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Kicking the Bucket Shop: The Model State Commodity Code as the Latest Weapon in the State Administrator's Anti-Fraud Arsenal

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KICKING THE BUCKET SHOP: THE MODEL STATE COMMODITY CODE AS THE LATEST WEAPON IN THE STATE ADMINISTRATOR'S ANTI-FRAUD ARSENAL

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In April 1985, the North American Securities Administrators Association adopted the Model State Commodity Code. The Model Code is designed to regulate off-exchange futures and options contracts, forward contracts, and other contracts for the sale of physical commodities but not exchange-traded commodity futures contracts or exchange-traded commodity options. Specifically, the Model Code addresses the problem of boiler-rooms and bucket shops—that is, the fraudulent sale of commodities to the investing public. The Model Code is meant to provide states that enact the Model Code with a vehicle to fill perceived enforcement gaps left by federal and state commodities and securities laws.

The Model Code was adopted by NASAA to serve dual objectives—to prohibit fraud and to permit the continued development of legitimate business. Like any powerful weapon, the Model Code must be used against its intended targets with restraint and discretion so as not to harm the legitimate commodities industry.

This article will analyze the substantive provisions of the Model Code as adopted, discussing prior drafts of the Model Code and federal commodities laws where relevant to an understanding of the Model Code and its impact on legitimate commodities businesses.

I. INTRODUCTION

The North American Securities Administrators Association ("NASAA")[1] adopted the Model State Commodity Code (the "Model Code")[2] at its annual spring meeting in April 1985.[3] Generally, the Model Code applies to

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1. NASAA is an umbrella organization which represents all state and provincial securities administrators. The 50 state administrators, together with administrators in Puerto Rico and the District of Columbia, administer and enforce their individual jurisdictions' securities laws. *See generally* North American Securities Administrators Association, Inc., Protecting the Integrity and Efficiency of the Capital Markets (available from NASAA, 2930 S.W. Wanamaker Drive, Suite 5, Topeka, Kansas 66614).

2. Model State Commodity Code (North American Securities Administrators Association, Inc. 1985), *reprinted in* 17 SEC. REG. & LAW REP. 731 (April 19, 1985) [hereinafter cited as *Model Code*].

3. *Id.* NASAA's adoption of the Model Code does not have the force of law in any state. Adoption by NASAA is non-binding on the states and their respective administrators. Individual jurisdictions, however, may enact the Model Code, in whole or in part, by statute

off-exchange futures and options contracts, forward contracts, and other contracts for the sale of physical commodities—that is, "any form of agreement to purchase or sell commodities primarily for investment or speculative purposes."[4] The Model Code does not apply to exchange-traded commodity futures contracts and exchange-traded options which are governed by federal commodities laws—the Commodity Exchange Act, as amended (the "CEAct"),[5] and the regulations of the Commodity Futures Trading Commission (the "CFTC").[6] The Model Code is intended to complement the federal commodities laws by regulating those commodity transactions which are not within the exclusive jurisdiction of the federal government.[7] In addition, the Model Code provides a second or back-up mechanism for regulating certain commodity-related activities that are also unlawful under the CEAct.

In adopting the Futures Trading Act of 1982,[8] Congress paved the way for states to enact substantive laws and regulations affecting commodity transactions.[9] Prior to the 1982 CFTC reauthorization,[10] the scope of the

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or in any other lawful manner. As of the time of this writing, New Mexico and Missouri have enacted versions of the Model Code. *See* N.M. STAT. ANN. §§ 58-13A-1 to 58-13A-21 (effective June 14, 1985); Mo. REV. STAT. §§ 409.800-.863 (effective September 28, 1985).

4. *Model Code, supra* note 2, Preamble.

5. Commodity Exchange Act, 7 U.S.C. §§ 1-26 (1982) [hereinafter cited as *CEAct*].

6. *See* 17 C.F.R. Parts 1-190 (1985) (CFTC regulations). The CFTC was established to administer the CEAct by the Commodity Futures Trading Commission Act of 1974, Pub. L. No. 93-463, 88 Stat. 1389 (codified as amended at 7 U.S.C. §§ 1-26 (1982)). The CFTC replaced the Commodity Exchange Commission and the Commodity Exchange Authority (part of the Department of Agriculture) and took over certain responsibilities of the Secretary of Agriculture. 1 COMM. FUT. L. REP. (CCH) ¶ 121 (March 1982).

7. *Model Code, supra* note 2, Preamble.

8. Pub. L. No. 97-444, 96 Stat. 2294 (1982) (codified at 7 U.S.C. §§ 1-26 (1982)).

9. *See* Futures Trading Act of 1982, Pub. L. No. 97-444, 96 Stat. 2294, § 229 (1982) (adding Section 12(e) to CEAct). Section 12(e) of the CEAct provides:

> Nothing in [the CEAct] shall supersede or preempt—
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> (1) criminal prosecution under any Federal criminal statute;
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> (2) the application of any Federal or State statute, including any rule or regulation thereunder, to any transaction in or involving any commodity, product, right, service, or interest (A) that is not conducted on or subject to the rules of a contract market, or (B) (except as otherwise specified by the [CFTC] by rule or regulation) that is not conducted on or subject to the rules of any board of trade, exchange, or market located outside the United States, its territories or possessions, or (C) that is not subject to regulation by the [CFTC] under [Section 4c or 19 of the CEAct]; or
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> (3) the application of any Federal or State statute, including any rule or regulation thereunder, to any person required to be registered or designated under this chapter who shall fail or refuse to obtain such registration or designation.
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> The [CFTC] may refer any transaction or matter subject to such other Federal or State statutes to any department or agency administering such statutes for such investigation, action, or proceedings as that department or agency shall deem appropriate.

7 U.S.C. § 16(e) (1982).

10. *See* 7 U.S.C. § 16(d) (1982). Section 12(d) of the CEAct authorizes the appropriation of money needed by the CFTC to administer the CEAct for a specified period of time. *Id.* The

CFTC's exclusive jurisdiction under the CEAct was unclear. Section 2(a)(1) of the CEAct sets forth the scope of the CFTC's regulatory power and provides that:

> the [CFTC] shall have exclusive jurisdiction . . . with respect to accounts, agreements (including any transaction which is of the character of, or is commonly known to the trade as, an 'option' . . .), and transactions involving contracts of sale of a commodity for future delivery traded or executed on a contract market designated pursuant to Section 5 of [the] Act or any other board of trade . . . and transactions subject to regulation by the [CFTC] pursuant to Section 19 of [the CEAct]. . . .[11]

The exclusive jurisdiction clause, coupled with the broad definition of "commodity" contained in Section 2(a)(1) of the CEAct,[12] undercut state regulators' authority to proceed against the sellers of fraudulent commodity investments. State regulators questioned whether they could apply state laws to transactions which might be characterized as off-exchange futures or whether such transactions fell within the purview of the CFTC's exclusive jurisdiction.

Pursuant to Section 12(e)(2) of the CEAct, however, the states are now expressly empowered to prohibit under their own laws those commodity transactions not permitted by the CEAct and CFTC regulations promulgated under the CEAct.[13] In addition, Section 12(e)(3) of the CEAct empowers the states to proceed through their own courts and administrative bodies against any person required to be registered or designated under the CEAct who fails or refuses to obtain such registration or designation.[14]

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reauthorization process in 1982 culminated in adoption of the Futures Trading Act of 1982 which, among other things, extended the authorization of appropriations through September 30, 1986.

11. 7 U.S.C. § 2 (1982). Pursuant to the CEAct, the CFTC has exclusive jurisdiction over United States exchange-traded futures and options contracts and certain foreign exchange-traded futures and options contracts. *Id.* In addition, the CFTC has exclusive jurisdiction over those leverage contracts that are regulated by the CFTC pursuant to § 19 of the CEAct. 7 U.S.C. § 23 (1982). The CFTC has exercised its authority over leverage contracts that extend over more than 10 years. *See* CFTC Regulation Part 31, 17 C.F.R. Part 31 (1985). The Office of the General Counsel of the CFTC has issued its interpretation that certain leverage contracts of less than 10 years' duration may be off-exchange futures contracts. Interpretation of CFTC Office of the General Counsel on the Regulation of Leverage Transactions and Other Off-Exchange Future Delivery Type Instruments, 50 Fed. Reg. 11,656 (1985). *See generally* 1 T. Russo, Regulation of the Commodities Futures and Options Markets §§ 10.01-.78 (1983) (regarding the scope of the CFTC's jurisdiction).

12. 7 U.S.C. § 2(a)(1)(a) (1982). Section 2(a)(1)(a) of the CEAct defines "commodity" as "wheat, cotton, rice, corn, oats, barley, rye, flaxseed, grain, sorghums, mill feeds, butter, eggs, Solanum tuberosum (Irish potatoes), wool, wool tops, fats and oils . . . , cottonseed meal, cottonseed, peanuts, soybeans, soybean meal, livestock, livestock products, and frozen concentrated orange juice, and all other goods and articles, except onions . . . and all services, rights, and interests in which contracts for future delivery are presently or in the future dealt in." *Id.*

13. *See supra* note 9 (Section 12(e) of CEAct).

