CTA registration if these activities are not found to constitute services rendered to the FCM as part of the associated person's employment. See CFTC Interpretive Letter No. 75-6, [1975-1977 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 20,093 at 20,754-55 (Aug. 13, 1975). Recently, the staff of the CFTC has issued an interpretive letter stating that operation of an advisory service on financial futures transactions by a bank, which is used by its customers for hedging purposes only, would be "solely incidental" to the bank's business if it: (1) is offered in connection with the bank's rendition of other commercial banking services; (2) is limited to hedging programs undertaken by customers of the bank; (3) is not actively marketed; and (4) does not generate a significant percentage of

Under this definition of a CTA, dealers offering precious metals may be subject to CTA registration if, in the course of their business, they regularly advise customers on the value of futures contracts on gold, silver, platinum or other metals. Prior to the 1982 amendments to the CEA, however, the definition of a CTA was considerably broader, encompassing not only those persons rendering advice on futures, option or leverage contracts, but also those who provided advice for compensation on the value of any physical commodity on which futures were traded.¹⁶⁵ As a result, a bank, brokerage firm or dealer might have been required to register as a CTA even if it limited its trading advice to transactions in cash metals. Indeed, under this definition, the CFTC generally had adopted the view that leverage merchants engaged in off-exchange metals trading were subject to CTA registration, although they were not within the definition of an FCM.¹⁶⁶

Pursuant to the narrower construction of the CEA, a dealer in cash metals should not be considered a CTA if it limits its advice to transactions in physical commodities. As currently drafted, the CEA explicitly exempts such "cash market" operations from the scope of CTA regulation, although it grants the CFTC authority to include within the definition any category of persons it deems necessary.¹⁶⁷ To date, however, the CFTC has not acted upon this authority.

The CFTC, therefore, may by rule include within the reach of CTA regulation any person providing advice on cash metals. As had been true with respect to leverage dealers, such action would grant the CFTC at least some regulatory control over these entities as well. Nevertheless, in the absence of the CFTC's exercise of this power, dealers engaged solely in a cash metals business remain outside the CFTC's jurisdiction over CTAs.

E. CEA Anti-Manipulation Provisions

As is evident from the foregoing discussions, the CFTC potentially retains jurisdiction over a number of off-exchange activities in the commodities markets. The CFTC may determine that a certain type of transaction warrants regulation as a futures, option or leverage contract, or the CFTC may exercise its authority to determine that entities engaged in cash commodities

the bank's revenues. CFTC Interpretive Letter No. 83-2, [1982-1984 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 21,788, at 27,177-78 (Mar. 18, 1983).

165. Mitchell, *The Regulation of Commodity Trading Advisers*, 27 EMORY L.J. 957 (1978). This definition, however, resulted in numerous problems as the definition of "commodities" within the scope of the CFTC's jurisdiction expanded in the course of the 1970's. As a result of the definition of a CTA, many persons simply rendering advice on physical commodities in commercial marketing channels could have become subject to registration and CFTC regulation.

166. See, e.g., CFTC v. Premex, Inc., [1982-1984 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 21,685 (N.D. Ill. 1983) (dealer in leverage contracts subject to CTA registration).

167. 7 U.S.C. § 2 (1982); 17 C.F.R. § 4.14 (1984). One commentator has suggested the reinstatement of a CTA registration requirement with regard to cash metals dealers as a means of combatting precious metals scams. See J. Rosen, *Cauldron Still Bubbling for U.S. Precious Regulations*, Futures World, Apr. 26, 1984.

businesses should be registered as CTAs. In addition, the CEA grants the CFTC the authority to investigate and prosecute trading in cash markets which constitutes a manipulation or attempt to manipulate the price of futures or options.¹⁶⁸ Where the CFTC finds cause to believe that such a violation is or may be occurring, it may pursue the matter on its own initiative or in conjunction with state or federal authorities.¹⁶⁹ Under this legislative mandate, the CFTC has undertaken numerous actions against persons allegedly engaged in manipulative conduct in the futures markets intended to influence prices in the cash markets.¹⁷⁰

Where no effect on the futures markets has been found to exist, however, the CFTC has adopted a "hands off" policy, pursuant to which it will not become involved in significant surveillance or enforcement efforts with respect to the trading of cash commodities.¹⁷¹ In 1976, a CFTC Advisory Committee adopted guidelines for the agency's enforcement of the anti-manipulation provisions of the CEA which, to date, essentially have remained the CFTC's policy on the cash markets.¹⁷² In its report, the Advisory Committee noted that regulation of the futures markets is more feasible than control of the cash markets,

168. See 7 U.S.C. § 13 (1982). Violation of the anti-manipulation provision of the CEA constitutes a felony, punishable by fines of up to \$100,000 imprisonment for up to five years and/or suspension of trading privileges. *Id.* See also 7 U.S.C. §§ 9, 13a, 13a-1, 13b (1982); 17 C.F.R. §§ 11.1-11.8 (1984), (regulations governing CFTC investigations).

