THE
SILVER CRISIS
OF 1980

A REPORT OF THE STAFF OF THE

U.S. SECURITIES AND EXCHANGE COMMISSION

OCTOBER 1982

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U.S. SECURITIES AND EXCHANGE COMMISSION
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INTRODUCTION AND SUMMARY

I. INTRODUCTION

On March 27, 1980, the Securities and Exchange Commission ("Commission") authorized a formal investigation into events relating to the so-called "silver crisis" of 1980. This report embodies the findings and conclusions of the Commission staff with particular emphasis on the role of certain silver traders and of securities industry participants in the events leading to the crisis of 1980 and the impact of those events on the industry. The staff also identified a number of areas in which it recommends that the Commission consider remedial legislation or rulemaking in order to prevent recurrence of the factors that produced the silver crisis.

In its investigation, the staff has received extensive document production and testimony or other statements from many witnesses. The staff has focused its attention on the activities of broker-dealers carrying silver positions for the Hunt family at the time of the crisis and on the actual and potential impact of those activities on the financial condition of those firms. These are the aspects of the crisis most directly related to the Commission's regulatory responsibilities. Except as necessary for an understanding of the matters just described, the staff does not report upon the activities of other silver traders, whether long or short, futures commission merchants not registered with the Commission as broker-dealers or boards of trade designated as contract markets in silver. Moreover, the report does not address the question as to whether the individuals or entities discussed in the report or otherwise involved in the silver crisis violated the federal securities or commodities laws or other relevant laws as they apply to such persons.

The staff that have developed this report are principally personnel in the Division of Enforcement. We have, however, received extensive assistance from the Office of General Counsel, the Division of Corporation Finance, the Office of Chief Accountant, and, most notably, the Division of Market Regulation. The latter division, in addition to providing valuable insights into the financial responsibility requirements, was principally responsible for the portion of this report concerning the role of the New York Stock Exchange.

II. SUMMARY OF EVENTS

For six days late in March 1980 it appeared to government officials, Wall Street and the public at large that a default by a single family on its obligations in the plummeting silver market might seriously disrupt the

U.S. financial system. Various broker-dealers carrying Hunt accounts, among the largest firms in the securities industry, faced the possibility of very substantial losses if this group of customers had failed to make good on its obligations. The potential failure of even one of these firms threatened a financial chain reaction that would have jeopardized commodity clearinghouses and their members, other broker-dealers and their customers and banks, public companies and their stockholders. Although financial catastrophe was ultimately averted, the silver crisis provides a valuable lesson in the fragility and interdependence of the financial structure, and challenges both the private sector and government to respond.

A. Buildup in Hunt Silver Holdings

Although the "silver crisis" first came to public attention on March 27, 1980, the conditions that produced it had been developing since the summer of 1979, when members of the family of the late Texas oilman H.L. Hunt, Jr. and related entities began buying silver in the cash and futures markets in a series of transactions that increased their already substantial position in the metal to more than 195 million ounces by the end of that year.

Meanwhile, the price of silver, which was below $10 per ounce prior to August 1, 1979, rose to $34.45 per ounce by December 31, 1979. It peaked at more than $50 on January 17, 1980. The silver in the Hunts' and related entities' position at the end of 1979, therefore, had an apparent value--assuming such a large position could have been liquidated at or near quoted prices--of approximately $6.6 billion. The magnitude of this holding is noteworthy even apart from its dollar value. Handy & Harman, the leading source of information on the silver market, stated in its 1979 market review that reported silver stocks in the United States, both government and private, totalled only 339.6 million ounces. The same report estimated that total world silver stocks--reported and "conjectural"--totalled 1.3 billion ounces. By either measure, the Hunts' physical silver holdings and futures positions represented an enormous amount of the metal.

The more significant feature of the Hunts' silver position for the financial markets, however, was the degree to which it was leveraged. At the end of 1979, approximately 50% of their position was in the form of long futures contracts on the two principal domestic silver futures exchanges. 1/ Like all futures traders, the Hunts were able to establish and maintain their position by making a margin deposit on each contract that was small in comparison with the value of the silver it controlled. On December 30, 1979, even at the highest margin rates prevailing on either market for silver futures contracts, a $30,000 deposit margined a contract for silver worth more than $170,000. The Hunts also leveraged their physical silver holdings by borrowing against the bullion they owned.

The Hunts were not the only silver market participants to bear the risks associated with their leveraged position. They conducted their silver futures trading and obtained a substantial portion of their bullion financing through approximately 20 futures commission merchants ("FCMs"). As clearing members of the exchanges upon which the Hunts carried their net long silver futures position these firms guaranteed the Hunts' performance of the obligations associated with the contracts. They guaranteed payment (1) of variation margin on a dollar-for-dollar basis if the price of silver declined and (2) of the amount necessary to take delivery of the underlying silver if the contract were allowed to mature. Finally, the FCMs carrying the Hunts' accounts would absorb any losses in the futures position and bullion loans if liquidated without recovery from the Hunts.

Among the FCMs carrying Hunt silver positions at the end of March 1980 were six broker-dealers registered with the Commission and certain of their affiliates. These included Bache Halsey Stuart Shields Inc. ("Bache Halsey"), Merrill Lynch, Pierce, Fenner & Smith, Inc. ("Merrill"), Dean Witter Reynolds, Inc. ("Dean Witter"), A.G. Edwards & Sons, Inc. ("Edwards"), E.F. Hutton & Co. Inc. ("Hutton"), and Paine Webber Jackson & Curtis Inc. ("Paine Webber"). At year-end 1979, these firms carried for the Hunts a total of 17,444 long silver futures and forward contracts covering approximately 87.2 million ounces of silver. Hunt accounts with these firms or their affiliates also held 14.9 million ounces of silver bullion as collateral for $127 million in loans.

1/ Throughout this report, references to silver futures contracts are to contracts for the purchase or sale of 5,000 ounces of silver. Unless otherwise noted, forward positions have been stated in 5,000 ounce units.

The silver in these positions had an apparent value of $3.35 billion at December 31, 1979, but the equity in the Hunt accounts, including securities holdings, physical silver and unrealized gain on silver and other commodities futures positions, was only $1.1 billion. Two of the firms, Bache and Merrill, accounted for 80% of the futures contracts and 87% of the physical silver held at year end by the six brokers.

The $1.1 billion equity in the Hunts' accounts with the six broker-dealers provided a "cushion" against an $11 per ounce, or 31%, price decline in silver in the event of a Hunt default. The protection afforded by this cushion, however, was seriously eroded by the increasing volatility of the silver market and the increasing proportion of the open interest represented by the Hunt position. As the price of silver had risen during the fall of 1979, the volatility of the market had increased as well. In January 1980, the average daily swing in the price of the metal was 9%, up from approximately 1.2% during August 1979. Trading volume and open interest on both principal exchanges had declined substantially. Both the market concentration indicated by the size of the Hunt position and the volatility of the market created a degree of exposure in certain of these firms that was significant in relation to their respective capital resources. This was particularly true at Bache Halsey, whose net capital at the end of February 1980 was approximately $38 million in excess of prescribed minimums.

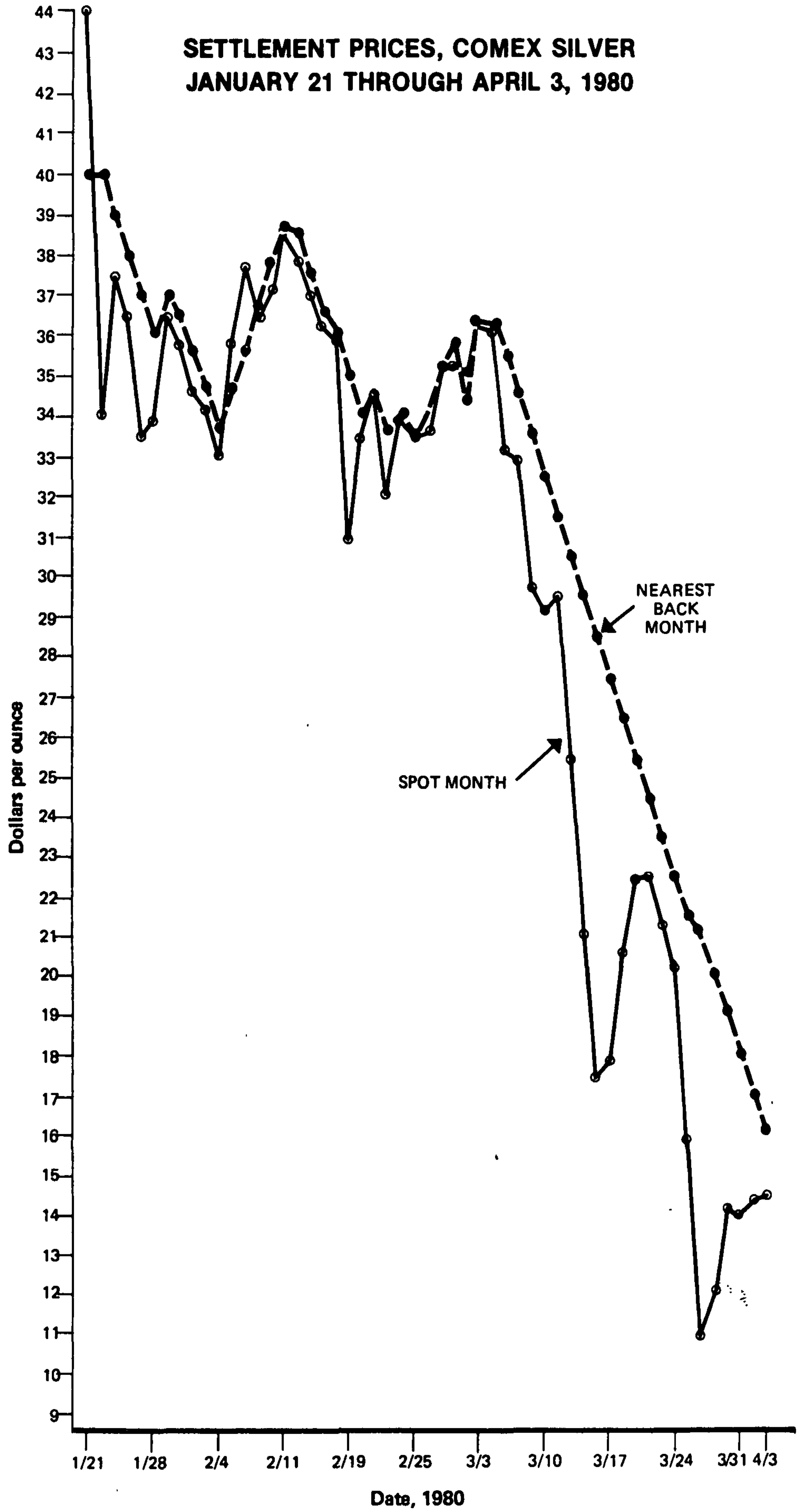
In the firms carrying the largest Hunt silver positions, the decision to assume the risks associated with such subtantial holdings was made at the executive committee level or higher. Certain of these decision makers had available extensive information of a general nature concerning the Hunts' reputation for enormous wealth and involvement in the silver markets. They were, however, without current or specific knowledge of the extent of the Hunts' silver trading activities with other firms, the extent and scheduled maturity of their liabilities, or the amount and availability to the Hunts of cash or other assets necessary to satisfy those obligations. Broker-dealers carrying Hunt positions did not insist on obtaining this data from the Hunts, nor did they seek such information from other firms. As a result, broker-dealers established and continued to carry Hunt positions with no clear idea of the extent of their potential exposure.