14. *Id.*

Generally, commodity-related fraud involves unscrupulous boiler-room and bucket shop operators who prey on the investing public, selling nonexistent or worthless gems, metals, oil and gas rights, and other commodities over the phone or by mail.[15] Before customers begin to ask for delivery or their money back, the operators go out of business and move to a new location, often several steps ahead of state and federal enforcement officials. The Bullion Reserve of North America and International Gold Bullion Exchange scandals of 1983, among others, highlighted the need for state regulators to address the ongoing problem of commodity fraud.[16]

In early 1984, the NASAA Commodities Committee (the "NASAA Committee") began drafting a model statute which would enable the states to combat commodity fraud effectively. Many fraudulent commodity investments involve the sale of securities as that term is defined by state and federal law[17] and thus their unregistered sale is illegal under existing state and federal securities legislation.[18] In addition, fraud in retail transactions is illegal under the laws of all states[19] and some states already have statutes

15. Boiler-room operators employ high-pressure sales tactics, usually at random and over the telephone, to sell commodities at prices not commensurate with their value or risk. Brokers operating bucket shops accept orders to buy and sell commodities but do not execute the orders. Instead, the orders are "bucketed" (*i.e.*, discarded), and no commodities are actually bought or sold on behalf of the customers.

16. Bullion Reserve of North America ("Bullion Reserve") and International Gold Bullion Exchange ("IGBE") both utilized conventional advertising rather than unsolicited telephone promotions. The companies sold precious metals to customers for cash at full market price. Bullion Reserve and IGBE issued certificates representing each customer's ownership of gold allegedly purchased on the customer's behalf and stored in the companies' vaults for safekeeping. Customers were promised that they could withdraw their gold whenever they so desired.

Unfortunately for the 50,000 investors who lost a total of approximately $100 million, Bullion Reserve and IGBE bucketed many orders, using the cash to speculate in other ventures rather than to purchase gold for their customers. When gold prices were flat or falling, few customers wanted to withdraw their gold, making it easy for the companies to divert customer funds to other projects in the expectation that gold could be purchased to cover customers' withdrawals at a later date for a cheaper price. When prices rose in August 1983, Bullion Reserve and IGBE were unable to meet their customers' demands for gold. In both instances, when the vaults were opened, virtually no gold was found. The Financial Times, Nov. 18, 1983, at 7.

17. *See* Securities Act of 1933 § 2(1), 15 U.S.C. § 77(b)(1) (1982). Section 2(1) defines security to include an investment contract. *Id.* Generally, state Blue Sky laws define security similarly. 1 BLUE SKY L. REP. (CCH) 1611 (March 1985); *see infra* note 50 (state Blue Sky laws). An investment contract is a scheme whereby a person invests money in a common enterprise with an expectation of profit to be earned solely from the efforts of others. S.E.C. v. W.J. Howey Co., 328 U.S. 293 (1946). Operations like Bullion Reserve may involve the sale of an investment contract because if gold is not purchased and stored on the customers' behalf as promised, the customers are, in fact, relying for profit not on the value of gold but rather on the seller's ability to cover his obligation to deliver. *See supra* note 16 (discussing Bullion Reserve scam).

18. *See* Securities Act of 1933 § 5, 15 U.S.C. § 77e (1982) (federal statute prohibiting sale of unregistered securities); *infra* note 50 (state Blue Sky laws).

19. *E.g.*, N.Y. GEN. BUS. LAW § 349 (McKinney Supp. 1984-1985) (prohibiting deceptive

specifically outlawing bucket shops.[20] The NASAA Committee determined, nevertheless, that such legislation had proven ineffective against the purveyors of fraudulent commodity investments.[21] The NASAA Committee wanted an expedited enforcement mechanism in order to put bucket shops out of business before they defraud the public.

The drafters of the Model Code wanted to prohibit those transactions which had been fraught with retail customer abuses without interfering with legitimate commodity business.[22] The Model Code, if adopted by the various states as drafted, would be a substantial step in that direction because it would achieve uniformity among states with respect to the regulation of commodities transactions. The uniformity provided by a widely adopted Model Code will facilitate legitimate interstate business which could be crippled by a patchwork of inconsistent state regulations. Even if a legitimate businessman sought to comply with inconsistent provisions, the administrative and economic burden could often prove prohibitive.

The NASAA Committee released two drafts of the Model Code for public comment. The first public draft was released on May 1, 1984[23] and the second public draft was released on September 4, 1984.[24] CFTC and National Futures Association staff assisted the NASAA Committee in the drafting process.[25] In addition, the NASAA Committee specifically sought comments from the commodities industry and trade groups to help insure that the Model Code would not unduly interfere with legitimate business.[26] Members of the NASAA Committee met on several occasions with industry members and representatives to foster a spirit of cooperation.[27]

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acts or practices in consumer transactions); N.Y. GEN. BUS. LAW § 352-c (McKinney 1984) (prohibiting deceptive acts or practices in sale of securities and commodities).

20. *E.g.*, N.Y. GEN. BUS. LAW §§ 351 to 351-e (McKinney 1968 & Supp. 1984-1985).

21. Generally, under state securities and anti-fraud statutes, action may be taken against unscrupulous sellers only when it is too late, that is, after the sellers have defrauded the public. In addition, resources available to investigate and bring enforcement proceedings with respect to commodity-related investment programs are limited. At the federal level, the Securities Exchange Commission ("SEC") has taken the position that the sale of a physical commodity is not the sale of a security within the meaning of the Securities Act of 1933. The Financial Times, Nov. 18, 1983, at 7. As with state agencies the SEC may take action only after the public has been defrauded and it is discovered that the sale of a security, rather than the sale of any physicial commodity, occurred. *See supra* note 17 (discussing characterization of fraudulent commodity investments as securities).

22. Letter from NASAA Committee to Interested Persons (May 1, 1984) (accompanying release of first draft of Model Code for public comment).

23. Model State Commodity Code (North American Securities Administrators Association, Inc., Proposed Draft May 1, 1984) [hereinafter cited as *First Draft*].

24. Model State Commodity Code (North American Securities Administrators Association, Inc., Committee Draft 3 September 4, 1984) [hereinafter cited as *Second Draft*]. The NASAA Committee's second draft was not publicly released.

25. Letter from NASAA Committee, *supra* note 22.

26. *Id.*

27. Representatives from the NASAA Committee, the CFTC, and the National Futures Association met with industry representatives in New York City on June 14 and 15, 1984 and again on February 26, 1985. In addition, on August 10, 1984, industry representatives were

The Model Code, as finally adopted, is comprised of four sections:

1. A preamble which sets forth the purposes of the Model Code and which contains a section-by-section overview of the Model Code,[28]
2. Part I which contains the Model Code's substantive prohibitions,[29]
3. Part II which contains the Model Code's administration and enforcement provisions,[30] and
4. Part III which contains a scheme pursuant to which a state may register and license commodity broker-dealers.[31]

II. THE MODEL CODE'S REGULATORY APPROACH—THE SECTION 1.02 BAN

The drafters of the Model Code were not content simply to identify and regulate those commodity transactions which had involved significant cus-

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permitted to attend a NASAA Committee meeting at Amelia Island Plantation, Florida. The author attended these meetings. The legitimate commodities industry has recognized that commodity-related scams harm their business as well as the public. Scandals like Bullion Reserve and IGBE undermine public confidence in reputable commodity investment programs. *See supra* note 16 (describing Bullion Reserve and IGBE scams).

28. *Model Code, supra* note 2, Preamble.

29. *Id.* §§ 1.01-.09.

30. *Id.* §§ 2.01-.12. Part II of the Model Code provides a state administrator with broad investigatory and enforcement powers. *Id.* Section 2.01(c) provides the administrator with the power to administer oaths, to subpoena witnesses, to take evidence, and to require the production of business records. *Id.* § 2.01(c).

Section 2.02(a) provides that the administrator may issue a cease and desist order, impose a civil penalty, or initiate various legal proceedings specified in § 2.02(b), or take disciplinary action against state-registered commodity broker-dealers pursuant to § 3.08. *Id.* §§ 2.02(a), 2.02(b), 3.08. The administrator is permitted to act under § 2.02, even prior to any investigation, if the administrator believes that any person has engaged or is about to engage in any act or practice constituting a violation of the Model Code. *Id.* § 2.02. In practical terms, § 2.02 permits an administrator to issue a cease and desist order, putting an operator out of business, based on little more than a newspaper advertisement. *Id.* While a protracted discussion of the administration and enforcement provisions of the Model Code is beyond the scope of this article, the extremely streamlined procedures for enforcing the Model Code's substantive provisions merit careful attention. These broad civil procedures could be utilized by an administrator hostile to the commodities industry to discourage legitimate commodities business. Such a course would be inconsistent with the intent of the NASAA Committee. Letter from NASAA Committee, *supra* note 22.