169. 7 U.S.C. § 13a-2 (1982). Although the CFTC is vested with exclusive jurisdiction over enforcement of the CEA, state authorities are provided with specific *parens patriae* authority to bring criminal antifraud actions under the CEA. See CFTC Interpretive Letter No. 76-19, [1975-1977 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 20,213 (Sept. 29, 1976); CFTC Office of General Counsel, *The States' Two-fold Commodities Enforcement Role: State Parens Patriae Suits To Uphold the Commodity Exchange Act and State Prosecutions Under General Criminal Antifraud Statutes*, [1975-1977 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 20,218 (Oct. 8, 1976). This *parens patriae* authority was subsequently incorporated explicitly into the CEA. See 7 U.S.C. § 13a-1 (1982). Moreover, the states recently have been authorized to initiate actions based upon the CEA in state court. See 7 U.S.C. § 13a-2 (1982).

170. See *In the Matter of Collins*, [1982-1984 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 21,960 (C.F.T.C. 1984) (traders who established long positions in potato futures contracts manipulated upward price of contracts by increasing their long positions so as to exceed maximum net positions for potato futures set by CFTC in order to extract settlement prices in excess of cash and contract closing prices); *In the Matter of Cox*, [1982-1984 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 21,767 (C.F.T.C. 1983) (parties holding majority of outstanding long contracts in wheat futures established price level which constituted manipulation of market); *In the Matter of Jules Nordlicht*, [1980-1982 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 21,027 (C.F.T.C. 1980) (revocation of registration is appropriate remedy for violation of anti-manipulation provisions of CEA); *In the Matter of Indiana Farm Bureau Cooperative Ass'n*, [1977-1980 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 20,964 (C.F.T.C. 1975) (manipulative intent is prerequisite for finding of violation of anti-manipulation provisions).

171. See *Recommended Policies on the Cash Market Regulatory Authority and Cash Data Needs of the Commodity Futures Trading Commission*, Report of the Advisory Committee on Definition and Regulation of Market Instruments, [1975-1977 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 20,225 (Oct. 18, 1976).

172. *Id.* at 21,219-22. The advisory committee conducted an investigation into various cash markets and determined that, for the most part, there was active competitive trading in such markets. Where less active trading was present, the advisory committee concluded that the CFTC

due to the greater standardization and centralization of futures trading.¹⁷³ As a result, the Advisory Committee concluded that the CFTC should rely upon its jurisdiction over the cash markets to investigate instances suggesting manipulation or fraud in connection with physical commodities affecting the futures market.¹⁷⁴ Where, however, no effect on the futures market is indicated, the Advisory Committee recommended that the CFTC simply refer the matter to the Department of Justice or other appropriate agency.¹⁷⁵

The Advisory Committee recommended, therefore, that the CFTC "should not commit itself to the massive and largely uncontrollable expense of regulating any cash market."¹⁷⁶ Instead,

The [CFTC] should undertake an affirmative monitoring or surveillance in connection with a cash market only in those extraordinary circumstances where (i) a danger to the public is clear and present; (ii) where that imminent danger threatens the [CFTC's] primary areas of responsibility such as futures markets, commodity options or leverage contracts; (iii) adequate resources are available for commitment to the program without dissipating the [CFTC's] ability to perform its primary functions; and (iv) only for such period of time as the benefits decisively outweigh the many negative consequences of the program.¹⁷⁷

In sum, the CFTC's authority under anti-manipulation provisions of the CEA, and its interpretation thereof, severely circumscribe its ability to prosecute fraud in cash metals transactions. Unless there is some discernible effect on, or attempt to influence, the markets within the CFTC's "primary areas of jurisdiction" it has construed its powers to be limited to investigation and possible referrals to other agencies. Accordingly, the CFTC thus far has not attempted to regulate precious metals dealers under the anti-manipulation ban unless these entities are sufficiently engaged in related futures or options trading to warrant CFTC intervention.

Nevertheless, it should be noted that the CFTC's jurisdiction over metals trading, even under its construction of the CEA, is far from insignificant. Many precious metals dealers engage in some futures trading in connection with their cash business, if only for the purpose of hedging commitments or exposure. While this in itself would not provide the CFTC with jurisdiction in the absence of some manipulative conduct or intent, it does allow the CFTC to monitor the activities of precious metals firms, since the possibility for manipulation exists. Moreover, as noted, even if no manipulation is found, the CFTC may refer the matter to other regulatory or enforcement agencies if violations of law are found in the course of cash trading.

should consider investigation of anti-competitive problems in those cash markets. *See id.* at 21,200.

173. *Id.*

174. *Id.*

175. *Id.*

176. *Id.*

177. *Id.* at 21,221.