B. Market Decline and Hunt Default

As long as silver prices continued to climb, broker-dealers' exposure to the Hunts was not considered a matter of serious concern. As discussed more fully below, however, and as illustrated in the chart on the following page, during the week of January 21, 1980, the bull market in silver reversed. By the end of January spot prices had fallen from approximately \$44 to approximately \$34 per ounce. During February and early March, spot prices ranged between \$31 and \$38.50, but on March 10 the decline resumed, with spot prices falling from \$29.75 to \$10.80 in the 14 business days ending Thursday, March 27. The rapidly declining prices generated margin calls on the Hunts' net long futures position as well as calls for additional bullion deposits to maintain required collateralization ratios on the loans the Hunts had obtained. The Hunts also purchased substantial amounts of silver standing for delivery on maturing contracts in their futures positions and in transactions with bullion dealers maintaining short hedges against physical silver inventories.

As these cash needs developed, the Hunts borrowed heavily from three of the six broker-dealers carrying their positions, from banks, commodity merchant firms and individuals and from Placid Oil Company ("Placid"), a petroleum concern owned by Hunt family trusts. Bache Halsey's parent, Bache Group Inc., through its Bache Halsey Stuart Metal Co. subsidiary, lent the Hunts \$193 million in February, bringing to \$233 million the unhedged bullion loans it had outstanding to family members and a related entity. In March, Merrill Lynch lent \$76 million to Herbert Hunt and, when a Hunt-related entity did not pay \$13 million for delivery on maturing forward contracts, Merrill financed the delivery for it. By March 12, Merrill had \$144 million in silver loans outstanding to the Hunts. On March 14, Hutton renewed a line of credit to the Hunts it had cancelled two months earlier and lent \$87 million to Bunker and \$13 million to Herbert Hunt. Despite these loans, the Hunts were experiencing difficulties obtaining financing elsewhere.

On Thursday, March 13, 1980, International Metals Investment Co., ("IMIC"), a Hunt-related entity with accounts at Merrill, told the firm that it would be unable to meet a \$45 million margin call on its silver position within 24 hours as was its custom because of what it asserted were administrative problems. The following Monday, March 17, the Hunts told Bache that they did not have the cash necessary to meet \$44 million in margin calls in their accounts. IMIC and the Hunts offered to Merrill and Bache bullion and other forms of physical silver instead. Those firms accepted the Hunts' silver in lieu of cash as


SETTLEMENT PRICES, COMEX SILVER
JANUARY 21 THROUGH APRIL 3, 1980
NEAREST BACK MONTH
SPOT MONTH
Dollars per ounce
Date, 1980
1/21
1/28
2/4
2/11
2/19
2/25
3/3
3/10
3/17
3/24
3/31
4/3

margin calls mounted during the ensuing two weeks. The Hunts continued to pay cash to the other four broker-dealers carrying their accounts until March 25 and 26, when they stopped all cash payments and bullion deposits and told the brokers that they were illiquid and thus unable to pay. The Hunts also defaulted on obligations to banks and precious metals dealers. The most notable of these was a $432 million installment due on March 31 toward the purchase of 28.5 million ounces of silver from the Engelhard Minerals & Chemicals Corporation. At the time of their default, the Hunts' overall silver-related obligations, exclusive of margin calls on futures positions, were approximately $1.75 billion.

1. Cash Drain on Brokers

As the market continued to decline, the firms remained obligated to make daily variation margin payments to the clearinghouses, on a dollar-for-dollar basis, for market losses on the Hunts' silver futures positions. At Bache, for example, Hunt family accounts, held approximately 4500 silver futures contracts going into the crisis; in the limit-down market conditions prevailing during the period in which the Hunts were paying no cash to the firm, Bache experienced $22.5 million per day in charges to its clearing account without receiving cash from the Hunts. Merrill also experienced unreimbursed charges to its clearing account in connection with IMIC's 3808-contract net long futures position. Both firms, in addition, received special margin calls from the CBT clearinghouse on March 27.

As long as the Hunts represented that additional bullion or cash would one day be forthcoming, Bache and Merrill chose not to sell out the Hunts' positions, which would have eliminated further exposure to price declines in silver. On March 25, however, Bache sought relief from the Commodity Exchange, Inc. ("Comex") by way of reduced margin requirements in silver. Comex acted on that request on March 26, and reduced margin requirements by one-third, thereby freeing approximately $80 million for Bache and smaller amounts for the other broker-dealers, to use to meet variation margin calls with the clearinghouse.

2. Potential Financial Implications

The Hunts' illiquidity and the continuing decline in silver prices threatened major losses to several of the firms involved. At least as early as March 14, the spot price of silver had fallen to a point that losses in certain of the Hunt accounts exceeded the assets on deposit with the firms. On March 14, the Hunts' accounts as a group at each of Bache, Edwards, Hutton and Paine Webber, had significant unsecured debit balances computed at spot prices. At Merrill Lynch, Hunt family members and related entities' accounts remained approximately $403 million in equity on March 14. In the IMIC account, however, loans and other debit balances on that date exceeded by $34 million the remaining value of IMIC's silver position and other holdings. Merrill Lynch officials testified that based on statements by Herbert Hunt, they believed the Hunt family had committed to stand behind the IMIC account. Until April 1, however, the firm had no written guaranty to that effect.

On March 27, when silver prices reached their low point during the crisis, unsecured debit balances in Hunt accounts, which represented potential losses to these firms if the accounts were liquidated without recovery, had increased substantially notwithstanding the Hunts' cash or collateral deposits in the intervening period. Table I on the following page illustrates the status of Hunt accounts had they been liquidated as of March 14 and March 27 and compares the credit or unsecured debit balances in the accounts with each firm's regulatory capital in excess of prescribed minimums and with the reported pre-tax earnings of each firm or its publicly-held parent for the then-current fiscal year.

The potential losses just described were not identified and addressed at the time they first occurred due to practices prevailing in the industry for valuing futures positions in customers' accounts. Industry practice has been to value these positions at the daily settlement price quoted by the commodity exchange for each maturity in each futures contract in the account. Such a valuation has been used both for purposes of determining whether a margin call is required and whether an account contains an unsecured debit balance required to be charged to regulatory capital. In the "limit-down" trading market prevailing in silver at the time, use of these prices assigned an unrealistically high apparent value to the Hunts' accounts. This occurred because the decline in silver futures prices for contracts in back months had been restrained by exchange-imposed price movement limitations, while the price of the spot contract was permitted to fall freely. May 1980 Comex silver, for example, was permitted to fall only $1 per ounce each day during much of March, whereas spot price

TABLE I
SUMMARY OF HUNT RELATED SILVER HOLDINGS AND EQUITY (DEFICIT) AT BROKER-DEALERS
C.O.B. MARCH 14 AND 27, 1980

	NET LONG (SHORT) SILVER FUTURES AND FORWARDS (Millions of Ounces)	PHYSICAL SILVER (Millions of Ounces)	EQUITY (DEFICIT) ($ MILLIONS) SILVER FUTURES MARKED TO SPOT PRICES	SILVER FUTURES MARKED TO FUTURES PRICES	NET CAPITAL IN EXCESS OF REQUIRED MINIMUMS ($ Millions)	REPORTED PRE-TAX EARNINGS F.Y. 1980 ($ Millions)
MARCH 14						
Bache Halsey	23	- 0 -	(107)	130	38	
Bache Group (includes Bache Halsey)	- 0 -	15	82	82		48
Dean Witter	1.6	- 0 -	6.8	24	68	62
Edwards	.5	- 0 -	(2.8)	2.6	32	29
Hutton	3.4	7.7	66	102	82	156
Merrill (IMIC Account)	19	5.2	(34)	170	175	366
Merrill (Hunt Family)	.005	10.1	290	290		
Merrill (other Hunt-related Entities)	- 0 -	- 0 -	113	113		
Paine Webber (Hunt Family)	3.6	- 0 -	(1.6)	37	64	(16)
Paine Webber (Placid Oil)	- 0 -	- 0 -	64	64		
MARCH 27						
Bache Halsey	18	7.8	(64)	178	52	
Bache Group (includes Bache Halsey)	.75	11.3	(120)	122		48
Dean Witter	1.6	- 0 -	(3.2)	18	68	62
Edwards	.5	- 0 -	(6.1)	.5	32	29
Hutton	3.4	8.7	(9.1)	36	82	156
Merrill (IMIC Account)	16	20.2	(150)	76	360	366
Merrill (Hunt Family)	(.5)	10.2	136	129		
Merrill (other Hunt-related Entities)	.5	.05	73	80		
Paine Webber (Hunt Family)	.9	- 0 -	(24)	(12)	64	(16)
Paine Webber (Placid Oil)	- 0 -	- 0 -	54	54		

assigned during the month to March and, later, April maturities fell without restraint. As a consequence, on March 14, 1980, the spot price of silver on Comex was $10.72 per ounce lower than the average of prices quoted by the exchange for futures contracts in back months. On March 27, this differential reached $13.26 per ounce. Under these circumstances, there was no market at quoted prices for futures contracts in back months, although trades could be accomplished at the spot price. Although the spot price thus represented the true value of the Hunts' silver futures contracts, industry practice permitted broker-dealers to continue to use the unrealistically high back month futures price in computing the margin and net capital rule status of the accounts. Commodity and securities exchanges, as well as the Commission and the CFTC, have been aware of this practice and have acquiesced in its continuation. Valued as they were at back month futures prices, 2/ the aggregate Hunt accounts at each firm appeared to be in equity even at the low point in silver prices during the crisis, and only fell into deficit in certain cases when Hunt futures accounts were liquidated on March 27 and 28 at or near the spot price.

3. Liquidation 3/

On March 25, the Hunts told Bache they had no more cash or silver to deposit with the firm. The next day they conveyed similar advice to Merrill and on March 27 the remaining four broker-dealers learned for the first time that the Hunts could not pay. Bache and Merrill, which had been accepting silver from the Hunts in lieu of cash variation margin, now determined to liquidate Hunt positions. The other four brokers, which had been receiving cash until March 25 or 26, made an immediate decision to sell out the accounts. By the close of business on March 28, Bache, Dean Witter, Edwards, Hutton and Paine Webber had liquidated, at or near spot prices, substantially, all of the Hunts net long futures positions. Hutton liquidated the bullion collateral for its $100 million loan.