Section 2.04 of the Model Code also provides criminal penalties for any person who willfully violates any provision of the Model Code, or any rule or order issued by an administrator pursuant thereto. Model Code, *supra* note 2, § 2.04. A person convicted of violating a provision of the Model Code may be fined not more than $20,000 or imprisoned for not more than 10 years, or both, for each violation. *Id.* A person convicted of violating a rule or order issued by an administrator may be fined, but not imprisoned, if he proves he had no knowledge of the rule or order. *Id.*

31. *Model Code, supra* note 2, §§ 3.01-.08.

tomer abuses in the past. The NASAA Committee feared that if they prohibited only certain discrete transactions, sellers of fraudulent investments simply would invent new schemes tailored to avoid the application of the Model Code. Thus, the Model Code's regulatory approach is to ban all commodity transactions except those specifically exempted.[32]

The core of Part I of the Model Code is Section 1.02 which prohibits the sale or purchase of, or offer to sell or purchase, any commodity contract or commmodity option.[33] Various legitimate transactions are then excluded from the general ban.[34]

Section 1.02 states that:

> Except as otherwise provided . . . no person shall sell or purchase or offer to sell or purchase any commodity under any commodity contract or under any commodity option or offer to enter into or enter into as seller or purchaser any commodity contract or any commodity option.[35]

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32. *Id.*, §§ 1.02-.04. The NASAA Committee rejected two approaches to solving the problems highlighted by the Bullion Reserve and IGBE scandals which commentators on the first public draft had suggested as alternatives to the general ban. *See supra* note 16 (describing IGBE and Bullion Reserve scandals).

The NASAA Committee rejected the suggestion that it regulate only precious metals transactions. This approach was embodied in a bill drafted by the Attorney General of New York. Attorney General's Legislative Program, An Act to Amend the General Business Law, In Relation to the Sale of Precious Metals to the Public (1983-84). That bill would have required that any person selling specific precious metals in a transaction not subject to CFTC regulation (i.e., not a futures contract, an exchange-traded or dealer option contract, or a 10-year or longer leverage contract) either deliver the precious metals to the purchaser within five business days of the sale or provide for segregation and maintenance of the precious metals or other specific property in an amount equal to the value of the precious metals, for the benefit of the purchaser, at a bank with a minimum combined capital and surplus of $50 million or a bullion dealer with a minimum net worth of $50 million. *Id.* The NASAA Committee believed that such a bill was inadequate because boiler-room operators would simply substitute another commodity for precious metals to avoid the law.

The NASAA Committee also rejected the suggestion that it regulate commodities transactions by requiring any person involved in commodity-related transactions to register with the state administrator. Part III of the Model Code permits commodity broker-dealers and commodity sales representatives to register and obtain licenses and thereby become exempt persons under § 1.03. *Model Code, supra* note 2, §§ 1.03, 3.01-.08. However, the Model Code is more than a simple registration statute.

New York has adopted a registration statute pursuant to which any person acting as a commodity broker-dealer, commodity salesperson, or commodity investment advisor who is not registered with the state or federal government and who is not a member of certain self-regulatory organizations is required to register with the attorney general. N.Y. GEN. BUS. LAW § 359-3(14) (McKinney Special Pamphlet 1984 Laws) (enacted August 5, 1984).

33. *Model Code, supra* note 2, § 1.02.

34. Exclusion of legimate transactions from the general ban of § 1.02 is accomplished in two ways under the Model Code—certain transactions are not subject to the Model Code at all by virtue of restrictive definitions contained in § 1.01 while other transactions are not subject to § 1.02 of the Model Code by virtue of exemptions contained in §§ 1.03 and 1.04. *Id.* §§ 1.01, 1.03-.04.

35. *Model Code, supra* note 2, § 1.02.

This provision prohibits the purchase of a commodity contract or option as well as the sale of such a contract or option.[36] Thus, the retail customer as well as his seller is subject to the Model Code's sanctions.[37] This represents a significant departure from most regulatory schemes aimed at protecting the investing public. For example, under the federal securities laws, only the seller of unregistered securities is subject to sanctions.[38]

In the second public draft of the Model Code, Section 1.02 included an absolute ban on leverage contracts, except for those leverage contracts within the CFTC's exclusive jurisdiction.[39] A leverage contract is a standardized contract for the sale of a commodity for deferred delivery which provides for periodic payments toward the purchase price and the payment of finance charges, service charges, and margin.[40] Such contracts are usually settled by offset[41] prior to the time for delivery of the commodity to the purchaser. Because the seller of a leverage contract may offer an investor the opportunity to purchase a substantial amount of a commodity for an initial payment of only a fraction of the total cost, leverage contracts are particularly susceptible to abuse. Leverage contracts are easily characterized as "can't lose" propositions—the unscrupulous seller will assure the investor that the value of the purchased contract will rise at a sufficient rate to pay the outstanding balance of the purchase price and any fees and still generate a profit.[42]

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36. *Id.* The first public draft of the Model Code prohibited only the sale (or offer to sell) of a commodity contract or option. *See First Draft, supra* note 23, § 1.02.

37. *See supra* note 30 (discussing sanctions).

38. *See* Securities Act of 1933 §§ 5 and 12, 15 U.S.C. §§ 77e, 77l (1982). A state administrator should exercise restraint in enforcing the Model Code against innocent purchasers victimized by unscrupulous sellers because the aim of the Model Code is to protect rather than to penalize the investing public. *Model Code, supra* note 2, Preamble.

39. *Second Draft, supra* note 24, § 1.02(a). Leverage contracts of more than 10 years' duration are regulated by the CFTC pursuant to § 19 of the CEAct which gives the CFTC exclusive jurisdiction over such contracts. *See supra* note 11 (exclusive jurisdiction of CFTC).

Section 1.02(a) of the second public draft provided that:

> Except as otherwise provided in Section 1.04(a)(1), [exemption for transactions within the CFTC's exclusive jurisdiction], no person shall offer to enter into, or confirm the execution of, any transaction for the delivery of any commodity under a commodity contract commonly known as a margin account, margin contract, leverage account, or leverage contract, or under any contract, account, arrangement, scheme, or device that serves the same function or functions or is marketed or managed in substantially the same manner as such account or contract.

Second Draft, supra note 24, § 1.02(a). The language of the section was borrowed from § 19 of the CEAct. 7 U.S.C. § 23 (1982). The exemptions discussed in Parts IV and V of this article would not have applied to leverage contracts under § 1.02 of the second public draft.

40. "Margin" is the money that a customer must deposit with his broker to insure the customer's performance of his obligation under the contract. Margin serves as a cash performance bond and not as a partial payment.

41. "Offset" refers to the characteristic provision in leverage contracts that the parties' obligations may be closed out by resale of the contract to the seller prior to the time for delivery. *See generally* 1 T. Russo, Regulation of the Commodities Futures and Options Markets §§ 8.01-.02 (1983) (basic terms and risks of leverage contracts).

42. Legitimate leverage contracts, of course, do serve an economic purpose by facilitating the purchase of commodities suitable for long-term investment, such as precious metals.

The absolute ban on leverage contracts was deleted in the final draft after being criticized for unduly interfering with legitimate business, most notably the interbank foreign currency market.[43] Leverage contracts, because they are commodity contracts as defined by Section 1.01 of the Model Code,[44] are nevertheless prohibited by Section 1.02 unless they fall within the exemptions contained in Sections 1.03 and 1.04.[45]

III. DEFINITIONAL EXCLUSIONS—SECTION 1.01

Section 1.01 contains definitions of key terms used in the Model Code. Some of the definitions serve to narrow the Model Code's otherwise broad scope.

"Commodity" is defined as any agricultural, grain or livestock product or by-product, any metal or mineral, any gem or gemstone, any fuel, any foreign currency, and all other goods, articles, products, or items but not numismatic coins, realty, or art work.[46] In the first public draft of the Model Code, the definition of "commodity" concluded with the catch-all phrase, all other "rights or interests of any kind."[47] Securities might have been "rights" or "interests" and thus "commodities" under the Model Code.[48] At the federal level, commodities and securities are subject to separate regulatory schemes and are within the jurisdiction of separate administrative

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43. *Compare Model Code, supra* note 2, § 1.02 *with Second Draft, supra* note 24, § 1.02. Because the second public draft of the Model Code did not define "leverage contract," the absolute ban on leverage contracts might have been read to prohibit any transaction where one party extends credit to the other to finance the transaction. Foreign currency forward contracts are traded by an informal network of banks and dealers, comprising the so-called "interbank" market, which enter into transactions by telephone and telex and have existing credit relationships. *See also infra* notes 52-56 and accompanying text (jurisdiction of CFTC over foreign currency transactions).