F. CFTC Regulation of Precious Metals Trading

In his testimony before the PSI, Dennis Klejna, Director of the CFTC's Division of Enforcement, reiterated that "[t]he CFTC's primary mission is to regulate the eleven commodity futures exchanges and the nearly 70,000 futures professionals who deal with the public."¹⁷⁸ Although the CFTC recognizes its "strong interest in working to find ways of combatting this fraudulent activity" of precious metals "boiler rooms," it acknowledges that "those who engage in off-exchange fraudulent activity scorn regulation and choose, rather, to operate outside the legal framework."¹⁷⁹ As a result, unless other activities of these entities subject the entities to CFTC jurisdiction, their cash metals business is outside the scope of CFTC authority.

As noted, the operation of cash metals programs, without more, generally does not involve the trading of off-exchange futures contracts.¹⁸⁰ Although certain of the elements of a futures contract may be present, customers ordinarily do take delivery, in the form of a certificate or otherwise, and cannot settle their obligations through offset. Similarly, such programs often do not constitute the offering of option or leverage contracts, and these bases of CFTC jurisdiction are therefore unavailable as well.

One commentator has recently suggested that the CFTC attempt to control the proliferation of precious metals fraud by exercising its existing authority to expand the range of persons required to register as CTAs to include those rendering advice on cash metals transactions.¹⁸¹ As noted, although the CEA definition of a CTA has been narrowed to encompass only those persons providing advice related to the value of or advisability of trading in futures contracts, the CFTC retains the authority to bring within that definition any category of persons it deems necessary.¹⁸² Accordingly, the CFTC could by regulation require the registration of any cash metals dealers rendering advice to fifteen or more customers concerning the value of or advisability of investing in physical metals, regardless of whether such advice included futures trading. FCMs, however, presumably would be exempt from CTA registration on this basis if their trading advice were "solely incidental" to their business, the exclusion presently available to FCMs.¹⁸³

This approach would accomplish several important results. First, the CFTC would be in a position to identify those individuals or entities engaged exclusively in a brokerage and advisory business in cash metals, and would not be dependent on a finding of futures, options or leverage trading in order

178. *PSI Hearings*, *supra* note 1, at 204.

179. *Id.*

180. *See id.* at 199-209. *See also supra* notes 85-97 and accompanying text.

181. J. Rosen, *Cauldron Still Bubbling For U.S. Precious Regulations*, *Futures World*, Apr. 26, 1984.

182. *See* 7 U.S.C. § 2 (1982).

183. *See* 7 U.S.C. § 2 (1982); CFTC Interpretive Letter No. 76-1, [1975-1977 Transfer Binder] *COMM. FUT. L. REP. (CCH)* ¶ 20,135 (Feb. 26, 1976).

to assert jurisdiction. Once aware of the existence of these firms, the CFTC would, at a minimum, maintain registration and antifraud authority with respect to the firms' activities and would be able to pursue the investigation and prosecution of schemes such as IGBE and Bullion Reserve.

In addition, many precious metals dealers required to register as CTAs would also be subject to CTA disclosure obligations if they accepted trading discretion from customers, and, therefore would be required to prepare and distribute an elaborate disclosure document. This could provide the CFTC as well as customers with extensive information about the dealers and their principals, and could help to avoid future frauds. Finally, even in those instances where CFTC prosecution is infeasible or impermissible, the fact of CTA registration could provide state or other authorities with an effective means of identifying precious metals dealers and obtaining necessary information.

Nevertheless, CTA registration may still be of limited effectiveness in combating precious metals frauds. Those dealers seeking to engage in illegal trading operations have demonstrated a remarkable ability for avoiding registration requirements simply by the manner in which they structure their operations. Thus, those who wished to avoid CFTC control would be required merely to refrain from offering any advice whatsoever, even with respect to physical metals, or from accepting discretionary authority. Indeed, those persons intent on establishing illegal "boiler rooms" would likely not register in any event, thereby depriving the CFTC of its ability to monitor their activities, even if it had the authority to do so.

Moreover, the expansion of the CTA category would bring within its scope many individuals and entities with little or no connection to the commodities industry and who are legitimately involved in an exclusively cash business. This in fact was the motivation for Congress' narrowing of the CTA definition, which was intended to remedy what had been perceived as an overly broad and inclusive CTA category.¹⁸⁴ If the definition were expanded again in this manner, therefore, the result could be an excessive drain on CFTC resources in areas bearing no relation to precious metals "boiler room" frauds and could have an effect opposite to that intended.

Finally, the CFTC clearly retains some authority over precious metals dealers, even if engaged in an exclusively cash business, under the anti-manipulation provisions of the CEA. As noted, the CFTC has adopted a "hands off" policy with respect to manipulation attempts, exercising its jurisdiction only where there is some effect or potential effect on the futures markets or other of the CFTC's primary areas of control. As a result, precious metals fraud which is unconnected to futures trading and unrelated to any attempt to manipulate the futures markets would be outside the CFTC's sphere.