2/ Throughout the remainder of this report, prices for futures contracts in back months as opposed to the spot month will for convenience, be referred to simply as "futures prices", while prices for the spot month contract will be called "spot prices".

3/ Unless the context indicates otherwise, the expressions "liquidation" or "sale" as used in this report includes outright sale or hedging of a position, or the closing out of a position in one or more offsetting transactions.

Bache, however, still held approximately 6.9 million ounces of bullion and 118 long futures contracts. Merrill liquidated only 9.9 million ounces of the 24.4 million ounce IMIC position it had carried on March 25.

Several firms liquidated Hunt positions other than silver and the Treasury bills the Hunts had posted as margin. Bache sold out gold, other non-silver futures positions and stock. Paine Webber liquidated cattle and currency futures. Merrill and Dean Witter liquidated substantial securities positions in Herbert and Bunker Hunt's accounts.

As of the close of business on March 28, giving effect on an accrual basis to liquidation trades not yet settled, Hunt-related accounts with broker-dealers appeared approximately as follows:

TABLE II

SUMMARY OF HUNT RELATED SILVER POSITIONS AND EQUITY AT BROKER-DEALERS, C.O.B. MARCH 28, 1980

	SILVER POSITION (Million Ounces)	EQUITY (DEFICIT) (Spot Prices) ($ Million)	EQUITY(DEFICIT) (Futures Prices) ($ Millions)
Bache	7.5	(55)	(55)
Dean Witter	-0-	4.6	4.6
Edwards	-0-	(4)	(4)
Hutton	.05	2	2
Merrill (IMIC Account)	30	(93)	64
Merrill (Hunt Family and other related entities)	10.7	295	295
Paine Webber (Hunt Family)	-0-	(8.4)	(8.4)
Paine Webber (Placid Oil)	-0-	56	56

The Hunts repaid Bache, Hutton, Edwards and Paine Webber over the following month out of the proceeds of transactions that ultimately refinanced the Hunts' silver debts.

The uncertainties associated with the crisis continued over the weekend and into the week of March 31. At Bache, the bullion collateralizing the bank loans that Bache had obtained to fund its lending to the Hunts was insufficient to cover the outstanding balances. Bache had incorrectly announced on March 28 that it had liquidated the Hunt positions without loss, and when it informed its bankers on Sunday, March 30 and Monday, March 31, of a $17 million collateral shortfall, several insisted on repayment and had to be bought out of the credit by the others. This was not accomplished until the early morning hours on April 1. Bache thereafter liquidated remaining bullion in the Hunt accounts and received cash deposits from Placid to settle the Hunts' remaining obligations.

At Merrill the IMIC account was $64 million in equity on March 28 valuing futures contracts remaining in the account at futures prices in accordance with recognized industry practices. At spot prices, however, remaining loans and debit balances exceeded by $83 million all of the collateral in the IMIC account. The Hunt family and related entities, meanwhile, had approximately $295 million in equity in other accounts with the firm. As previously noted, Merrill Lynch management believed that Hunt family members stood behind the IMIC account from the time of its inception, but it was not until March 27 that they sought a written guaranty from the Hunts. Five days later, after initial resistance on the part of the Hunts' attorneys, Bunker and Herbert Hunt executed a personal guaranty that enabled the firm to utilize assets in Hunt family accounts to avoid charging against net capital unsecured debit balances and unmet margin calls in the IMIC account. In reliance on this document, Merrill maintained the IMIC account, without taking charges to capital, until Hunt interests paid off the deficit in connection with the Hunts' refinancing of their silver debts.

4. The Hunts Refinance

As noted in the foregoing section, the Hunts repaid the broker-dealers carrying their positions by refinancing their silver debt. They accomplished this by obtaining bank credit and ultimately, a $1.1 billion loan from a group of banks and through Placid Oil Company. They satisfied their additional $702 million obligation on the silver purchase contract with Engelhard by conveying to that firm interests in petroleum licenses in the Beaufort Sea offshore arctic Canada and permitting that firm to retain silver deposited as collateral and remaining to be delivered under the contract.

III. SUMMARY OF PRINCIPAL FINDINGS

As evident in the foregoing discussion, a principal focus of the staff's investigation has been to establish and evaluate the role in the Hunts' silver activities of broker-dealers regulated by the Commission, the impact and potential impact of those activities on the firms involved, and the sufficiency of the current regulatory scheme. A summary of the staff's conclusions and recommendations follows.

A. Excessive Exposure in Particular Customers' Accounts

The magnitude of the potential losses confronting broker-dealers upon the Hunts' default is directly attributable to decisions by senior management in those firms (1) to permit the Hunts to establish very large commodity futures positions with respect to which the broker-dealers acted as guarantors, and (2) to lend amounts to the Hunts, secured by physical silver, that were very substantial in relation to the capital resources of the firms. These decisions created the potential that default by this single group of customers could jeopardize entire firms.

The exposure associated with the extension of such large amounts of credit to, and role as a guarantor for, a single customer was compounded by the customer's concentration in silver. The size of the Hunt silver position, even at certain individual firms, was so substantial as to endanger liquidity given sufficiently large adverse market movement. The positions of any individual firm, moreover, were only a portion of the total.

To address these problems the staff recommends that the Commission consider establishing a limitation on the extent of broker-dealers' exposure to any one customer or group of related customers, and that it reestablish in the net capital rule a full range of charges for excessive concentration in commodities like those removed from the rule in 1979. The two recommendations are non-duplicative and will, if put into place together, tend to prevent the recurrence of conditions which caused the crisis at the broker-dealers.

B. Inappropriate Valuation of Customer Commodity Accounts

As noted above, industry practice has been to value commodity futures positions in customer accounts at futures prices quoted by commodity exchanges, even when limit-down or up trading conditions have rendered the realizable market value of the position substantially less than that computed at futures prices. Accordingly, industry practice permits broker-dealers to margin and evaluate customer accounts in limit-up or down markets at inflated values, thus permitting unsecured debit balances to develop in customer accounts without appropriate margin calls or net capital charges.

The staff recommends that the Commission initiate discussions with the Commodity Futures Trading Commission ("CFTC") to rectify this situation. One possible solution, since adopted by the Comex in connection with its customer margin requirements, is to require a customer account to be marked to the spot market in price limited trading conditions when price movements occur adverse to the account's open trade positions.

In addition, in certain specific respects, including determination of required levels of margin, the net capital rule expressly incorporates board of trade or clearing organization requirements. This leaves open the possibility that, as apparently occurred in Comex silver on March 26, 1980, commodity exchanges can manipulate margin requirements to benefit particular market participants in derogation of the protections of the net capital rule. The staff believes it is inappropriate for these entities to affect the net capital protections in a manner potentially adverse to the public interest or without appropriate Commission oversight.

C. Inadequate Credit Information

The staff has also observed that broker-dealers permitted the Hunts to establish and maintain large, concentrated positions based on a general belief concerning the extent of the Hunts' financial resources, but without detailed or current information concerning those resources, their availability to satisfy obligations of a particular Hunt account holder or the extent of the Hunts' silver position at other brokers, banks or metals dealers.

The staff believes that current "know your customer" rules, while adequate as tools for ascertaining customer suitability, had not, in their development or present application, been directed to credit decision-making and thus cannot assure that brokers have enough information about customers to make credit judgments. Specifically, "know your customer" rules either do not specify the information to be obtained or are nonmandatory. In either case competitive considerations may result in less than vigorous application of the rule.

The staff believes that if the Commission effectively controls single-customer exposure as proposed above there is no need to strengthen or expand the "know your customer" rules. If, however, as at present, broker-dealers retain the discretion to take on excessively exposed or highly concentrated customer positions, then the Commission should consider establishing mandatory and specific requirements that brokers obtain, review and maintain current information as a basis for reasonable credit decisionmaking.

D. Separately Capitalized Commodity Subsidiaries

One alternative to insulate public securities customers from the risk to broker-dealers associated with the guarantee of highly leveraged commodity positions is the establishment of separately capitalized subsidiaries, whose liabilities are not traceable to the broker-dealer, to handle firms' commodity activities. One broker-dealer involved in the silver crisis has already established such a subsidiary to act as the exchange clearing member for its customers' commodity trading. The staff recommends that the Commission study the advisability of mandating separation of these two functions.

E. Public Disclosure

Before March 27, 1980, there was no public disclosure of the existence or magnitude of the Hunt silver positions or the associated exposure notwithstanding that each of the broker-dealers carrying these positions was at the time a public company itself or the principal subsidiary of a publicly-held parent.

The staff recommends that issuers be reminded of their obligations to timely disclose material corporate information. In addition, issuers should be reminded that material changes in items such as liquidity must be discussed annually and updated quarterly in management's discussion and analysis of financial conditions and results of operations, and that such discussion is subject to the anti-fraud provisions of Rules 10b-5 and 12b-20. The staff also recommends one substantive amendment to Regulation S-K. Finally, the staff suggests that insufficient attention has been given to the proper accounting treatment of the contingent liabilities associated with customer commodity futures transactions.

F. NYSE Surveillance

The staff's inspection of the NYSE's surveillance of its member firms which dealt in silver commodities indicated that with respect to those firms with Hunt and Hunt related accounts, the Exchange failed to obtain sufficient information from its members, failed to verify the information it did receive from its members, and failed to be alert to the potential of a crisis situation as it developed. The staff recommends that the Exchange adopt more formal procedures for the conduct of its member firm surveillance which would include, in cases of potentially serious import, submission to the Exchange of hard copy data from its members, attestation of the accuracy of such data by a senior officer of the member, and field verification of the data. The staff also recommends that the Exchange adopt procedures and supervisory controls to assure the closest possible interrelationship between the individuals performing surveillance and examination operations.

IV. OTHER PUBLIC RESPONSE TO THE SILVER CRISIS

The silver crisis prompted the Congress and a number of other public agencies to inquire into various aspects of these events, particularly as they relate to the Hunts and other substantial longs trading in the silver market in their own names or through offshore financial institutions or other entities. These matters are only incidentally related to the Commission's regulatory responsibilities and accordingly we have not sought to duplicate the activities of other agencies.

In the Congress, several committees have held hearings on the crisis and received testimony or statements from numerous witnesses. These include the Commerce, Consumer and Monetary Affairs Subcommittee of the House Committee on Goverment Operations, chaired by Representative Benjamin Rosenthal, (the "Rosenthal Subcommittee"); the Subcommittee on Agricultural Research and General Legislation of the Senate Committee on Agriculture, Nutrition and Forestry, chaired by Senator Donald W. Stewart, (the "Stewart Subcommittee"); the Senate Committee on Banking, Housing and Urban Affairs, chaired by Senator William Proxmire, (the "Senate Banking Committee"); and the Subcommittee on Conservation, Credit, and Rural Development of the House Committee on Agriculture, chaired by Representative Edward Jones (the "Jones Subcommittee"). Each of these committees has published the volume of its hearings 4/ and the House Committee on Government Operations has published a report

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4/ Silver Prices and the Adequacy of Federal Actions in The Marketplace, 1979-80, 96th Cong., 2d Sess. (Rosenthal Subcommittee, 1980); Price Volatility in the Silver Futures Markets, 96th Cong., 2d Sess. (Stewart Subcommittee, 1980); Margin Requirements for Transactions in Financial Instruments, 96th Cong., 2d Sess. (Senate Banking Committee, 1980); Joint Agency Reports on the Silver Markets, 97th Cong., 1st Sess. (Jones Subcommittee, 1981), and earlier volumes.

of the Rosenthal Subcommittee inquiry. 5/ Former Chairman Harold M. Williams and Commissioner Philip A. Loomis testified at one or more of these hearings and the Commission has furnished information to various committees in response to requests.