44. *See infra* note 57 (defining commodity contracts under Model Code).

45. *Model Code, supra* note 2, §§ 1.01-.04. Leverage contracts that are longer than 10 years' duration are exempt under § 1.04(a)(1) because they are within the exclusive jurisdiction of the CFTC. *See supra* note 11 and accompanying text. Leverage contracts that are shorter than 10 years' duration may be exempt under § 1.03 if offered by an exempt person. *Model Code, supra* note 2, § 1.03. However, the § 1.03 exemption would be unavailable if a leverage contract of less than 10 years' duration is deemed to be an illegal off-exchange futures contract. *See supra* note 11 (referring to Office of the General Counsel of the CFTC interpretation on leverage contracts of less than 10 years' duration); *infra* notes 71 and 72 and accompanying text (§ 1.03 exemption does not apply to illegal off-exchange futures).

46. *Model Code, supra* note 2, § 1.01(d). The preamble to the Model Code and footnote 2 accompanying § 1.01(d) suggest two alternative definitions of commodity. The alternatives suggested, but not specifically set forth by the NASAA Committee, are (1) a specific list of items and (2) a broad, generic definition followed by an inclusive, but not exhaustive, list of items. *Id.* Preamble and § 1.01(d) note 2.

47. *First Draft, supra* note 23, § 1.01(e). The definition of commodity in the first public draft included "government securities" as well as traditional commodity items and "all rights and interests of any kind." *Id.*

48. Many commentators on the first public draft criticized the inclusion of language in the definition of commodity that would subject securities to regulation under the Model Code. *See, e.g.*, Letter from T.A. Russo to E.C. Anderson (July 23, 1984).

agencies.[49] At the state level, securities presently are subject to regulation under so-called "Blue Sky" laws.[50] Following the federal pattern, the drafters of the Model Code deleted the phrase "rights or interests of any kind" in the second public draft of the Model Code in order to prevent multiple regulation of securities transactions at the state level.[51]

Certain foreign currency transactions are not subject to the CEAct.[52] In 1974, Congress added a provision, often called the "Treasury Amendment," to Section 2(a)(1) of the CEAct that "[n]othing in [the CEAct] shall be deemed to govern or in any way be applicable to transactions in foreign currency."[53] While the scope of the Treasury Amendment is currently the subject of debate,[54] Congress added the provision in response to the Treasury Department's concern that CFTC regulation of foreign exchange trading by

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49. *See* Securities Act of 1933, 15 U.S.C. §§ 771-77aa (1982) (regulation of securities by SEC); Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78kk (1982) (regulation of exchanges, broker-dealers, and reporting companies by SEC); the Investment Advisers Act of 1940, 15 U.S.C. §§ 80b-1 to 80b-21 (1982) (regulation of investment advisers by SEC); Investment Company Act of 1940, 15 U.S.C. §§ 80a-1 to 80a-64 (regulation of investment companies by SEC); *supra* notes 5, 6, 11 (discussing regulation of commodities by CFTC). Prior to 1981, the two agencies battled at the border between their respective jurisdictions, each asserting jurisdiction over territory claimed by the other. In 1981, however, the CFTC and SEC reached an agreement, known as the SEC/CFTC Jurisdictional Accord (the "Accord"), settling their dispute. *See* SEC/CFTC Release No. 853-81 (December 7, 1981). The substance of the Accord was enacted by Congress in the Futures Trading Act of 1982. Pub. L. No. 97-444, 96 Stat. 2294 (1983). *See generally* 1 T. Russo, Regulation of the Commodities Futures and Options Markets §§ 10.22-.26 (1983).

50. *See generally* L. Loss & E. Cowett, Blue Sky Law 3-10 (1985). In 1911, Kansas adopted the first modern statute requiring licensing of broker-dealers and state registration of all securities offerings. *Id.* Such laws were adopted in an effort to eliminate speculative schemes which had no more substance than "a square foot of Kansas blue sky." *Id.*

While most state securities laws require full disclosure similar to the federal securities laws, many also provide for pre-sale review to prevent promotion of fraudulent or worthless issues. These statutes authorize the state securities administrator to apply a "fair, just and equitable" standard in evaluating offerings prior to public sale. *Id.*

51. *See Model Code, supra* note 2, Preamble (definition of "commodity" does not "purport to include a security"). Section 1.08 of the Model Code provides that nothing in the Model Code shall impair the authority of the state administrator under the state's securities law or the application of such law to any securities transaction. *Id.* § 1.08.

52. *See* 7 U.S.C. § 2 (1982). Futures contracts on foreign currencies and options on foreign currencies which are traded on CFTC-designated contract markets are within the CFTC's exclusive jurisdiction. *Id.* Spot and forward contracts for foreign currencies, however, are generally excluded from the CFTC's jurisdiction. *Id. But cf. infra* note 54 (debate over whether certain forward contracts for foreign currency are illegal off-exchange futures contracts). In addition, options on foreign currencies which are traded on a national securities exchange are excluded from the CFTC's jurisdiction. 7 U.S.C. § 6c(f) (1982).

53. Commodity Futures Trading Act of 1974, Pub. L. 93-463, § 201, 88 Stat. 1389, 1395 (codified at 7 U.S.C. § 2).

54. *See Imminent CFTC Interpretation of Exchange Act Amendment Stirs Concern*, Sec. Week, September 16, 1985, at 9. The Office of the General Counsel of the CFTC is planning to issue an interpretative release on the Treasury Amendment to the effect that certain forward contracts for foreign currency sold to non-institutions are off-exchange futures contracts prohibited by the CEAct. *Id.* Industry representatives contend that such an interpretation would be inconsistent with the plain meaning of the Treasury Amendment. *Id.*

banks and dealers in the interbank market would be unnecessary and harmful.[55] Foreign currencies are included in the definition of commodity in the Model Code, however, and thus foreign currency transactions are generally prohibited by the Model Code. Because not all dealers in the interbank foreign currency market are entities which would be exempt under Section 1.03 from the general ban of Section 1.02, some foreign currency transactions in the interbank market could be prohibited by the Model Code.[56] The Model Code should not apply to transactions between institutional participants in the interbank market.

"Commodity contract" is defined in Section 1.01(e) to include any contract for the sale of any commodity for a speculative or investment purpose.[57] The definition contains a presumption of speculative or investment purpose. Sales of commodities for use or consumption by the purchaser are excluded from regulation under the Model Code.[58] The definition of commodity contract also excludes from regulation contracts which provide for

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55. *See* S. REP. No. 1131, 93d Cong., 2d Sess. 49, at 50 (1974). In a letter to the Chairman of the Senate Agriculture Committee, the Treasury Department stated that:

> Virtually all futures trading in foreign currencies in the United States is carried out through an informal network of banks and dealers. This dealer market, which consists primarily of the large banks, has proved highly efficient in serving the needs of international business in hedging the risks that stem from foreign exchange rate movements. The participants in this market are sophisticated and informed institutions, unlike the participants on organized exchanges, which, in some cases, include individuals and small traders who may need to be protected by some form of governmental regulation.

Id. The Treasury Department also expressed concern about the possibility that the CFTC would not have the "expertise" to regulate the foreign currency transactions engaged in by banks and "would confuse an already highly regulated business sector." *Id.*

56. *See supra* notes 52, 54. If a forward contract for a foreign currency is deemed to be an off-exchange futures contract prohibited by the CEAct, rather than a forward contract, the § 1.03 exemption is unavailable. *Id; see also* notes 72-73 and accompanying text.

57. *Model Code, supra* note 2, § 1.01(e). The full text of the definition of "commodity contract" is as follows:"Commodity Contract" means any account, agreement or contract for

> the purchase of sale, primarily for speculation or investment purposes and not for use or consumption by the offeree or purchaser, 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, forward contract, futures contract, installment or margin contract, leverage contract or otherwise. Any commodity contract offered or sold shall, in the absence of evidence to the contrary, be presumed to be offered or sold for speculation or investment purposes. A commodity contract shall not include any contract or agreement which requires, and under which the purchaser receives, within 28 [or other period determined by the state] calendar days from the payment in good funds of any portion of the purchase price, physical delivery of the total amount of each commodity to be purchased under the contract or agreement.

Id.