184. See, e.g., H.R. REP. NO. 565, Part I, 97th Cong., 2d Sess. 130 (1982).

V. FEDERAL TRADE COMMISSION AUTHORITY OVER PRECIOUS METALS TRADING

A third federal regulatory agency, the FTC, also has been involved in efforts to control precious metals investment scams.¹⁸⁵ The FTC is a civil enforcement agency, with jurisdiction over various commercial activities, primarily in areas where consumer protection is required.¹⁸⁶ The FTC, therefore, is authorized to investigate and prosecute ventures or schemes engaged in the defrauding of customers. As a civil agency, however, the FTC has no power to initiate strictly criminal proceedings, but instead is limited to seeking remedies such as administrative orders, federal court injunctions, consumer redress, industry-wide guidelines and trade regulation rules.¹⁸⁷

The FTC, as noted, began investigating IGBE in early 1983, after its Chicago Regional Office began receiving information indicating that customer complaints against the firm were not being satisfied.¹⁸⁸ By March, 1983, the FTC had compiled a list of approximately 200 complainants who had been unable, for substantial periods of time, to obtain either refunds or the precious metals they had ordered.¹⁸⁹ At the same time, the FTC initiated investigations of Bullion Reserve and United Precious Metals.¹⁹⁰

None of these investigations, however, resulted in the initiation of civil proceedings by the FTC. Several of the firms went out of business before the FTC could take any formal actions, and a number of others were prosecuted by state authorities, causing the FTC to drop its parallel efforts.¹⁹¹ In addition, the FTC was informed by the CFTC that four of the firms it was investigating were subject to CFTC regulation by virtue of their sale of leverage contracts.¹⁹²

In any event, FTC jurisdiction and enforcement powers appear to be inadequate to regulate or control precious metals firms. First, the agency cannot register or otherwise monitor the activities of these firms, but can only respond to customer complaints on reports of fraud. Moreover, because the FTC is a civil enforcement body, it has a much more limited ability to obtain information compared to other federal or state authorities. As a result, the FTC is largely dependent upon other agencies for information required in its investigations. Further, even after an inquiry has been launched, the FTC's limited prosecutorial role prevents effective legal actions. In sum, the FTC

185. *PSI Hearings*, *supra* note 1, at 210-22.

186. *Id.* at 211. The FTC's principal mandate set out in § 5 of the FTC Act states that: "Unfair methods of competition in or affecting commerce, and unfair or deceptive acts or practices in or affecting commerce, are declared unlawful." 15 U.S.C. § 45(a)(1) (1982). *See also PSI Hearings*, *supra* note 1, at 171-73.

187. *PSI Hearings*, *supra* note 1, at 211.

188. *Id.* at 214.

189. *Id.*

190. *Id.* at 215.

191. *Id.* at 215-16.

192. *Id.*

simply is not suited to deal with the problems of precious metals trading, other than in an ancillary capacity.

VI. JURISDICTION OF STATE AND SELF-REGULATORY AUTHORITIES OVER PRECIOUS METALS TRADING

The New York Attorney General's office, as noted, has insisted that either state jurisdiction over precious metals trading be enhanced or that the authority of federal agencies be expanded.¹⁹³ In addition, representatives of the precious metals industry have suggested that abuses be curbed through self-regulatory efforts and the establishment of a self-regulatory organization modeled after the National Association of Securities Dealers, Inc. (NASD) and the National Futures Association (NFA).¹⁹⁴ These proposals, either alone or in conjunction with expanded federal jurisdiction, may represent viable alternatives to filling the perceived regulatory "gap."

Under the CEA, state regulatory authorities are completely preempted from undertaking any action in areas of the CFTC's exclusive jurisdiction.¹⁹⁵ Although the states could bring actions in state court for violations of the CEA, they were foreclosed from requiring the registration of commodities professionals or prosecuting trading abuses under state law.¹⁹⁶ The 1982 amendments to the CEA, however, included a so-called "open season" provision, which eliminated any restriction on prosecution of commodities fraud under any federal criminal statute, as well as the preemption of state authority over

193. *Id.* at 126-32. As noted, representatives of Florida and California expressed a similar interest in an expansion of state prosecution powers combined with a more effective federal regulatory effort. *Id.* at 107-19.

194. *Id.* at 229-41 (statement of Luis Vigdor, on behalf of the Industry Council for Tangible Assets). The NASD and NFA are the self-regulatory organizations for, respectively, the securities and commodity futures industries. The agencies are responsible for many of the registration, auditing and other responsibilities regarding the monitoring of the activities of industry participants which were formerly the province of the SEC and CFTC. The self-regulatory approach, in both industries, represents an attempt to reduce the burden imposed upon the federal regulatory agencies by shifting some of their responsibilities to organizations funded by the industries they regulate. See H.R. REP. No. 565, Part I, 97th Cong., 2d Sess. 41 (1982).