The Commodity Futures Trading Commission ("CFTC") has also been actively involved in inquiries concerning the silver crisis. In an investigation styled In the Matter of ACLI International Commodity Services, Inc., et al., the CFTC's Division of Enforcement is inquiring into possible violations of the Commodity Exchange Act by silver market participants. There has been no public dissemination of the results of that investigation.

After the crisis, CFTC's Division of Trading and Markets prepared, with the assistance of Commission staff and staff of the Treasury and the Board of Governors of the Federal Reserve System ("Fed"), a lengthy report concerning these matters pursuant to Section 21 of the Commodity Exchange Act (the "Section 21 Report"). 6/ The portion of the report dealing with silver market activities contains an extensive economic analysis of the behavior of the silver market during 1979 and early 1980, and a review, based largely on reports filed with the CFTC, of the activities of the Hunts and other major longs active in the market. The Section 21 Report does not make use of information gathered in the CFTC or the Commission's enforcement investigations. The Section 21 Report also recounted the responses of the principal domestic commodity exchanges and the CFTC to events in the market, and described the Commission's activity during the crisis period. The Section 21 Report briefly described the position of FCMs and broker-dealers carrying and financing Hunt positions, but did not examine in detail the circumstances leading up to the crisis in these firms nor identify, except by implication, the problems discussed in the foregoing section.

5/ Silver Prices and the Adequacy of Federal Actions in The Marketplace, 1979-80, H.R. Rep. No. 395, 97th Cong., 1st Sess. (1981).

6/ CFTC, Report to the Congress in Response to Section 21 of the Commodity Exchange Act, Pub. L. No. 96-276, 96th Cong., 2d Sess. Section 7, 94 Stat. 542 (June 1, 1980), (May 29, 1981). The CFTC had earlier transmitted to Congress an abbreviated report on the silver situation recounting many of the same events. Report of the Commodity Futures Trading Commission on Recent Developments in the Silver Futures Markets, (April 25, 1980).

The CFTC has also undertaken inquiries in connection with its enforcement investigation, the Section 21 Report and its periodic rule enforcement reviews of commodity exchanges relating to allegations by the Hunts and others that commodity exchange governors acted out of self-interest in voting to raise margin requirements, establish position limits and impose liquidation-only trading in silver during the 1979-80 bull market. These allegations are based on the observation that a number of exchange governors or their employers maintained substantial short positions in the silver futures market during its rapid rise and were thus subject to substantial margin calls to finance their short position as the price continued to climb. On February 8, 1982, CFTC Chairman Philip McB. Johnson sent to Chairman Jack Brooks of the House Government Operations Committee a summary of the results of the CFTC's rule enforcement review. The Johnson letter concluded that the CFTC's inquiry had "failed to uncover evidence that would prove conflicts of interest on the part of any board member." The CFTC's enforcement investigation of these matters continues.

In addition to the foregoing, the Fed recounted generally the makeup of the Hunts' overall silver-related borrowing in its Interim Report on Financial Aspects of the Silver Market Situation in Early 1980, published as a part of the Rosenthal Subcommittee hearings.

While the foregoing summary is not a comprehensive review of the literature of the silver crisis, it does cover the major published material developed by government agencies with respect to these events. None of this material, however, has addressed in detail the aspect of the silver crisis of most concern to the Commission: the genesis and impact of the crisis in the securities industry. 7/ The remainder of this report seeks to address those issues.

7/ The staff in this report makes no findings nor draws any conclusions with respect to violations of the federal securities laws by any person.

PART ONE

AN OVERVIEW OF HUNT FAMILY ACTIVITY IN THE SILVER MARKET

I. INTRODUCTION

Many market participants contributed to the circumstances producing the silver crisis. The principal cause of the financial instability experienced by securities broker-dealers, however, was their relationship with the Hunt family and entities it controlled 8/ and the Hunts' failure to meet margin calls on silver futures positions and make cash or collateral deposits required to maintain loans they had obtained to finance their silver trading activities. It is, accordingly, important to an understanding of the circumstances leading to the crisis and the crisis itself to have some familiarity with the Hunts' overall activity in the silver market, the financial arrangements that accompanied it and the principal features of the Hunt family businesses. This section of the report will, therefore, describe in general terms:

(1) The ownership, structure and business of principal Hunt family enterprises; and

(2) The nature and extent of the Hunts' silver trading activities and the means by which they were financed.

II. THE HUNT FAMILY AND ITS BUSINESSES

Silver trading was one of a number of business activities conducted by Herbert, Bunker and Lamar Hunt (the "Hunt brothers") and members of their family. The nature and extent of the Hunts' other businesses, as well as the ownership arrangements characterizing them, were important to brokers extending commodity credit to the Hunts for silver trading and to the banks that ultimately funded the Hunts' refinancing of their obligations after the silver crisis. In this section of the report, we briefly describe the more important Hunt individual and family enterprises involved directly or indirectly in the silver situation

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8/ It should be emphasized that the "Hunt family" described in this report is the so-called "first family" of the late Haroldson Lafayette Hunt, Jr. (1889-1974) ("H.L. Hunt"), comprised of descendants of his first wife, Lyda Bunker. The first family includes H.L. Hunt's sons Hassie, William Herbert ("Herbert Hunt"), Nelson Bunker ("Bunker Hunt") and Lamar and their respective children and grandchildren, and H.L. Hunt's daughters Margaret Hunt Hill and Carolyn Hunt Schoellkopf and their children and grandchildren. For the sake of convenience and as the context so indicates, this report frequently refers to two or more Hunt family members and Hunt-related entities and their activities collectively, or describes their holdings in the aggregate.

and the trusts and holding companies that own them. A schematic summary of the relationships among family members and related entities involved in the silver market is presented at page 27 below.

A. Individuals

1. Nelson Bunker Hunt ("Bunker Hunt" or "Bunker"), 56, is the fourth child in H.L. Hunt's first family. In addition to his and his wife's interests in silver during early 1980, Bunker owned in his own name and through various partnerships and closely-held corporations, oil, gas, geothermal and coal properties, real estate and ranches, cattle, racehorses, rare coins and art, securities and gold. His personal holdings in April 1980 were valued for purposes of the Placid loan at approximately $2.9 billion. 9/ On April 30, 1980, he had debts and other pending obligations of approximately $679.3 million. At $14.05 per ounce, Bunker's silver position comprised $562 million, or 19%, of his assets. In addition, Bunker is the income beneficiary of the Nelson Bunker Hunt Trust Estate, settled on him by his father in 1935. The Trust Estate holds his interest in, among other things, Placid and Penrod.

Bunker Hunt has four children, each of whom was the record owner of accounts trading silver futures or physical silver. In addition, Bunker's children are the beneficiaries of testamentary trusts (the "Lyda Hunt-Bunker Trusts") settled on them by their grandmother at her death in 1955. These trusts owned a portion of the family's interest in IMIC through a holding company called Profit Investment Co.

9/ Approximately $1.14 billion, or 50% of Bunker's estimated assets were attributed to his 50% share of the Hunt brothers' interests through a general partnership called Hunt International Petroleum Company of Canada ("HIPCO (Can.)") in petroleum licenses in the Beaufort Sea. The valuation used in the text was prepared late in April 1980 in connection with the Placid loan to cover the 80% remaining portion of the Hunts' earlier Beaufort holdings after the settlement with Engelhard Minerals and Chemical Corp. described below at page 41. The true value of the properties, however, appears speculative. On March 27, 1980, a bank to which the properties had been pledged valued the Beaufort Sea properties at a much lower figure, assigning $510 million as the value of the holdings before the Engelhard settlement. Based on this valuation, Bunker's 50% share of the 80% remaining after the Engelhard deal would appear to be worth only $208 million, 82% less than the value assigned for purposes of the Placid loan. His total assets using this valuation would be 40% less than described in the text.

2. William Herbert Hunt ("Herbert Hunt" or "Herbert"), 54, is the fifth child in H.L. Hunt's first family. In April 1980 his holdings, like Bunker's, included energy properties, real estate, securities, rare coins and art and silver and gold positions. In April 1980, his holdings were valued for purposes of the Placid loan at approximately $1.38 billion, 10/ of which $569 million, or 41%, was represented by his silver position. At April 30, 1980, he had debts of $591.5 million. Herbert is the income beneficiary of the William Herbert Hunt Trust Estate, settled on him by his father in 1935. The Trust Estate holds Herbert's interest in, among other things, Placid and Penrod.

Herbert Hunt has five children, four of whom appear to have been the record owner of accounts trading or holding silver. In addition, Herbert's children are the stockholders of Pentad Resources, Inc. (formerly Hunt Holdings), a corporation that engaged in silver trading. Like their cousins in Bunker's family, Herbert's children are also the beneficiaries of trusts settled on them by their grandmother in 1955. These "Lyda Hunt-Herbert Trusts" owned, with the Lyda Hunt-Bunker Trusts described above, the family's interest in IMIC.

3. Lamar Hunt ("Lamar Hunt" or "Lamar"), 49, is the youngest of the six children H.L. Hunt's first family. Although Lamar is best known for his role in founding the American Football League and his ownership of the Kansas City Chiefs professional football team and World Championship Tennis, his personal holdings also include energy, oil and gas properties, real estate, art and securities. In April 1980, his assets were valued for purposes of the Placid loan at $601.9 million, 11/ and at April 30, 1980, he had debts of $40.6 million. Lamar is the income beneficiary of the Lamar Hunt Trust Estate, settled on him by his father in 1935. The Trust Estate holds Lamar's interest in, among other things, Placid and Penrod.

10/ Approximately $568 million, or 41%, of Herbert's estimated assets were attributed to his 25% share of the Beaufort Sea properties described at n. 9, above. As described in the note just cited, however, the March 27 bank evaluation assigned a value to these properties 82% lower than that estimated for the Placid loan. Adjusting the Beaufort properties to trust valuation, Herbert's estimated net worth appears to be approximately $320 million rather than the $790 million calculated in connection with the Placid loan. Using this valuation, Herbert's silver position comprised 62% of his assets.

11/ Lamar's assets included 25% of the Hunt brothers' interests in the Beaufort Sea. Adjusted to the bank valuation described at n. 9, Lamar's assets were $136.6 million.