58. *Id.* The first public draft of the Model Code contained a transaction exemption for the sale of a commodity for consumption by the purchaser. *First Draft, supra* note 23, § 1.04(a). Because such transactions were exempt rather than excluded, the anti-fraud provision of the Model Code would have applied to such transactions. *Cf. infra* text accompanying notes 111-112.

delivery of the purchased commodity within 28 days of payment of any part of the purchase price—that is, so-called cash-and-carry commodity transactions.[59] Cash-and-carry transactions remain unregulated by the Model Code because the risk of fraud is reduced where the buyer takes possession of the purchased commodity rather than receiving only the seller's promise of future delivery.[60]

The definition of "commodity option" in Section 1.01(i) excludes from the Model Code's coverage options traded on national securities exchanges registered with the SEC.[61] The first public draft of the Model Code excluded options traded on CFTC-designated contract markets but did not exclude securities exchange-traded options.[62] No basis exists in this context for distinguishing between securities and commodities exchange-traded options because both are already regulated by the federal government.[63] Therefore, securities exchange-traded options were excluded in the second public draft of the Model Code.

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59. *See supra* note 57 (defining commodity contract under Model Code to exclude cash-and-carry contracts). The cash-and-carry exclusion applies only to transactions which require delivery within 28 days of payment in good funds and in which such delivery actually occurs. *Id.* Thus, inadvertent or unavoidable delay by the seller will subject an otherwise excluded transaction to the Model Code. In addition, full delivery must occur within 28 days of any partial payment. *Id.* Thus, installment sales of commodities are prohibited by the Model Code except to the extent covered by the exemptions contained in Sections 1.03 and 1.04. *Model Code, supra* note 2, §§ 1.03, 1.04.

60. The Office of the General Counsel of the CFTC has stated that a state administrator may determine that physical delivery to a depository constitutes physical delivery for purposes of the cash-and-carry exclusion by analogy to the precious metals transaction exemption contained in § 1.04(a)(2). *See infra* notes 83-92 and accompanying text. CFTC, Office of the General Counsel, Interpretive Letter No. 85-2, note 4 (August 6, 1985), *reprinted in* 2 COMM. FUT. L. REP. (CCH) ¶ 22,673. Such an interpretation, however, would be inconsistent with the unambiguous language of § 1.01(e). *Model Code, supra* note 2, § 1.01(e). In addition, had the NASAA Committee intended such a result, they could have explicitly so provided as they did in § 1.04(a)(2). *Id.* § 1.04(a)(2).

61. *Model Code, supra* note 2, §§ 1.01(i) and 1.04(a). The full definition of "commodity option" is as follows:

> "Commodity Option" means any account, agreement or contract giving a party thereto the right but not the obligation to purchase or sell one or more commodities and/or one or more commodity contracts, whether characterized as an option, privilege, indemnity, bid, offer, put, call, advance guaranty, decline guaranty or otherwise, but shall not include an option traded on a national securities exchange registered with the United States Securities and Exchange Commission.

Id. § 1.01(i). Options traded on CFTC-designated contract markets are excluded from the § 1.02 ban by the § 1.04(a) exemption for transactions within the exclusive jurisdiction of the CFTC. *Id.* § 1.04(a).

62. *First Draft, supra* note 23, § 1.03(a).

63. *See* Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78kk (1982) (national securities exchanges are registered with and regulated by SEC). *See also supra* note 49 (discussing history of the Accord). *Cf. supra* note 52 (options traded on CFTC-designated contract markets are exclusively regulated by the CFTC); *infra* note 82 (such options are exempt under the Model Code pursuant to § 1.04(a)(1)).

IV. THE EXEMPTIONS—SECTIONS 1.03 AND 1.04

The Model Code provides two types of exemption from the Section 1.02 ban—(1) Section 1.03 provides an exemption for transactions offered by certain commodities markets participants and (2) Section 1.04 provides exemptions for certain types of transactions.

A. *Exempt Persons*

Section 1.03 provides that transactions offered by and in which the following persons are either the purchaser or seller are exempt from the Section 1.02 prohibition on commodity transactions:

1. CFTC-registered futures commission merchants, leverage transaction merchants, and their guaranteed affiliates,[64]
2. SEC-registered broker-dealers and their guaranteed affiliates,[65]

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64. *See* 7 U.S.C. § 2 (1982). A futures commission merchant ("FCM") is a person who solicits or accepts orders for the purchase or sale of futures contracts and, in connection therewith, "accepts any money, securities, or property (or extends credit in lieu thereof) to margin, guarantee, or secure" any futures contract resulting therefrom. FCMs (unless exempt) must register with, and are subject to extensive regulation by, the CFTC. 1 T. Russo, Regulation of the Commodities Futures and Options Markets § 4.05 (1983). A leverage transaction merchant ("LTM") is a person who offers or enters into or confirms the execution of leverage contracts as defined by CFTC Regulation § 31.4(w) and, in connection therewith, accepts leverage customer funds as defined by CFTC Regulation § 1.3(pp). 17 C.F.R. §§ 1.3(pp), 31.4(w) (1985). LTMs must register with and are regulated by the CFTC. CFTC Regulations §§ 31.1-.24, 17 C.F.R. §§ 31.1-.24 (1985).

The exemption provided for in § 1.03(a) of the Model Code for FCMs and LTMs applies only to those registered FCMs and LTMs who are required to be so registered. *Model Code, supra* note 2, § 1.03(a). Thus, a person could not register simply to avoid § 1.02. Section 1.03(c) exempts affiliates of FCMs and LTMs whose obligations with respect to the transactions otherwise prohibited by § 1.02 of the Model Code are guaranteed by the affiliated FCM or LTM. *Id.* § 1.03(c). Notably, the § 1.03(c) exemption would not apply to those introducing brokers that are not guaranteed by an FCM. *Id.*

An introducing broker ("IB") is a person who solicits or accepts orders for the purchase or sale of futures contracts and, in connection therewith, "does *not* accept any money, securities, or property (or extend credit in lieu thereof) to margin, guarantee, or secure" any futures contracts resulting therefrom. 7 U.S.C. § 2 (1982) (emphasis added). IBs must register (unless exempt) with, and are subject to extensive regulation by, the CFTC. *See, e.g.*, CFTC Regulation §§ 1.10, 1.12, 1.17, 1.18, 3.12, 17 C.F.R. §§ 1.10, 1.12, 1.17, 1.18, 3.12 (1985). An IB may satisfy the minimum net capital requirement set forth in CFTC Regulation § 1.17 by operating under a guarantee agreement with an FCM which complies with CFTC Regulation § 1.10(j). 17 C.F.R. §§ 1.10(j), 1.17 (1985).

65. *See* Securities Exchange Act of 1934 § 3(a)(4), 15 U.S.C. § 78c(a)(4) (1982). A broker is a "person engaged in the business of effecting transactions in securities for the account of others, but does not include a bank." *Id.* A dealer is a "person engaged in the business of buying and selling securities for his own account, through a broker or otherwise." *Id.* § 3(a)(5), 15 U.S.C. § 78(c)(5) (1982). Generally, securities brokers and dealers are required to register with, and are subject to extensive regulation by, the SEC. *See generally* N. Wolfson, R. Phillips & T. Russo, Regulation of Brokers, Dealers, and Securities Markets 1.01-.02 (1977).

The exemption provided for in § 1.03(b) for securities broker-dealers applies only to those

3. members of CFTC-designated contract markets or their clearing houses,[66]
4. financial institutions,[67]
5. state-registered securities broker-dealers,[68] and
6. state registered commodities broker-dealers and sales representatives.[69]

Although such persons are exempt from the Section 1.02 ban, all of the exempt persons are otherwise subject to extensive state and/or federal regulation.[70] In addition, despite the Section 1.03 exemption, such persons may not offer contracts that are illegal under the CEAct.[71] Because forward contracts are excluded form the CEAct, exempt persons may offer forward contracts but not off-exchange futures contracts.[72]

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registered broker-dealers who are required to be so registered. *Model Code, supra* note 2, § 1.03(b). Section 1.03(c) exempts affiliates of broker-dealers whose obligations with respect to the transactions otherwise prohibited by § 1.02 of the Model Code are guaranteed by the affiliated broker-dealer. *Id.* §§ 1.02, 1.03(c).

66. *See* 7 U.S.C. § 6 (1982). Pursuant to § 4 of the CEAct, futures contract trading, to be lawful, must be conducted on a CFTC-designated contract market. *Id.* The CFTC may designate a board of trade as a contract market if the board of trade satisfies certain conditions and requirements set forth in § 5 of the CEAct. *Id.* § 7. A designated contract market must comply with various requirements set forth in the CEAct and CFTC regulations. *Id.* § 7a. *See generally* 1 T. Russo, Regulation of the Commodities Futures and Options Markets §§ 1-1 to 1-95 (1983). Each contract market has a clearing house which clears all futures contracts executed on the contract market. *Id.* § 2-1. A clearing house interposes itself between the parties to a futures contract, becoming the seller's buyer and the buyer's seller. *See generally id.* §§ 2-1 to 2-25. Contract market and clearing house members occasionally engage in spot and forward physical transactions in connection with their futures and options business. Such transactions are entered into with commercials and facilitate market liquidity and fair pricing.