The NFA was created in 1978 as a "registered futures association" pursuant to § 17 of the CEA. See 7 U.S.C. § 21 (1982). That provision clearly contemplated an organization analogous to the NASD, which supervises certain broker-dealer registration activities, as well as off-exchange securities transactions with respect to which no other self-regulatory body has jurisdiction. See NFA MANUAL, ¶ 305.1; L. LOSS, FUNDAMENTALS OF SECURITIES REGULATION 689-94 (1983). Both the NASD and the NFA, therefore, were created largely for the purpose of monitoring and preventing abuses in connection with off-exchange trading. Congress enacted amendments to the CEA in 1982 designed to facilitate and effectuate the NFA's supervisory role in the futures industry. See H.R. REP. No. 565, Part I, 97th Cong., 2d Sess. 41-42 (1982). The CFTC thereafter adopted a regulation mandating NFA membership on the part of FCMs. See 48 Fed. Reg. 26304 (1983).

195. See 7 U.S.C. § 2 (1982).

196. Thus, the CFTC has stated:

[I]t is clear, beyond any reasonable dispute, that the Act totally preempts any state licensing or registration provisions. Further, we think it is clear that any form of state regulation, as such, of any persons, entities or activities affecting or involving trading

off-exchange transactions.¹⁹⁷ As a result, the states now are authorized explicitly to investigate and prosecute off-exchange commodities fraud. Moreover, the amendments expanded the ability of the CFTC to furnish any information within its control to state or local authorities for law enforcement purposes.¹⁹⁸

in commodity futures contracts, the sale of gold and silver coin and bullion on margin, or commodity options would be inconsistent with the pervasive regulatory scheme established by Congress. Today, state regulation of any sort would be preempted under the Supremacy Clause of Article VI of the Constitution.

Speech by CFTC Vice-Chairman John V. Rainbolt, II, before the North American Securities Administrators Conference, Sept. 9, 1975, *reprinted in* [1975-1977 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 20,075, at 20,706-07. Mr. Rainbolt also noted:

Section 2 of the Commodity Exchange Act now provides for "exclusive jurisdiction" with respect to accounts, agreements and transactions involving . . . commodity options. This reflects the expressed intent of Congress to establish a clear line of authority between SEC and CFTC jurisdiction. . . . With much the same thought in mind it is likewise clear that Congress intended to centralize regulatory authority in the CFTC with an intent to exclude state regulation.

Id. at 20,706.

Soon after the enactment of the CFTC Act, the CFTC undertook to assert the exclusive jurisdiction granted it and to clarify the role it envisioned for the SEC and state authorities. The CFTC concluded that "a commodity option dealer who complies with federal regulations (e.g., CFTC registration) has done all he needs to do; he cannot be required to do more or additional things, or conform to added regulations, even though they in no way conflict with what is demanded of him under the Act." CFTC Interpretive Letter No. 77-2, [1975-1977 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 20,257 (Jan. 27, 1977). The CFTC stated:

In light of the plain meaning of Section 2(a)(1) of the Commodity Exchange Act and its relevant legislative history, we consider it beyond serious dispute that the Commodity Futures Trading Commission has exclusive jurisdiction with respect to all accounts, agreements and transactions involving commodity futures contracts, both discretionary and nondiscretionary, and that the exclusivity of its jurisdiction is not affected by whether the account, agreement or transaction might otherwise be viewed as a "security."

Id. at 21,371; see CFTC Interpretive Letter No. 76-20, [1975-1977 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 20,214, at 21,160-61 (Sept. 19, 1976) ("Congress intended by that provision to preempt regulation of commodity futures transactions by the states."); Letter from CFTC Deputy General Counsel to Central Securities Administrators Council on Proposed Guidelines for State Regulation of Commodity Pool Operators, [1977-1980 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 20,445, at 21,708 (July 5, 1977) ("We believe, however, that the states have been preempted from imposing regulatory requirements on commodity pool operators. . . .").

The assertion of its exclusive jurisdiction in these areas did not, however, lead the CFTC to argue for a total preemption of state authorities in the commodities field. Indeed, even while seeking to clarify its primary role in enforcing the CEA, the CFTC attempted to delineate a continued involvement on the part of state agencies within the context of its exclusive jurisdiction. CFTC Interpretive Letter No. 76-19, [1975-1977 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 20,213 at 21,160 (Sept. 29, 1976). Specifically, the CFTC urged the states to act as *parens patriae* to enforce the CEA, and it asserted that the states could bring criminal antifraud actions without running afoul of CFTC exclusive jurisdiction. *CFTC Office of General Counsel, The States' Two-Fold Commodities Enforcement Role: State Parens Patriae Suits to Uphold the Commodity Exchange Act and State Prosecutions Under General Criminal Antifraud Statutes*, [1975-1977 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 20,218 (Oct. 8, 1976). This *parens patriae* authority was later incorporated into the Commodity Exchange Act. See 7 U.S.C. § 13a-1 (1982).

197. 7 U.S.C. § 13a-2 (1982). See also H.R. REP. NO. 565, Part I, 97th Cong., 2d Sess. 44-45, 103-04 (1982).