B. Corporations and Partnerships

1. Hunt Energy Corporation ("Hunt Energy" or "HEC") is a Delaware corporation wholly owned by Hunt Industries, a general partnership of the Lyda Hunt-Bunker and Lyda Hunt-Herbert Trusts and groups of similar trusts settled by H.L. Hunt's first wife on her grandchildren. As of April 28, 1980, Bunker served as chairman of HEC and Herbert and Lamar were vice presidents and directors. Their cousin, Tom Hunt, was president and a director.

While HEC is active in the oil and gas industry, it is important to the present discussion because it provides bookkeeping and accounting services for most of the approximately 150 corporations, partnerships, trusts, joint ventures and foundations that collectively encompass the interests of H.L. Hunt's first family. With respect to the silver positions of Hunt family members and related entities, Hunt Energy personnel maintained books reflecting positions, margin calls and silver financing, handled the receipt and disbursements of funds in the Hunts' bank accounts, and confirmed trades with the various brokers handling silver positions. HEC appears not to have traded silver for its own account.

2. Placid Oil Company ("Placid") is a Delaware corporation owned by the Nelson Bunker (20.9%), William Herbert (21.3%), Lamar (22.1%), Caroline (18.9%), Margaret (8.4%) and Haroldson L. (8.4%) Hunt Trust Estates. Carroll Dan Brown ("Brown"), a non-family petroleum geologist, is president of Placid. Caroline Hunt Schoellkopf and Margaret Hunt Hill, each a vice president and director, are the only family members on the board. 12/ Although Herbert and Bunker Hunt hold no formal positions with the company, they appear to have actively participated in management.

Placid is principally engaged in the domestic and international oil and gas business as a producer, refiner and pipeline owner. It invests in securities and commodities through various subsidiaries. For the 11 months ended December 31, 1979, Placid realized net earnings of $153 million on revenues of $756 million and paid $13.5 million in dividends. Shareholders' equity at the end of 1978, accounting for petroleum reserve assets at cost, was $477 million. Recasting Placid's balance sheet to reflect

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12/ As late as April 5, 1980, Lamar Hunt was a director of Placid, but left that position sometime prior to the closing of the Placid loan.

the current market value of its petroleum reserves, however, Morgan Guaranty Trust Co. of New York ("Morgan Guaranty") on February 8, 1979, estimated its stockholders' equity at $1.08 billion.

3. Hunt Minerals International Limited ("Hunt Minerals") is a Delaware corporation owned in equal proportions by Bunker and Herbert Hunt. Bunker and Herbert are both directors and serve respectively as president and vice president. The company owns royalties on coal properties in South Africa. In 1979 and 1980 Hunt Minerals maintained physical and future silver positions with Bache Group subsidiaries and borrowed from Bache against physical silver collateral.

4. Hunt Holdings, now doing business as Pentad Resources, Inc. (this report will refer to this entity as "Hunt Holdings"), is a Delaware corporation wholly owned by Herbert Hunt's four children. Herbert's son Douglas H. Hunt is president and a director of the firm and his sisters Barbara Hunt Crow and Lyda Bunker Hunt are vice presidents. Hunt Holdings carried silver futures contracts with Merrill Lynch and obtained loans from that firm collateralized by silver during 1979 and 1980. It also owns oil and gas properties and real estate.

5. International Metals Investment Co., Ltd. ("IMIC") is a Bermuda corporation. Its common stock, carrying 50% of the voting power in the corporation, is owned by Profit Investment Company ("Profit"), 13/ a Delaware corporation in turn owned by the Lyda Hunt-Bunker and Lyda Hunt-Herbert Trusts. Two Saudis, Ali Bin Mussalam and Mohammed Aboud Al-Amoudi, owned all of a class of preferred stock carrying the remaining 50% of the voting rights. Herbert and Bunker shared a class of nonvoting preferred stock and served as vice president and director, respectively.

IMIC was created in July 1979. During August and September 1979, it established at Merrill Lynch a long silver futures position totalling approximately 50 million ounces. Thereafter, in "exchange for physicals" transactions and by standing for delivery on its contracts, IMIC obtained

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13/ Herbert, Bunker and Lamar Hunt comprise a majority of the boards of directors of Profit and of the Planet Investment Corporation discussed below at p. 28. Lamar is vice president of each. Lamar and Herbert are co-trustees with their sisters of the two testamentary trusts that own Planet and Profit.

approximately 57.4 million ounces of physical silver and continued to maintain a futures position of an additional 19 million ounces. IMIC's capitalization and its silver trading activities are covered in detail in the section of this report describing the activities at Merrill Lynch.

6. Hunt International Resources Corp. ("HIRCO") is a Delaware corporation owned by Planet Investment Corporation ("Planet"), itself a Delaware corporation owned by the same testamentary trusts that own Profit. HIRCO is the successor to the Great Western United Corporation, in which Herbert and Bunker acquired a majority interest in a 1974 tender offer. In 1979 they sold their interest to Planet, which acquired the remaining public interest in the firm using a $37 million bank loan collateralized by three million ounces of silver. Bunker and Herbert Hunt nevertheless continue as chairman and vice chairman of the board, respectively.

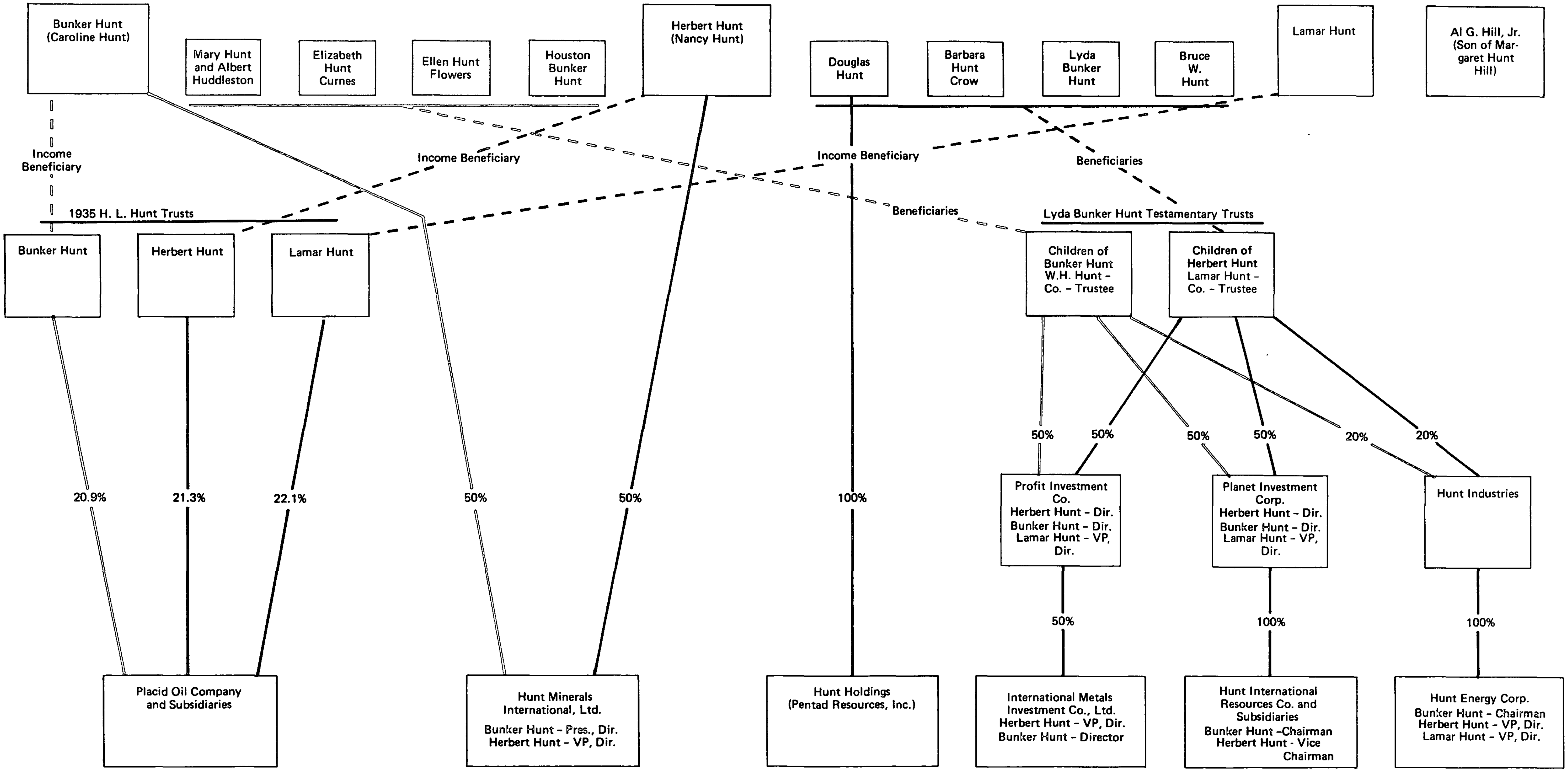
Through various subsidiaries, HIRCO is engaged in the oil and gas, sugar, real estate and pizza parlor businesses. It had earlier held substantial interests in the silver market, through subsidiaries Western Bullion Co. and Western Investment Co., but had ceased those activities by mid-1979. For the fiscal year ended September 30, 1979, HIRCO realized $821,000 in net earnings on $446 million in sales. Its net worth at that date was approximately $55.8 million.

C. Trusts

As evident in the foregoing discussion, a substantial portion of Herbert, Bunker and Lamar Hunt's family resources --including Placid--is held in the William Herbert, Nelson Bunker and Lamar Hunt Trust Estates; Herbert, Bunker and Lamar are income beneficiaries of the Trust Estates while their descendants are remaindermen. The terms of the trust instruments recite that the beneficiaries play no role in determining the amounts of distributions from the trusts, nor have they any right to the corpus of the trusts nor to call for partition, division or dissolution. According to the trust instruments, these decisions are reserved to a trustee with the advice and consent of an advisory committee.

The William Herbert and Nelson Bunker Hunt Trust Estates, at least through June 1979, distributed to the beneficiaries practically all of the income available. Distributions in fiscal 1978 and 1979 were $41.65 million to both brothers over those two years. Combined trust equity for all three Hunt brothers' trusts at June 30, 1979, was $386 million using the equity method of accounting for the Trusts' interests in Placid and other entities. It should be noted, however, that this amount substantially understates the real value of

RELATIONSHIPS AMONG HUNT FAMILY MEMBERS AND RELATED ENTITIES INVOLVED IN THE SILVER CRISIS OF 1979 - 1980 (AS OF APRIL 28, 1980)



the trusts' equity because it is based on a valuation of Placid and other properties that uses historical cost in valuing assets. A Morgan Guaranty memorandum dated March 17, 1980, estimated the Hunt brothers' trust estates' share of Placid to be worth $1.9 billion.