67. *See Model Code, supra* note 2, § 1.01(j). Section 1.01(j) of the Model Code defines financial institution as "a bank, savings institution or trust company organized under, or supervised pursuant to, the laws of the United States or of any state." *Id.*

68. *See* 1 Blue Sky L. Rep. (CCH) ¶ 2711 (March 1985). State Blue Sky laws generally provide for registration of securities brokers and dealers with the state administrator. *Id.; see also supra* note 50 (discussing state Blue Sky laws). The exemption provided for in § 1.03(f) for securities broker-dealers applies only to those registered broker-dealers who are required to be so registered. *See Model Code, supra* note 2, § 1.03(f).

69. *See Model Code, supra* note 2, §§ 3.01-.08. Part III of the Model Code sets forth a scheme pursuant to which a state may license and regulate commodity broker-dealers and commodity sales representatives. *Id.*

70. *See supra* notes 64-69. Commodity pool operators ("CPOs"), commodity trading advisors ("CTAs"), and associated persons ("APs") of CPOs and CTAs are not included in the list of exempt persons. CPOs, CTAs, and APs, however, are required to register with and are regulated by the CFTC. *See generally* 1 T. Russo, Regulation of the Commodity Futures and Options Markets §§ 5.01-.16 (1983). The Model Code definition of commodity contract, which includes accounts and agreements for the purchase or sale of futures contracts, should not be interpreted to apply to registered or exempt CPOs, CTAs and their APs who operate in compliance with the CEAct and CFTC regulations. *Model Code, supra* note 2, § 1.01(e).

71. *See id.* § 1.03. Section 1.03 of the Model Code concludes with a provision that "[t]he exemption provided by this Section 1.03 shall not apply to any transaction or activity which is prohibited by the [CEAct] or CFTC Rule." *Id.*

72. 7 U.S.C. § 2 (1982). The characterization of an instrument as a forward contract as opposed to an off-exchange futures contract is critical for purposes of determining the

The first public draft of the Model Code did not contain a section corresponding to Section 1.03. Rather, that draft excluded financial institutions from the definition of "person" and, as a result, financial institutions were exempted from all but the anti-fraud provision of the Model Code.[73] In response to criticism that banks were being given an unwarranted competitive advantage over other market participants, the drafters broadened the category of exempt persons.[74]

In the second public draft, which introduced the exempt person concept into the Model Code, it was unclear whether both parties to a commodity transaction were required to be exempt persons in order to remove the transaction from the purview of the Model Code. In the second public draft, the section read: "[t]he prohibition in Section [1.02] . . . shall not apply to any of the following persons."[75] Since both the seller and buyer are subject to Section 1.02, it appeared that only transactions between exempt persons were permitted.[76] This would have prevented exempt persons from offering legitimate commodity-related investments to their customers. The language of the final draft, however, makes it clear that the exemption is transactional, covering transactions where the offeror, which may be either the seller or purchaser, is an exempt person.[77] Thus, exempt persons may offer commodity investments to retail customers without otherwise complying with the Model Code's substantive provisions as long as they do not commit fraud or misappropriate customer funds[78] or violate the CEAct.[79]

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instrument's legality under both the Model Code and the CEAct. The distinction is not always clear, however, and the issue often provokes debate. *Cf. supra* note 54 (discussing controversy between CFTC and industry representatives over characterization of foreign currency contracts).

73. *First Draft, supra* note 23, § 1.01(n). The full definition of "person" in the first draft of the Model Code was as follows:

> "Person" means an individual, a corporation, a partnership, an association, a joint-stock company, a trust where the interests of the beneficiaries are evidenced by a security, an unincorporated organization, a government, or a political subdivision of a government, *but shall not include, except for purposes of Section 1.06 of this chapter, a financial institution* (or any employees, officers or directors thereof acting solely in that capacity).

Id. (emphasis added)

74. Financial institutions compete with other commodity market participants in the purchase and sale of certain commodities such as precious metals and foreign currency. Financial institutions also compete with many of the same market participants for customers, whether in the provision of money market accounts, brokerage, or other retail investment services. Giving financial institutions an advantage in their commodities business might also have given them a competitive edge in other aspects of their business especially in light of the growing trend toward unified financial services businesses.

75. *Second Draft, supra* note 24, § 1.03.

76. *Id.* The customer of the exempt person was not clearly protected by the § 1.03 exemption in the second public draft. *Id.*

77. *Model Code, supra* note 2, § 1.03. Section 1.03 of the Model Code reads in part: "[t]he prohibitions in Section 1.02 of this chapter shall not apply to any transaction *offered by* and in which any of the following persons (or an employee, officer or director thereof acting solely in that capacity) *is the purchaser or seller. . . .*" *Id.* (emphasis added).

78. *See Model Code, supra* note 2, § 1.06.

79. *See supra* notes 71-72 and accompanying text.

B. Exempt Transactions

Section 1.04 of the Model Code provides that certain types of transactions otherwise subject to the Section 1.02 ban are exempt.[80] First, transactions within the exclusive jurisdiction of the CFTC are exempt from the prohibition in Section 1.02 of the Model Code.[81] This exemption is intended to cover exchange-traded futures contracts and options, foreign futures, authorized commodity options, ten-year or longer leverage contracts, and exchange of physical commodities for futures positions.[82]

Second, precious metals[83] transactions which provide for delivery of the purchased metal within seven days of payment and otherwise comply with Section 1.04(a)(2) are also exempt from the prohibition in Section 1.02.[84]

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80. *Model Code, supra* note 2, §§ 1.02, 1.04.

81. *Id.* § 1.04(a)(1). Section 1.04(a)(1) of the Model Code reads as follows: "The prohibitions in Section 1.02 . . . shall not apply to the following: (1) an account, agreement, or transaction within the exclusive jurisdiction of the [CFTC] as granted under the [CEAct]." *Id.* (footnote omitted).

82. *Id.* Preamble. *See supra* note 11 and accompanying text (discussing treatment of 10-year or longer leverage contracts). Originally, it was unclear whether the exemption for transactions within the CFTC's exclusive jurisdiction covered the cash market side of exchange for physicals ("EFP") transactions since the CEAct excludes cash forward contracts from the grant of exclusive jurisdiction to the CFTC. 7 U.S.C. § 2 (1982). Subsequently, however, the NASAA Committee included language in the preamble to the Model Code to clarify that such transactions are intended to be covered by the exemption. *See Model Code, supra* note 2, Preamble. An EFP is a transaction in which one party enters into a spot or forward contract with another party to buy or sell a commodity at a price defined as being a specified amount above or below the price of a specified futures contract that will be exchanged by the parties on a given date. Both parties usually hold futures contracts as a hedge. On the agreed transfer date, the cash commodity is transferred and the parties' futures contracts are exchanged. EFPs are permitted by the CEAct and CFTC regulations as long as they are carried out in accordance with contract market rules approved by the CFTC. CFTC Regulation § 1.38, 17 C.F.R. § 1.38 (1985).

83. *See Model Code, supra* note 2, § 1.01(m). Section 1.01(m) of the Model Code defines precious metal as follows: " 'Precious Metal' means the following in either coin, bullion or other form: (1) silver, (2) gold, (3) platinum, (4) palladium, (5) copper, and (6) such other items as the Administrator may specify by rule, regulation or order." *Id.*

84. *See id.* § 1.04(a)(2). Section 1.04(a)(2), in full, provides that the prohibitions of § 1.02 shall not apply to:

> A commodity contract for the purchase of one or more precious metals which requires, and under which the purchaser receives, within 7 [or other period] calendar days from the payment in good funds of any portion of the purchase price, physical delivery of the quantity of the precious metals purchased by such payment, provided that, for purposes of this paragraph, physical delivery shall be deemed to have occurred if, within such 7 day period, such quantity of precious metals purchased by such payment is delivered (whether in specifically segregated or fungible bulk form) into the possession of a depository (other than the seller) which is either (i) a financial institution, (ii) a depository the warehouse receipts of which are recognized for delivery purposes for any commodity on a contract market designated by the Commodity Futures Trading Commission, (iii) a storage facility licensed or regulated by the United States or any agency thereof, or (iv) a depository designated by the Administrator, and such depository (or other person which itself qualifies as a depository as aforesaid) issues and the purchaser receives, a certificate, document of

Unlike the cash-and-carry exclusion contained in the definition of commodity contract, delivery of the entire amount of the purchased metal is not required upon partial payment.[85] Only partial delivery is required.[86] Also unlike the cash-and-carry exclusion, delivery to the purchaser is not required.[87] Instead, delivery to the purchaser or a qualified depository other than the seller constitutes delivery for purposes of the precious metals transaction exemption.[88] To qualify, a depository must be a financial institution, a depository approved by a CFTC-designated contract market, or a depository licensed by the federal government or any agency thereof or by the government of the adopting state.[89] If delivery is made to a qualified depository and not to the purchaser, the depository must deliver a certificate, document of title, or confirmation to the purchaser.[90] Precious metals held by a qualified depository may be specifically segregated or held in fungible bulk form[91] and

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> title, confirmation or other instrument evidencing that such quantity of precious metals has been delivered to the depository and is being and will continue to be held by the depository on the purchaser's behalf, free and clear of all liens and encumbrances, other than liens of the purchaser, tax liens, liens agreed to by the purchaser, or liens of the depository for fees and expenses, which have previously been disclosed to the purchaser.