198. H.R. REP. NO. 565, Part I, 97th Cong., 2d Sess. 44 (1982).

Pursuant to this authority, the CFTC and state officials are now in a position to coordinate efforts against off-exchange commodities fraud through a sharing of information and expertise as well as manpower. Accordingly, the CFTC has held meetings with representatives of the North American Securities Administrators Association (NASAA) and the NFA in order to establish a working group for the development of model state legislation governing precious metals.¹⁹⁹ The CFTC has also conducted two State Cooperative Enforcement Seminars designed to provide state officials with a working knowledge of CFTC files and information and to establish bases for joint actions.²⁰⁰ As noted above, these efforts have resulted in one prosecution in state court to date brought by a state agency in conjunction with the CFTC.²⁰¹ In addition, the CFTC's Office of General Counsel, and a United States district court, recently have stated that contracts for the sale of precious metals which do not fall within the definition of "leverage contracts" set out in CFTC regulations are outside the CFTC's exclusive jurisdiction and may properly be the subject of state prosecutions.²⁰²

Also as a result of these efforts, NASAA issued a Proposed Model State Commodity Code (Model Code) designed to supplement the federal regulatory scheme and provide state authorities with necessary authority over precious metals firms and other commodity operations.²⁰³ The Model Code would prohibit certain activities which are also unlawful under the CEA, such as the sale of off-exchange futures contracts or the operation of unregistered commodity pools.²⁰⁴ It also would prohibit all types of trading in "commodity contracts" other than those which are within the exclusive jurisdiction of the CFTC or are encompassed within one of a number of other exemptions, one of which permits the sale of commodity contracts by banks.²⁰⁵ The Model

199. *PSI Hearings, supra* note 1, at 207, 227. The NFA has also undertaken to provide educational services to consumers in order to enable the public to detect and avoid commodity investment fraud schemes.

200. *Id.* at 208. See also *CFTC Helps Forge Tool to Regulate Metals Dealers*, Legal Times, Mar. 5, 1984.

201. *PSI Hearings, supra* note 1, at 208. See also *supra* notes 132, 156-58 and accompanying text.

202. CFTC Office of General Counsel, Interpretive Letter No. 84-1, (June 1, 1984) (state prosecution of persons offering precious metals through so-called "leverage loan programs" were not pre-empted by CFTC's exclusive jurisdiction, since contracts offered were of less than 10 years' duration and were therefore outside CFTC's definition of leverage contracts); *Texas v. Imperial Capital, Inc.*, 2 COMM. FUT. L. REP. (CCH) ¶ 22,307 (N.D. Tex. 1984) ("cash date delivery contracts" are not subject to CFTC's exclusive jurisdiction, since such instruments are outside scope of CFTC's definition of leverage contracts).

203. MODEL STATE COMMODITY CODE (North American Securities Administrators Association, Inc., Tent. Draft 1984) [hereinafter cited as MODEL CODE]. Like the Uniform Securities Act, which was intended as a model for state "blue sky" securities statutes, the Model Code is designed to be enacted by state legislatures to provide a method of enforcement against commodity investment fraud schemes within each state.

204. See *id.* at § 1.05.

205. See *id.* at § 1.02. The Model Code defines the term "commodity" to include "any agricultural, grain or livestock products or by-products, any metals or minerals (including a precious

Code also would prohibit the use of any fraudulent device in connection with the sale of permissible commodity contracts.²⁰⁶

The Model Code would exempt from its proscriptions commodity contracts for the sale of a commodity for the purchaser's consumption as well as contracts which require the receipt of delivery within twenty-eight days of the date of purchase, if delivery actually is received.²⁰⁷ With respect to precious metals trading, this latter provision would exempt a commodity contract providing either for physical delivery of the metals or for the delivery of a warehouse receipt or other document of title.²⁰⁸ In addition, the Model Code would specifically exempt any precious metals contract which does not allow for settlement by waiver, liquidation or offset and which requires, and under which the purchaser receives, physical delivery of metals or warehouse receipts, within seven days of the payment of any installment, representing the amount of the metal purchased by that installment.²⁰⁹

The Model Code thus would give state authorities some antifraud jurisdiction over precious metals trading and would, to this extent, serve to complement federal regulation. Nevertheless, in the absence of a registration or licensing requirement, the Model Code will not provide a means for ongoing oversight by state agencies of the activities of precious metals firms. Moreover, the Model Code's expansive definition of a "commodity," and its approach of prohibiting all non-exempt transactions may be unduly broad, encompassing and prohibiting many legitimate activities.²¹⁰

metal set forth in paragraph (f) of this section), any gem or gemstone (whether characterized as precious, semi-precious or otherwise), any fuel, whether liquid, gaseous or otherwise, any foreign currency, any government securities set forth in paragraph (j) of this section, and all other goods, articles, products, items, services, rights, or interests of any kind." *Id.* at § 1.01(e). The term "precious metal" is left to definition by state authorities, although the Model Code includes an abbreviated example encompassing silver coins and bullion, gold coins and bullion and platinum. *See id.* at § 1.01(f). The Model Code further defines the term "commodity contract" to mean "any account, agreement or contract for the purchase or sale of one or more commodities, whether for immediate or subsequent delivery or whether delivery is intended by the parties, and whether characterized as a cash contract, deferred shipment or deferred delivery contract, call forward contract, futures contract, installment or margin contract, leverage contract or otherwise." *Id.* at § 1.01(g). The instruments covered by the Model Code are therefore substantially broader than those encompassed within the CEA, taking in off-exchange instruments as well as those traded on a contract market.