III. HUNT SILVER ACTIVITY - JULY 1979 THROUGH MARCH 1980

A. Hunt Family Members and Related Entities Involved in Silver

Information obtained in the investigation indicates that the following 21 Hunt family members and related entities held or traded silver during the fall and winter of 1979-80:

Nelson Bunker Hunt

- Carolyn Hunt
- Houston Hunt
- Mary Hunt Huddleston
- Ellen Hunt Flowers
- Elizabeth Hunt Curnes
- Albert Huddleston
- Thomas J. Curnes

William Herbert Hunt

- Nancy B. Hunt
- Douglas H. Hunt
- Bruce W. Hunt
- Barbara Hunt Crow
- Lyda Bunker Hunt

Lamar Hunt

A.G. Hill, Jr. (Margaret Hunt Hill's son)

Related Entities

- International Metals Investment Co. Ltd
- Hunt Minerals International Ltd
- Hunt Holdings (now doing business as Pentad Resources, Inc., a trading vehicle for Herbert's children)
- Planet Investment Corp. (holding company for HIRCO)

Bunker and Herbert Hunt, IMIC and, to a lesser extent, Lamar Hunt were the principal Hunt family silver market participants. At December 31, 1979, Bunker, Herbert and IMIC owned or controlled approximately 195 million ounces of silver. Members of Bunker and Herbert's immediate families owned or controlled an additional 8.9 million ounces through broker-dealers registered with the Commission.

The Hunts conducted their silver trading activities with a number of broker-dealers, FCMs, precious metals dealers, banks and individuals. The Hunt family carried 102 million ounces of its overall position in accounts maintained with broker-dealers registered with the Commission.

B. Developments in the Hunt Silver Position through Mid-January 1980

1. Early Interest in Silver

Bunker and Herbert Hunt's first activity in the silver market started in the early 1970's when they became convinced that silver, then selling for about $2 per ounce, was underpriced and an excellent investment. They determined to accumulate positions in silver futures contracts and silver bullion.

In 1973-1974, the Hunts began to build up a substantial position in silver futures contracts on the Comex and CBT. Bunker's first major acquisition of silver bullion occurred in late 1973 when he bought an estimated 20 million ounces of silver in a price range from $2.80 to $3.10 per ounce. Early in 1974 the Hunts purchased approximately 23 million ounces and eventually accumulated a total of about 50 million ounces of silver. The price of silver had edged up past $6.00 to $6.70, but faltered and fell back when Mexico sold 55 million ounces of silver.

In the spring and summer of 1976, Bunker and Herbert took delivery of substantial quantities of silver on the CBT. Most of the deliveries were accepted by corporations controlled by the Hunts.

Thereafter the Hunts each changed their pattern of trading in silver futures. Although they maintained large, net long or spread positions in silver, the Hunts generally did not take delivery of silver. Rather, they periodically rolled their positions forward to more distant maturities, a pattern they were to maintain through approximately July 1979.

The Hunts' purchasing patterns with respect to silver were not confined to the metal itself. From at least 1977 through the silver crisis in March 1980 the Hunts engaged in several efforts to acquire major silver producers.

2. Buildup in the Hunt Silver Position

During the fall and early winter of 1979-1980, the amount of silver controlled by Bunker and Herbert Hunt and IMIC increased from approximately 123 million ounces at July 31, 1979, to 195 million ounces at January 1, 1980. Meanwhile, as the price of silver rose from approximately $9.00 per ounce to approximately $35.00 per ounce, the apparent value of the silver represented by the position increased from approximately $1.1 billion to $6.8 billion. When silver reached its historical high of $50.00 per ounce on January 17, 1980, the apparent value of the Hunt position was more than $9.8 billion.

The largest share of the increase in Hunt silver positions prior to January occurred through IMIC, which acquired cash and futures positions totalling 57 million ounces from July through December. The other 12 million-ounce portion of the increased position occurred in the personal accounts of other Hunt family members. Of the net increase of approximately 69 million ounces in Herbert, Bunker and IMIC's position, approximately 46 million was in the form of physical silver; the remainder was attributable to the acquisition of new futures contracts and the establishment of forward positions in London and Zurich. Lamar carried an 8.1 million ounce futures position at January 31, 1980. The other family members and related entities combined had a 5.8 million ounce net long position in future, forward and physical silver at that date.

The combined Hunt/IMIC net long futures position at the end of 1979 - approximately 20,000 contracts - represented 9% of the combined open interest on Comex and CBT and approximately 76% of the certificated silver stocks of those two exchanges. The Hunt/IMIC net long position in physical and futures, moreover, comprised approximately 15% of Handy and Harmon estimates of world silver stocks and 121% of domestic industrial consumption in 1979.

Meanwhile, the Hunt's silver position generated a substantial cash flow as the price of the metal increased. This occurred in two ways. First, pursuant to customary practice in the futures industry, broker-dealers and FCMs carrying Hunt futures positions wired daily to the Hunts' cash representing the appreciation in value of their open futures contracts. The cash generating potential of this practice is obvious. At January 1, 1980, for example, Herbert and Bunker Hunt and IMIC maintained silver futures positions aggregating approximately 19,350 contracts, or approximately 96.8 million ounces. Each $1 per ounce increase in the price of silver, therefore, produced a cash flow of approximately $96.8 million into the Hunts' account. At year end 1979, the "deferred credit" item on Bunker and Herbert Hunt's balance sheets, which represented cash received in this manner, totaled approximately $1.4 billion.

The Hunts obtained an additional, but less significant, amount of cash by borrowing against their silver position. Table III on the following page summarizes silver-related financing transactions effected by Bunker, Herbert and/or Lamar Hunt and/or Hunt Holdings, Hunt Minerals and/or IMIC from August 1, 1979 through March 27, 1980. As the table illustrates, by January 17, 1980, when the spot price of

TABLE III

Hunt Silver Related Borrowings - August 1, 1979 to January 17, 1980 and January 17, 1980 to March 27, 1980 ($ Millions)

Lender	Loan Balance 8/1/79	Additional Borrowing 8/1/79-1/17/80	Loan Reductions 8/1/79-1/17/80	Loan Balances 1/17/80	Additional Borrowing 1/17/80-3/27/80	Loan Reductions 1/17/80-3/27/80	Loan Balances 3/27/80
ACLI International, Inc.	29.8	64.0	13.3	80.5	53.7		134.2
Bache Halsey Stuart Metals Co.	38.0	41.6	35.9	43.7	191.8		235.5
Mocatta Metals Corp.	50.4	25.5	50.4	25.5			25.5
J. Henry Schroder Bank	5.0	13.0		18.0	11.0		29.0
Swiss Bank Corp.	70.0	164.0	84.0	150.0	200.0	150.0	200.0
Credit Lyonnais	10.1	4.9		15.0	15.0		30.0
First National Bank of Chicago	30.0		20.0	10.0	90.0		100.0
Clayton Brokerage Co.	37.3		37.3				
Merrill Lynch, Pierce, Fenner & Smith		57.0	3.0	54.0	140.0	25.0	169.0
Citibank		25.0		25.0	65.0		90.0
E.F. Hutton & Co., Inc.		100.5		100.5	107.1	107.6	100.0
Placid Oil Co.					110.0		110.0
First National Bank in Dallas					79.2		79.2
Naji Nahas					29.5		29.5
Bank Leu					50.0		50.0
Saudi Finance Corp.					26.0		26.0
Bank Arab International, Inc.					10.0		10.0
TOTALS	270.6	495.5	243.9	522.2	1178.3	282.6	1417.9

silver reached its historic intraday high of approximately $50, the Hunts' outstanding silver-related borrowing totaled $522 million.

C. Hunt Silver Activities During the Market Decline

1. The Silver Markets, January Through March 1980

During the fall and winter of 1979-1980, the principal domestic silver futures exchanges, in consultation with CFTC, reacted to surging silver prices with a number of measures. 14/ These included, among others, (1) dramatic increases in original margin requirements, particularly for large net positions, (2) imposition of limits (some of them retroactive) on the size of traders' positions, and (3) rules limiting trading in silver futures to orders placed for liquidation or bona fide hedging only. Meanwhile, as silver prices climbed, industrial demand declined rapidly and new supplies came into the market as holders were lured into selling by high prices.

Action by the exchanges in response to developments in silver appear to have culminated during the last full week in January 1980. On Monday, January 21, Comex imposed an "emergency" rule limiting silver futures trading to liquidation only. The next morning, CBT followed suit, imposing liquidation only trading in the January, February and March contracts and ordering that all positions in the February 1980 contract be reduced by 25% in each of the ensuing four weeks. On Wednesday, January 23, Comex instructed broker-dealers and FCMs with whom the Hunts maintained accounts to aggregate Bunker, Herbert, Lamar and Douglas Hunt's accounts with one another and with IMIC's account for purposes of position limits imposed by that exchange early in the month. On February 4, Comex margin requirements on positions of the magnitude of the Hunts' at certain firms increased from $30,000 to $60,000 per contract.

Meanwhile, on January 22 the spot price of silver fell approximately $10.00 per ounce to settle at $34.00 on Comex. Over the ensuing six weeks (January 22 - March 7, 1980), spot silver settled between $31.00 and $38.50 per ounce until it resumed its decline on March 10, falling from $29.75 to $10.80 in the fourteen business days through Thursday, March 27.

14/ The exchanges and the CFTC's response to conditions in the silver market have been exhaustively documented in reports issued by these agencies and by congressional committees that have held numerous hearings concerning the silver crisis. We make no attempt in this report to recount such matters in detail, but direct the reader to those sources for further information.

2. The Impact on the Hunts of Silver Market Conditions

a. Overview

As the price of silver declined after January 21, the positive cash flow the Hunts enjoyed in the fall and early winter was reversed. To maintain their futures positions, the Hunts were required to deposit variation margin with the brokers carrying their silver futures accounts. In addition, rather than closing out their futures positions as they matured by effecting offsetting transactions, the Hunts in January and thereafter stood for delivery of the silver represented by the contracts, a practice that required them to pay for physical silver at prices then prevailing. 15/ Finally, during this period the Hunts effected a number of so-called "exchange for physicals" ("EFP") transactions with holders of physical silver, whereby they acquired silver at or near prevailing prices and transferred to the sellers a corresponding number of open long futures contracts.

b. The Engelhard Deal

Of the EFP transactions effected by the Hunts, that with the Philipp Brothers ("Phibro") subsidiary of Engelhard Minerals & Chemicals Co. is particularly significant to an understanding of the silver crisis because of the magnitude and timing of the Hunts' resulting obligation. Raymond Nessim, Phibro group vice president for precious metals trading, later described to one of Engelhard's banks that prior to January 1980, Phibro maintained a short position in the silver futures market of approximately 12,000 contracts, established to hedge its physical silver inventory. As silver prices increased during the fall and winter of 1979-80, Phibro was required to post significant variation margin that Nessim said had strained its resources. Nessim told the banks that the firm was concerned that a continued increase in the price of silver could require additional variation margin payments of as much as $3 billion, a figure beyond its means. To reduce the size of its inventory position, and the required hedge, to manageable levels, Phibro determined to approach those with a long interest in the market concerning sale of part of Phibro's inventory in off-exchange EFP transactions. The firm realized that the

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15/ It will be recalled that the Hunts had already withdrawn from their accounts the unrealized appreciation on their futures positions; in effect, they had to remit this amount and the contract price to the carrying broker to pay for delivery of the physical metal.