Id.

85. *Id.* Section 1.04(a)(2) of the Model Code requires, within 7 days of payment of any portion of the purchase price, "delivery of the quantity of the precious metals purchased by such payment." *Id. Cf. id.* § 1.01(e) (requiring, within 28 days of payment of any portion of the purchase price, delivery of the total amount purchased).

86. *Id.* § 1.04(a)(2).

87. *But cf. supra* note 60 (discussing whether delivery to depository constitutes delivery for purposes of cash-and-carry exclusion).

88. *Model Code, supra* note 2, § 1.04(a)(2). The NASAA Committee included the requirement of a qualified third-party depository to insure that sellers of precious metals actually deposit the metals on behalf of the customer. *But cf.* text following note 97.

89. *Model Code, supra* note 2, § 1.04(a)(2). In the first public draft of the Model Code, the only qualified depositories were financial institutions. *First Draft, supra* note 23, § 1.04(b). The category of qualified depositories was expanded, however, to include depositories approved by a designated contract market or licensed by the federal or state government. *Model Code, supra* note 2, § 1.04(a)(2). Such approved and designated depositories, like financial institutions, are easily identified and are reliable.

90. *Id.* The seller of precious metals may deliver the certificate, document of title, or confirmation to the purchaser only if the seller would itself qualify as a depository, that is, if the seller is a financial institution, a depository approved by a designated contract market, or a depository licensed by the federal or state government. *Id.*

91. *Id.* The exemption for precious metals transactions in the first public draft of the Model Code would not have permitted bulk segregation of precious metals held by a depository. *See infra* note 93. Bulk segregation, however, is an established industry practice in the case of fungible physical commodities. Segregating commodities, especially precious metals, for each individual purchaser would be impractical and costly. Retail purchasers buy precious metals in dollar amounts and not by standard bar size. Usually, a retail purchase in dollars is of a fraction of a bar. The cost of specific segregation would be passed on to customers who would thus suffer without gaining additional protection. Alternatively, purchaser would lose the convenience of being permitted to buy in round dollar amounts.

may be held by the depository subject to certain liens.[92]

The precious metals transaction exemption was much narrower in the first public draft of the Model Code.[93] the NASAA Committee expanded the exemption in an attempt to allow for existing legitimate retail precious metals investment programs.[94] Such programs permit a customer to invest in precious metals without being responsible for storing and insuring the metals and without incurring prohibitive fabrication charges associated with the purchase of less than a standard amount of metals. Yet, in certain respects the Model Code exemption is still narrower than existing legitimate programs. Programs where the seller acts as depository or where the seller itself delivers the certificate, document of title, or confirmation to the purchaser will no longer

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92. *Model Code, supra* note 2, § 1.04(a)(2). The exemption for precious metals transactions in the first public draft of the Model Code required that precious metals held by a depository be free of all liens. *See infra* note 93. While it is necessary to protect the retail customer from exposure to the credit risks of the seller, the seller and the depository must also be permitted to protect themselves from the buyer's lack of creditworthiness. The seller has a legitimate right to a lien on the precious metals for their price. Likewise, the depository has a legitimate right to a possessory lien on stored precious metals for the payment of storage fees which are typically charged to the buyer by the seller separately from the purchase price. Sellers' and warehouse liens traditionally have been recognized by the common law. Such liens also conform to established business practice. *See, e.g.,* Uniform Commercial Code §§ 2-401, 2-702, 1A U.L.A. 131, 348 (1976); Uniform Commercial Code § 7-209, 2A U.L.A. 371 (1977).

93. *See First Draft, supra* note 23, § 1.04(c). Section 1.04(c) of the first public draft of the Model Code exempted transactions involving:

> a commodity contract for the purchase of one or more precious metals on an installment or other deferred payment basis and which does not permit, either by its terms or otherwise, any party thereto to waive or discharge its rights or obligations thereunder (except by performance) by any form of offsetting, liquidation, termination, repurchase, refinancing, or rollover agreement or transaction, and which requires, and under which the purchaser receives, within 7 days of each installment payment, either (i) physical delivery of an amount of the precious metal at least equal in proportion to the total quantity to be purchased as the portion of the total purchase price represented by such installment payment or (ii) a certificate or documents of title issued by a financial institution, or by any other person specified by the [Administrator] by rule or regulation, stating that title to such amount of the precious metal has passed to the purchaser and that such amount of the precious metal has been deposited with, and is being and will continue to be held by, the financial institution or such other person solely for the benefit of the purchaser, free and clear of all interests, liens and encumbrances, except those of the purchaser.

Id.

94. *See supra* notes 89, 91, 92 (detailing changes in precious metals transactions exemption). The exemption for precious metals transactions in the first public draft of the Model Code did not permit "any form of offsetting, liquidation, termination, repurchase, refinancing or rollover agreement." *First Draft, supra* note 23, § 1.04(c). Thus, actual delivery to the purchaser ultimately would have been required in all cases. Such a requirement, however, would result in unnecessarily increased charges to the purchaser reflecting increased delivery expenses, including fabrication charges, incurred by the seller. Commonly, purchasers of precious metals stored at depositories liquidate their investment by reselling to the seller.

be permitted.[95] The problem with precious metals scams, however, is not sellers acting as depositories or issuing certificates.[96] Rather, the problem is sellers with no metal on deposit.[97] Requiring a third-party depository and requiring the depository to deliver some form of confirmation to the purchaser interfere with existing legitimate programs but may not solve the problem—an unscrupulous seller simply will operate outside of the Model Code.

A third type of exempt transaction is any commodity transaction between "commercials."[98] Commercials are "persons engaged in producing, processing, using commercially or handling as merchants" commodities or by-products thereof. The Model Code requires both the seller and purchaser of the commodity contract or option to be commercials.[99]

Section 4c(c) of the CEAct prohibits all option transactions except those which are exempted by that section or by CFTC regulation.[100] CFTC Regulation Section 32.4 exempts option transactions in which the purchaser is "a producer, processor, or commercial user of, or a merchant handling"[101] the underlying commodity. The seller need not be a commercial.[102] The Model Code should not prohibit options which are permitted by CFTC regulation.[103]

The fourth category of exempt transactions is set out in Section 1.04(d) of the Model Code. Section 1.04(d) exempts transactions in which the purchaser is an exempt person under Section 1.03 of the Model Code,[104] an

95. *But cf. supra* note 90 (discussing limited instances where seller may deliver certificate) and text accompanying notes 78-79 (discussing ability of persons exempt under § 1.03 to offer precious metals investments without complying with § 1.04(c)).

96. *See supra* note 16 (discussing Bullion Reserve and IGBE scams).

97. *Id.*

98. *Model Code, supra* note 2, § 1.04(a)(3). The rationale of the commercial exemption is two-fold. First, commercials are sophisticated market participants who do not require protective legislation. Second, transactions between commercials are, generally, legitimate business transactions. The commercial exemption contained in the first public draft of the Model Code did not permit the discharge of contractual obligations by offset. *First Draft, supra* note 23, § 1.04(d). The exemption was revised to permit offset in recognition of the fact that offset is a common, legitimate industry practice. For example, if Englehard sells silver under a forward contract to Kodak and the demand for film subsequently declines, Kodak may take delivery of only a portion of the silver while settling the remainder of the obligation by cash offset.

99. *Model Code, supra* note 2, § 1.04(a)(3).

100. 7 U.S.C. § 6c(c) (1982).

101. 17 C.F.R. § 32.4 (1985). The language in CFTC Regulation Section 32.4 is the same language used to define commercials for purposes of § 1.04(a)(3) of the Model Code. *See supra* text accompanying note 99.

102. 17 C.F.R. § 32.4 (1985).

103. The preamble to the Model Code states that the § 1.04(a)(1) exemption is intended to cover "authorized commodity options." *Model Code, supra* note 2, Preamble. *See supra* notes 61-63 and accompanying text (discussing exemption of authorized commodity options). Since the preamble also refers to exchange-traded options, "authorized commodity options" presumably includes trade and dealer options permitted by CFTC Regulations §§ 32.4 and 32.12. 17 C.F.R. §§ 32.4, 32.12 (1985). *See generally* 1 T. RUSSO, REGULATION OF THE COMMODITIES FUTURES AND OPTIONS MARKETS §§ 7.01-.14 (1983).