206. *Id.* at § 1.06. The antifraud provision of the Model Code is patterned after the analogous section of the CEA. *See* 7 U.S.C. § 4b (1982).

207. *See* MODEL CODE, *supra* note 203, at § 1.04.

208. *See id.* at § 1.04(b). The exemption would require that the purchaser receive, within twenty-eight days from the payment of any portion of the purchase price, either physical delivery of the total quantity of the commodity to be purchased or a certificate, warehouse receipt or other document of title. *Id.* at § 1.04(c).

209. *See id.* at § 1.04(c).

210. The criticism was asserted by the Futures Industry Association (FIA), the trade association of the commodity futures industry. Letter from Don L. Horwitz, President, FIA Law & Compliance Division, to E.C. Anderson, Chairman, NASAA Commodities Committee, (July 19, 1984). The FIA took issue with the Model Code's general approach of prohibiting all transac-

In response to much of the criticism initially directed toward the Model Code, NASAA has made substantial revisions to several of its provisions.²¹¹ In pertinent part, NASAA has excluded from the definition of "commodity" certain numismatic coins, real property and works of art, thereby placing investments in these types of instruments beyond the scope of the Model Code.²¹² In addition, NASAA has created a category of "exempt persons," encompassing registered FCMs and broker-dealers as well as financial institutions, and has exempted such entities from the Model Code's prohibition on the sale of "commodity contracts."²¹³

A different approach has been adopted by New York State, which recently enacted into law a state commodities bill.²¹⁴ The legislation requires registration of any person engaged in the sale of, or rendering advice with respect to, contracts on any "commodity," defined to include agricultural commodities as well as precious metals, gems and foreign currency.²¹⁵ The registration provision, however, does not apply to (a) any bank or trust company; (b) member firms of contract markets regulated by the CFTC or of national securities

tions within its scope unless specifically exempted, questioning its constitutionality as well as its breadth. *See id.* In addition, the FIA asserted that many ordinary commercial transactions would be prohibited by the Model Code and suggested that it be revised to include specific exemptions for all off-exchange transactions among commercial, institutional and other sophisticated parties. *See id.*

211. MODEL STATE COMMODITIES CODE (North American Securities Administrators Association Inc., First Revised Draft, Oct. 26, 1984) [hereinafter cited as REVISED MODEL CODE]. *See also Commodity Group Adopts Spurned Fraud Code*, Legal Times, Aug. 27, 1984.

212. REVISED MODEL CODE, *supra* note 211, at § 1.01(e).

213. *Id.* at § 1.03. The revision came about as a result of brokerage firm criticism that the "financial institution" exemption would provide banks with an unfair competitive advantage. *See Commodity Group Adopts Spurned Fraud Code*, Legal Times, Aug. 27, 1984. Exempt persons remain subject to the Model Code's prohibition on off-exchange instruments prohibited or regulated by the CEA. REVISED MODEL CODE, *supra* note 211, at § 1.02.

214. N.Y. GEN. BUS. LAW 4186-E (Consol. 1984) (amending § 359e of General Business Law).

215. *Id.* The definition of "commodity" includes "any agricultural, grain, animal, chemical, metal or mineral product or by-product, any gem or gemstone (whether characterized as precious, semi-precious or otherwise), any fuel, whether liquid, gaseous or otherwise, any foreign currency, and any other good, article or material." *Id.* at § 14(a)(i). The "commodity contracts" encompassed within the registration provisions include:

[A]ny account, agreement or contract for the purchase or sale of, or any option or right to purchase or sell, primarily for speculation or investment purposes and not for use or consumption by the offeree or purchaser, one or more commodities, whether for immediate or subsequent delivery or for storage and whether or not delivery is intended by the parties, and whether characterized as a cash contract, deferred shipment or deferred delivery contract, forward contract, futures contract, installment or margin contract, leverage contract, option, privilege, indemnity, bid, offer, put, call, advance guaranty, decline guaranty or otherwise. Any commodity contract offered for sale or sold to a person other than a producer, processor, merchant, handler, commercial user or ultimate consumer of the commodity shall, in the absence of evidence to the contrary, be presumed to be offered for sale or sold for speculation or investment purposes.

Id. at § 14(a)(ii). These definitions are roughly analogous to those employed by the Model Code.

exchanges regulated by the SEC, and their affiliates; and (c) other persons registered with the CFTC or SEC.²¹⁶

Thus, rather than prohibiting commodity transactions, like the proposed NASAA code, the New York legislation would require those engaging in such transactions to register. In addition, by incorporating the bill into the existing state "blue sky" statute governing securities activities, the state has provided the Attorney General or private parties with authority to initiate antifraud actions against commodity brokers under state law.²¹⁷ The enactment of such regulatory schemes, and the advent of increased cooperation between state and federal agencies, clearly will serve to provide increased controls over precious metals dealers.