Hunts were the only potential counterparty with a meaningful long position. It determined to modify its policy against doing business with individuals or speculators and approach the Hunts with a deal.

As ultimately negotiated on January 11 and during the week of January 14, 1980, the Hunts agreed to purchase from Phibro, in a series of transactions, approximately 28.5 million ounces of silver at approximately $36 per ounce, 16/ for a total consideration of approximately $1.04 billion. The Hunts conveyed to Phibro 5698 long silver futures contracts (1500 Feb. 80 CBT; 3398 Mar. 80 CMX; 800 May 80 CMX) which the firm used to offset an equivalent short position, thus relieving it of the obligation to pay variation margin on those contracts. In addition, the Hunts posted 8.5 million ounces of silver as collateral for their performance of the contractual obligation.

The dates negotiated by the parties for payment by the Hunts and delivery by Phibro are significant:

TABLE IV

DATE	OUNCES TO BE DELIVERED (millions)	AMOUNT OF PAYMENT (millions)
January 16, 1980	4.5	$157.0
January 30, 1980	2.0	74.0
February 1, 1980	3.0	105.0
March 31, 1980	12.0	434.0 17/
May 1, 1980	2.0	76.0
July 1, 1980	5.0	192.0

16/ During that week, spot silver settled on Comex at prices ranging from $38.75 (Friday, January 11) to $48.70 (Thursday, January 17). Phibro's price to the Hunts thus represented a significant discount from the market.

17/ It should be noted that the agreements between Phibro and the Hunts provided that Phibro could, at its option, make delivery of a portion of the March delivery as early as Monday, March 3, 1980. When Phibro notified the Hunts of its intention to deliver 7.1 million ounces of the March delivery on March 3, and requested payment of $253 million on that date, however, Herbert Hunt told Nessim that the

Footnote continued on next page.

Thus, in January, just before silver began the price decline that culminated on March 27, the Hunts obligated themselves to a $434 million payment on March 31. The Hunts were unable to meet that payment.

3. Financing Silver in the Market Decline

To finance the margin calls and delivery payments described in the foregoing section, the Hunts substantially increased their borrowing from banks, broker-dealers, individuals and from affiliated Hunt entities such as Placid Oil Co.

Although, as indicated on Table III, during this period, the Hunts were apparently able to arrange a net increase in borrowing of approximately $896 million, their records and those of various banks indicate that as time went on they encountered an increasing level of resistance to further borrowing requests. They were turned down at a number of institutions. In February 1980, Morgan Guaranty refused Herbert Hunt's request to borrow $100 million to be secured by silver.

On March 4, Barclays Bank International Ltd. ("Barclays"), to whom the Hunts had been introduced by First National Bank of Chicago ("First Chicago"), refused a joint request by Herbert and Bunker to borrow $100 million secured by silver. 18/ According to Barclays' memoranda, the bank rejected the request for several reasons: (1) in the light of the Fed's October 1979 credit restraint program it did not wish to be seen assisting the Hunts to obtain credit to continue their silver activities; (2) there was a strong possibility that the London Metal Exchange would impose restrictions on silver

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Footnote continued from previous page.

Hunts' funds were invested until month end and that it was "not convenient" for the Hunts to stand for delivery on March 3. Nessim told the Hunts that their failure to tender payment until March 31 would cost Phibro $1.7 million in interest and, as the price for delaying delivery until March 31, insisted on an upward modification of the price to compensate Phibro for the lost interest.

18/ In presenting the Hunts' request, Parker told Barclays' personnel that as CBT and Comex tightened their restrictions, the Hunts had begun to look to Europe as the site for their silver activities and that he (Parker) was then visiting banks in Zurich, Frankfurt and London to arrange financing. Parker told the bank that the Hunts wanted to borrow $300 million on a short term basis, of which Barclays' share would be one-third.

speculation similar to those implemented by U.S. exchanges; (3) the amount of silver collateral required to collateralize the Hunts' proposed financing was so enormous that any attempt to liquidate in the event of default would so erode the price of silver that collateral coverage could be insufficient; and (4) the bank did not have the wherewithal, on short notice, to adequately evaluate the Hunts' financial capacity.

On March 10, Deutsche Bank, like Barclays, turned down a loan request from Bunker and Herbert Hunt. On March 12, Merrill Lynch refused a $25 million request from IMIC and on March 18, Royal Bank of Canada, Toronto Dominion Bank and Bank of Nova Scotia each refused a $100 million borrowing request, 19/ although Toronto Dominion later agreed to lend $75 million to IMIC after Placid Oil treasurer Walter Fraker intervened with Toronto Dominion's U.S. office to arrange a further meeting.

In addition to the foregoing institutions, First Chicago, a major lender to the Hunt family, also declined in March to make an additional $135 million loan to Bunker and Herbert Hunt 20/ above the $90 million it had lent them and Lamar in February. Finally, on March 26, the Hunts sought to raise money in an offering in Europe of silver-backed bonds.

19/ Like Barclays', Deutsche Bank, Royal Bank, Toronto Dominion and Bank of Nova Scotia each cited the Fed's credit restraint program in declining to lend to the Hunts. Interestingly enough, the Fed and a number of bankers whose institutions financed the Hunts' silver trading stated after the crisis that such lending did not contravene the Fed's credit restraint guidelines because the loan proceeds were used to maintain the Hunts' existing positions rather than establish new ones.

20/ First Chicago entered the period of silver price declines in mid-January with $144 million in loans to the Hunts and related entities on its books. On January 1, 1980, the bank had outstanding to Herbert and Bunker Hunt $10 million of a $35 million commitment and $134 million to Placid, Penrod and HIRCO of $161 million in commitments. The Hunts had invested $200 million through First Chicago's money market desk.

By early February, however, the Hunts' borrowing at First Chicago began to increase. On February 4, Lamar Hunt borrowed $50 million to help him meet $101 million in margin requirements on his silver futures position, a loan that was secured in part by silver bullion he obtained from Bunker. Bunker and Herbert, meanwhile requested that their lines of credit be increased to $80

Footnote continued on next page.

IV. THE SILVER CRISIS

A. The Hunts' Default

On March 13, IMIC told Merrill Lynch it was unable to meet, within the customary 24 hours, a $44 million variation margin call generated March 11 on its 3808-contract futures position with the firm. It also failed to pay approximately $12 million for delivery of 600,000 ounces of silver pursuant to maturing forward purchase commitments in the London market. On Monday, March 17, the Hunts told Bache they were unable to satisfy with cash a margin call for $44 million in the family's accounts. Thereafter, until well into the week of March 31, Merrill and Bache financed the Hunts' variation margin requirements at the clearinghouse against physical silver held in the Hunts' accounts or deposited by the Hunts in lieu of cash. They continued, however, to post margin with the other four firms, which carried approximately 33% of the total Hunt position. On March 26, the Hunts told Bache, Merrill and ACLI that they were stopping margin payments. 21/

Meanwhile, on March 28 Bunker Hunt informed Engelhard chairman Milton Rosenthal ("Rosenthal") that the brothers would not make the required payment of $434 million to Phibro in partial settlement of the EFP transactions described earlier. During the same period, the Hunts failed to meet $78.9 million in margin calls on forward purchase commitments with Swiss Bank Corporation in Zurich, commitments they had taken over from IMIC on March 19. As silver prices fell, moreover, the Hunts' bank loans became undercollateralized and the Hunts explained to bankers that they had no further cash or liquid assets with which to pay down or further

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Footnote continued from previous page.

million and by February 22 requested a further increase to $185 million ($150 million above the existing $35 million line). On February 26, the bank indeed increased the line, but only to $50 million. As the crisis developed, therefore, First Chicago had outstanding to individual Hunts $100 million in loans, ten times the credits on its books in early January. Its total outstanding to all of the Hunt interests was $223.1 million, up 55% from January.

21/ The circumstances surrounding the Hunts failure to meet margin calls and the brokers' financing of those calls at the clearinghouses are described in detail in the portions of this report dealing with individual firms.

collateralize the loans. At March 28, 1980, Herbert and Bunker Hunt and IMIC had outstanding, exclusive of margin calls, approximately $1.75 billion in silver related obligations.

B. The Hunts Refinance Their Silver Debt

The magnitude of the Hunts' obligations became apparent over the weekend of March 29 and 30, 1980, when Fed Chairman Volcker and others learned of the Hunts' impending default on the Engelhard/Phibro EFP obligation. During the weekend, the Hunts sought, without success, bank loans to meet the $434 million payment. By Sunday night, March 30, Volcker and senior bank officials attending the Reserve City Bankers Association convention in Boca Raton were discussing the potential for a financial disaster the next day when news of the impending Engelhard default became public. Engelhard had requested that trading in its stock be halted 22/ and its personnel were discussing whether to file a petition to have the Hunts declared bankrupt.

The Hunts extricated themselves from this situation primarily through two transactions. To satisfy the balance of their total obligation to Engelhard, which was approximately $635 million, the Hunts on March 31 agreed to forego delivery of the silver they had contracted to purchase, yielded to Engelhard the 8.5 million ounces of silver they had deposited as security for the performance of the contract and conveyed to the firm 20% of the Hunt brothers' interest, through HIPCO (Can.), in the Beaufort Sea licenses described at note 9 above. 23/

With respect to the remaining obligations, the Hunts utilized Placid's resources to satisfy their personal silver debts. As early as March 11, the Hunt brothers had sought and obtained from Placid funds to support their silver trading. On that day, Bunker and Herbert had executed in favor of Placid promissory notes for an aggregate of $500 million and on March 21 Lamar executed notes for $40 million. Pursuant to these notes, Bunker and Herbert drew $50 million and

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22/ Trading in Engelhard stock was halted for part of Monday, March 31.

23/ The Beaufort Sea properties, as it turned out, were at the time of the agreement with Engelhard already pledged to First Chicago as a part of the collateral pool supporting its $50 million loan to Bunker and Herbert. First Chicago refused to release those properties until the Hunts had repaid $100 million in personal loans from the bank. Placid repaid those loans on the Hunt brothers' behalf on April 8, 1980, out of the proceeds of the interim loans described below.

$55 million respectively, and Placid purchased from the Kansas City Chiefs a $5 million note Lamar had earlier executed in its favor. In addition, sometime before April 3, 1980, Placid purchased for $132 million the Hunt brothers' 40% interest in a North Sea petroleum license. The money Placid passed to the Hunt brothers thus totaled approximately $242 million. Placid funded the loans to the brothers and the North Sea purchase in part by borrowing $50 million from Bankers Trust on March 14 and $65 million from Citibank on March 31 and April 1. Placid also repatriated $65 million in guilder investments and relied to an indeterminate degree on its own float and working capital. On Sunday, March 30, however, the Hunts told Rosenthal that no more funds could be obtained from Placid and Morgan Guaranty records reflect that on April 3, Placid had told the Hunt brothers that the $242 million it had passed to them as described above was the "end of the line."