104. *See supra* text accompanying notes 64-69 (listing persons exempt under Section 1.03 of Model Code from prohibition on commodity transactions).

insurance company, or an investment company.[105] This exemption, like the exemption for transactions between commercials, is based on the premise that such sophisticated purchasers do not need protective legislation. The inclusion in Section 1.04(d) of those persons exempt under Section 1.03 is necessary despite the Section 1.03 exemption. Section 1.03 requires that the exempt person be the offeror whether the seller or purchaser.[106] Section 1.04(d) augments Section 1.03 by covering the situation where the exempt person is the purchaser but not the offeror.

Finally, the Model Code gives the state administrator broad authority to issue regulations providing for additional transactional exemptions.[107] Although permitting each state to adopt additional exemptions may defeat uniformity, it will allow a state to prevent the unwarranted application of the Model Code to legitimate transactions which are not otherwise covered by existing exemptions.[108]

V. UNREGISTERED OR UNDESIGNATED PERSONS—SECTION 1.05

Section 1.05 of the Model Code provides that it is unlawful for an entity to engage in activities which require CFTC registration or designation without being so registered or designated.[109] This section implements the portion of Section 12(e) of the CEAct which provides that nothing in the CEAct

105. *Model Code, supra* note 2, § 1.04(a)(4). Section 1.04(a)(4) of the Model Code exempts transactions involving:

> a commodity contract under which the offeree or the purchaser is a person referred to in section 1.03 of this chapter, an insurance company, an investment company as defined in the Investment Company Act of 1940, [or an employee pension and profit sharing or benefit plan (other than a self-employed individual retirement plan, or individual retirement account)].

Id. A footnote to the section reads: "The bracketed exemption is modeled on that contained in many states' securities laws. A state may decide this exemption is inappropriate for commodity contracts." *Id.* at n. 8.

106. *Id.* § 1.03. *See supra* note 77 (quoting language of Section 1.03 of Model Code).

107. *Model Code, supra* note 2, § 1.04(b). Section 1.04(b) of the Model Code reads as follows:

> The Administrator may issue rules, regulations or orders prescribing the terms and conditions of all transactions and contracts covered by the provisions of this chapter which are not within the exclusive jurisdiction of the Commodity Futures Trading Commission as granted by the Commodity Exchange Act, exempting any person or transaction from any provision of this chapter conditionally or unconditionally and otherwise implementing the provisions of this chapter for the protection of purchasers *and sellers* of commodities.

Id. (emphasis added).

108. The adoption of various additional transaction exemptions by the states will not seriously undercut the benefits achieved by the Model Code. Individual states will be able to facilitate those transactions which pose little risk of fraud while the Model Code will provide a lowest common denominator for the prudent businessman engaging in legitimate interstate commodities transactions.

109. *Model Code, supra* note 2, § 105. Section 105 of the Model Code reads as follows:

> (a) No person shall engage in a trade or business or otherwise act as a commodity merchant unless such person (1) is registered or temporarily licensed with the Com-

preempts "the application of any . . . State statute . . . to any person required to be registered or designated under [the CEAct] who shall fail or refuse to obtain such registration or designation."[110]

VI. THE ANTI-FRAUD PROVISION—SECTION 1.06

Section 1.06 prohibits fraud and misappropriation in commodity transactions.[111] The anti-fraud provision applies to exempt persons and certain exempt transactions but not to transactions excluded from the Model Code by virtue of the definitions in Section 1.01. Transactions within the CFTC's exclusive jurisdiction and transactions between commercials, that is, transactions exempt pursuant to Sections 1.04(a)(1) and 1.04(a)(3) of the Model Code, are also not subject to the anti-fraud provision.[112]

Section 1.06 of the Model Code provides that no person shall, in connection with the sale of a commodity contract or commodity option:

> (a) cheat or defraud, or attempt to cheat or defraud, any other person or employ any device, scheme or artifice to defraud any other person,
> (b) make any false report, enter any false record, or make any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading,
> (c) engage in any transaction, act, practice or course of business, including, without limitation, any form of advertising or solicitation, which operates or would operate as a fraud or deceit upon any person, or
> (d) misappropriate or convert the funds, security or property of any other person.[113]

The language of paragraphs (a), (b), and (c) of Section 1.06 is patterned after SEC Rule 10b-5.[114] There is no equivalent of Rule 10b-5 in the CEAct.[115]

> modity Futures Trading Commission for each activity constituting such person as a commodity merchant and such registration or temporary license shall not have expired, nor been suspended nor revoked; or (2) is exempt from such registration by virtue of the Commodity Exchange Act or of a CFTC rule.
>
> (b) No board of trade shall trade, or provide a place for the trading of, any commodity contract or commodity option required to be traded on or subject to the rules of a contract market designated by the Commodity Futures Trading Commission unless such board of trade has been so designated for such commodity contract or commodity option and such designation shall not have been vacated, nor suspended nor revoked.

Id.

110. 7 U.S.C. § 16e (1982).

111. *Model Code, supra* note 2, § 1.06.

112. *Id.*

113. *Id.*

114. 17 C.F.R. § 240.10b-5 (1985).

115. *See* 7 U.S.C. §§ 6b, 6c, 6o (1982); 17 C.F.R. §§ 30.02, 31.3, 32.9 (1985). Sections 4b, 4c, and 4o of the CEAct contain substantive anti-fraud provisions, as do CFTC Regulations §§

SEC Rule 10b-5 has spawned an entire body of federal securities law concerning non-disclosure as well as misrepresentation.[116] Misrepresentation, not non-disclosure, is at the heart of commodity fraud. Indiscriminate application to commodity transactions of securities law concepts regarding the duty to disclose would be inappropriate.

VII. CONTROLLING PERSON LIABILITY—SECTION 1.07

Section 1.07 of the Model Code provides that a controlling person will be jointly and severally liable for Model Code violations by the controlled person unless the controlling person proves that he could not have known of the violation with the exercise of reasonable care.[117] In 1982, Congress rejected the CFTC's proposal of the "could not have not known" standard for controlling person liability[118] under the CEAct in favor of Section 13(b) of the CEAct which requires the CFTC to prove that the controlling person did not act in good faith.[119] Congress expressly declined to impose liability on controlling persons for mere negligence or inadvertence or on parent companies for the activities of their separate subsidiaries.[120] Via Section 1.07 of the Model Code, however, the "could not have known" standard may come in through the back door with respect to activities which are prohibited by both the Model Code and the CEAct.

30.02, 31.3, and 32.9. *Id.* Only CFTC Regulation § 31.3 borrows language directly from SEC Rule 10b-5. 17 C.F.R. § 31.3 (1985). In a release announcing the adoption of its three anti-fraud rules, the CFTC stated:

> [The CFTC] feels it would be inappropriate generally to apply the language of Rule 10b-5 to commodity futures or other transactions regulated under the [CEAct], since this might invite an uncritical application of securities law principles and practices.

Adoption of Antifraud Rules, [1975-1977 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 20,049 (CFTC June 17, 1975). In a footnote to the quoted passage, the CFTC stated that it was "particularly concerned with the possibility that determinations reached on commodity cases might misapply nondisclosure-of-information standards taken from securities law decisions". *Id.*

116. *See generally* N. WOLFSON, R. PHILLIPS, AND T. RUSSO, REGULATION OF BROKERS, DEALERS, AND SECURITIES MARKETS 2.04-.20 (1977).

117. *Model Code, supra* note 2, § 1.07.

118. *See* H.R. No. 97-565, 97th Cong., 2d Sess., *reprinted in* 1982 U.S. CODE CONG. & AD. NEWS 3871, 3975.

119. 7 U.S.C. § 13c(b) (1982). Section 13(b) of the CEAct provides:

> Any person who, directly or indirectly, controls any person who has violated any provision of this Act or any of the rules, regulations, or orders issued pursuant to this Act may be held liable for such violation in any action brought by the Commission to the same extent as the controlled person. In such action, the Commission has the burden of proving that the controlling person did not act in good faith or knowingly induced, directly or indirectly, the act or acts constituting the violation.

Id.

120. *See* H.R. No. 97-565, 97th Cong., 2d Sess., *reprinted in* 1982 U.S. CODE CONG. & AD. NEWS 3871, 3975.

VIII. CONCLUSION

The NASAA Committee adopted the Model Code both as a complement to federal commodities laws for transactions not within the exclusive jurisdiction of the CFTC and as a back-up mechanism for state regulation of activities that are already unlawful under the CEAct and that may be unlawful under state securities laws. The Model Code represents a substantial step in the effort to fill perceived enforcement gaps between the federal regulatory network and state law.

The Model Code will provide states enacting it with a powerful anti-fraud statute to use in the fight against boiler-rooms and bucket shops. It is difficult to foresee all possible applications of this type of regulatory scheme, however. The Model Code should be read and enforced in a manner which is consistent with the CEAct, CFTC regulations, and federal policies embodied therein and in a manner which will not inhibit innovation within the legitimate commodities industry.

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