Nevertheless, these actions may be insufficient if the ultimate result is simply to shift responsibility to state agencies. To the contrary, it would appear that, given the national dimensions of the precious metals industry, some sort of continued federal participation will be required. Moreover, given the strong interest of the CFTC, and perhaps the SEC, in regulation of metals trading, due to their close connections with their primary spheres of responsibility, there should be a significant and sustained involvement by these agencies in any enforcement effort.

One possible approach would be the establishment of a precious metals industry self-regulatory organization, along the lines of the NFA or NASD, and the imposition of a statutory requirement that all firms engaged in a cash metals business register with that entity, with the exception of those already subject to SEC or CFTC authority.²¹⁸ The registration requirement might include some minimum net capital obligations, but would not establish a comprehensive regulatory scheme such as that mandated for FCMs or broker-dealers. It would, however, provide a basis for identifying metals brokers and dealers not otherwise subject to SEC or CFTC regulation and would allow their activities to be monitored to some extent.

Drawing on information made available by the SEC, CFTC and the states, the self-regulatory organization could maintain pertinent data on such firms and could in turn provide these materials to federal or state authorities for investigations or prosecution in the event of alleged fraud or other wrongdoing. In this manner, it may be possible to prevent the types of abuses which have recently occurred before the occurrence of massive customer losses.

A proposal along these lines has been put forward by the Industry Council for Tangible Assets (ICTA), a trade association for bullion, coin and foreign exchange trading firms, which is attempting to develop an industry-wide insurance program through which customers would be protected from losses attributable to a dealer's failure by reason of fraud, bankruptcy or insolvency.²¹⁹ The organization is also promulgating a code of ethics as well as advertising

216. *Id.* at § 14(g).

217. *See id.* at § 352-c.

218. *PSI Hearings, supra* note 1, at 229-41.

219. *Id.* As noted, the ICTA, which opposes changes in the federal regulatory scheme to encompass precious metals dealers, has set out a number of proposals for self-regulation of the

guidelines.²²⁰ In testimony before the PSI, Luis Vigdor, Chairman of the ICTA, stated that the establishment of a comprehensive federal regulatory scheme governing precious metals trading, such as those enforced by the SEC and CFTC, would be "inappropriate and unworkable."²²¹ Nevertheless, Mr. Vigdor noted that "it is possible that the industry would accept and support some form of statutory authority for a trade association that would authorize the association to pursue certain consumer protection activities, including enforcement of a reasonable and flexible code of standards."²²² The ICTA's conception of such a statutory approach, however, does not include minimum net capital or other requirements.²²³

The PSI has not yet issued its recommendations on regulation of precious metals trading, although it appears likely that some form of congressional action will be taken. In the interim, other states, notably California and Florida, are likely to follow the lead of New York and attempt to regulate metals dealers at the state level. Such a result, however, as noted, could impose conflicting and contradictory requirements on these firms, creating a largely unworkable situation.

VII. CONCLUSION

The recent wave of precious metals scandals proves once again the resilience and persistence of the "boiler room" operators and fraud perpetrators, who continually demonstrate an uncanny ability to seek out popular forms of unregulated investment activity. In contrast to the securities and commodities industries, however, attempts to regulate precious metals firms cannot easily be categorized or even identified in such a way as to permit creation of a federal regulatory scheme. The formidable task facing Congress, the precious metals industry and the regulatory agencies, therefore, is the establishment of an approach which will assure customer protection without unduly stifling legitimate commercial enterprises.

precious metals industry. These would include insurance against customer losses, as well as advertising guidelines and education programs for government officials charged with enforcement of antifraud statutes. The industry opposes federal regulation based upon its argument that such an approach would be unworkable and ineffective in practice, since registration is unlikely to deter or prevent "boiler room" operations.

220. *Id.* at 235-36. The proposed Code of Ethics and Standards would likely include disclosure requirements regarding terms, conditions and risk of a particular transaction, segregation of inventory necessary to cover delivery, required entry into covering transactions, a time limitation on delivery delays, the availability of sight draft procedures at the option of the customer, storage generally at an independent depository, internal accounting requirements and periodic outside audits. These measures are substantially similar to many employed presently by the NASD and NFA with respect to firms registered with the SEC and CFTC.

221. *Id.* at 240. See also *Precious Metals Executive Opposes Regulatory Action*, American Metal Market, Mar. 22, 1984, at 1.

222. *PSI Hearings*, *supra* note 1, at 240.

223. *Id.* at 239. Mr. Vigdor stated with respect to IGBE and Bullion Reserve that "we also doubt that a minimum capital requirement would have been relevant in either of those cases, since these firms likely had sufficient access to start-up funds to meet any reasonable capital requirement, and any plausible requirement would have been dwarfed by the amounts of reported investor losses in each case." *Id.*

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