On Monday, April 7, however, Placid entered an interim agreement with a group of banks under which $300 million was advanced to Placid to meet certain of the Hunts' immediate obligations. The next day, First in Dallas disbursed $230 million of this amount to various of the Hunts' creditors. $101.5 million was paid to First Chicago to repay the Hunt brothers' personal loans from that bank, thereby securing the release of the Beaufort and North Sea petroleum interests the Hunts had already contracted to sell to Engelhard and Placid, respectively. $78 million was paid to Swiss Bank Corporation. $22.7 million was paid to Bache Group to cover Mary Hunt Huddleston and her husband Albert's losses on a forward silver position in London.

Meanwhile, the Hunts and various banks, led by First in Dallas and Morgan Guaranty, discussed a transaction that would refinance and consolidate all of the Hunts' silver debts. As ultimately arranged, Placid financed the Hunts' repayment of their silver debt by advancing the necessary amounts through a wholly-owned subsidiary (Placid Investment Co.), created for that purpose, to a partnership comprised of the Hunt brothers as limited partners and Placid Investment Co. as general partner (the "limited partnership"). The Hunt brothers, in turn, contributed to the partnership their and IMIC's remaining silver positions (valued at $1.29 billion using $14.05 per ounce as the price of silver) and coal properties in Montana and North Dakota valued at $294 million. The Hunts contributed the assets "subject to but without any assumption by the [p]artnership of" $1.13 billion in debts. Notwithstanding the disclaimer of assumption just quoted, the limited partnership undertook to discharge this debt out of the proceeds of Placid's capital contribution.

To repay Placid for the amounts expended to satisfy their silver debt, the Hunt Brothers committed to make periodic additional "capital contributions" to the limited partnership to the extent that its operations and the sale, if any, of the Hunt brothers' silver positions produced an insufficient return. This obligation was secured by a second lien on personal assets of the Hunt brothers valued at $2.84 billion, but subject to $93.8 million in debt. $2.3 billion of this collateral was comprised of the Hunt brothers' remaining interest in the Beaufort Sea oil licenses, a portion of which had been conveyed to Engelhard in settlement of the Hunt/Phibro EFP transaction. As noted previously, however, the collateral value of these properties was questionable and the value assigned in the Placid loan documentation is approximately four times greater than recent earlier estimates.

To fund its repayment of the Hunt brothers' obligations, Placid borrowed $1.1 billion from a consortium of 13 banks secured by, among other things, Placid's interests in oil and gas properties, refineries and pipeline systems. The Hunt brothers guaranteed the credit individually secured by a first lien on the assets described in the preceding paragraph. The loan carried interest payable quarterly at a premium over prime and was subject to covenants requiring Placid to maintain cash flow from engineered properties and operations of 166% and 125% of the debt service on the loan, respectively.

By May 31, after the transaction just described had been effectuated, Placid had paid the Hunt brothers' silver debts and the crisis had passed.

PART TWO

BACHE GROUP INC.

I. THE BACHE GROUP COMPLEX

A. The Holding Company

Bache Group Inc. ("Bache Group"), incorporated in Delaware in 1974, is a holding company engaged through 35 subsidiaries in retail and institutional securities brokerage, investment banking, commodities futures merchandising, precious metals trading, insurance and real estate. On July 31, 1980, Bache Group was a publicly-held company; its 8,752,791 outstanding common shares were in the hands of approximately 4,641 holders of record. 24/ Its common stock was registered with the Commission pursuant to Section 12(b) of the Exchange Act and listed on the New York, Pacific and Midwest Stock Exchanges.

For the fiscal year ending July 31, 1980, Bache Group reported net pre-tax income of $47.6 million on revenues of $622 million. The company derived its revenues principally from brokerage commissions on securities transactions ($217 million), interest on customer margin accounts and financings ($163 million), spreads on transactions as principal ($85 million) and commissions on commodity transactions ($71 million). Its principal expenses were employee compensation and benefits ($299 million) and interest expense ($110 million). During its 1980 fiscal year, Bache Group as a broker handled approximately 2.8 million securities transactions and 900,000 commodity transactions. Trades that it executed in securities listed on the NYSE represented approximately 2.7% of the volume on that exchange. As of July 31, 1980, Bache Group reported a net worth of $154 million.

B. The Broker-Dealer

Bache Group's principal subsidiary is Bache Halsey Stuart Shields Inc. ("Bache Halsey"), a broker-dealer registered with the Commission pursuant to section 15(b) of the Exchange Act. On March 31, 1980, Bache Group's reported equity in Bache Halsey represented approximately 96% of the reported equity of Bache Group itself.

24/ Following a tender offer for Bache Group's common warrants, Bache Group on June 12, 1981 merged into Pru Holding Inc. ("PruHo"), an indirect wholly owned subsidiary of Prudential Insurance Company of America ("Prudential"). PruHo changed its name thereafter to Bache Group Inc. As a result of the merger, Bache Group is an indirect wholly-owned subsidiary of Prudential.

According to Bache Group, as of December 31, 1979, Bache Halsey "ranked among the top eight in terms of total capital among the 562 members of the NYSE." Bache Halsey is a member of all major securities and commodities exchanges in the United States, and it or its subsidiaries or affiliates hold memberships or associate memberships on several principal foreign securities and commodities exchanges.

As a registered broker-dealer and as a member of the NYSE, Bache Halsey is subject to the financial responsibility requirements of the Uniform Net Capital Rule promulgated by the Commission as Rule 15c3-1 pursuant to the Exchange Act ("Rule 15c3-1") and adopted by the NYSE as its Rule 325 ("Rule 325"). Bache Halsey computes its net capital pursuant to the "alternative method" permitted by the Uniform Net Capital Rule, which required that it maintain minimum "net capital" (as defined in Rule 15c3-1, hereinafter "Rule 15c3-1 capital") equal to or greater than 4% of its debit items from customer transactions (as defined). 25/ At July 31, 1980, Bache Halsey reported its Rule 15c3-1 capital to be $112 million; $68.7 million more than that required by the Rule 15c3-1. $63 million of Bache Halsey's Rule 15c3-1 capital was comprised of subordinated debt to five banks; the remaining $49.0 million represented shareholders' equity in Bache Halsey less various capital charges.

Bache Halsey is also subject to the so-called "early warning" provisions of NYSE Rule 325(b), which provides that it must notify the New York Stock Exchange if its Rule 15c3-1 capital falls below 7% of its aggregate debit items arising from customer transactions. Under NYSE Rule 326(c), Bache Halsey would, immediately upon falling below the 7% floor, be precluded from drawing, lending or advancing any funds to its stockholders without obtaining the Exchange's prior approval. 26/ If that condition persists for 15 consecutive business days after the Exchange is notified, NYSE Rule 326(a) prohibits Bache Halsey from expanding its business. If the Rule 15c3-1 net capital falls below 6% of aggregate debit items arising from customer transactions

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25/ The Commission has since reduced the minimum net capital requirement to 2% of aggregate debit items. See Securities Exchange Act Release No. 18417, (Jan. 25, 1982).

26/ The practical effect on Bache Group of Bache Halsey's net capital falling below the 7% level is to deprive it of upstream dividends or other advances that it could otherwise expect from its principal subsidiary.

for 15 consecutive business days after the Exchange is notified, Bache would be required to reduce the volume of its business so long as the condition persisted.

C. The Metal Company and Bache London

Two of Bache Group's other 34 subsidiaries handled silver related Hunt business and are relevant to a discussion of the silver crisis. These are Bache Halsey Stuart Metal Co., Inc. ("Bache Metals"), Bache Group's bullion trading arm, and Bache Halsey Stuart (London) Limited ("Bache London"), its London production and service office.

1. Bache Metals

Bache Metals is the subsidiary through which Bache Group acts as broker for individual and corporate clients in the cash markets in metals, and as a dealer in metals for spot or forward delivery. In addition, Bache Metals finances customer spot commodity positions received in delivery on futures contracts and makes loans to customers secured by warehouse receipts evidencing ownership of physical commodities. As described more fully elsewhere in this report, Bache Group conducted these activities in Bache Halsey prior to 1975. 27/

The existence of Bache Metals as an entity legally distinct from Bache Halsey is directly attributable to Bache Group's desire to lend to the Hunts against silver collateral without incurring charges to Bache Halsey's capital, and to avoid certain other capital charges associated with Bache Halsey's spot commodity activities. 28/ Bache Metals is not a registered broker-dealer and is not subject to the net capital requirements of Rules 15c3-1, 325 and 326. Bache Metals is a bookkeeping vehicle with no payroll or offices of its own. Bache Halsey personnel are its officers; Bache Halsey's money management department arranges its loans; Bache Halsey's account executives manage its customers' accounts; and Bache Halsey's spot commodity department receives and accounts for warehouse receipts collateralizing Bache Metals' loans.

27/ See discussion below at pages 67 through 68.

28/ See discussion below at page 67.

On December 31, 1979, Bache Metals reported assets of $98.3 million of which $53.9 million was receivable from customers. It reported liabilities of $97.5 million of which $76.0 million represented loans from banks, the proceeds of which it used to lend to customers and to finance its own trading inventory. Bache Group's equity in Bache Metals was $848,661.

2. Bache London

Bache Halsey's London operations are also conducted through a separate Bache Group subsidiary not subject to the net capital rules. Bache London's activities have two components. As a production office, Bache London has account executives that generate business for the firm from customers in the United Kingdom ("U.K.") and elsewhere overseas including, in certain instances, the United States. As a servicing office, Bache London executes trades in U.K. markets for customers of Bache Halsey's U.S. branches, whose orders are funneled into an omnibus account maintained by Bache Halsey with Bache London. U.S. customers' positions, therefore, continue to be carried in their accounts with Bache Halsey's U.S. branches, which are ordinarily charged internally with any losses to the firm arising from customer defaults in connection with U.K. market trading activities in those accounts.

On February 29, 1980, Bache London had assets of $22.7 million and liabilities of $22.1 million. Bache London's net worth was $576,680.

II. THE INCEPTION AND DEVELOPMENT OF THE HUNT RELATIONSHIP

In about June 1973, Alvin Brodsky ("Brodsky"), the Hunts' floor broker on Comex, began to direct some of Bunker Hunt's silver business to Charles Mattey ("Mattey"), a 45 year Bache Halsey employee. 29/ From 1973 on, Mattey was Bunker and Herbert Hunt's principal account executive

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29/ Mattey, 71, has served as president and chairman of Comex and as a member of its board of governors.

Mattey attributes the orders Brodsky directed to Bache Halsey beginning in June 1973 to an overflow of business that Brodsky would otherwise have directed to Bunker's account with Les Ming, a former Bache Halsey broker then at Reynolds Securities Inc. ("Reynolds"). Mattey believes that Bunker's trading became too large for Reynolds to handle.

at Bache. Bunker and Herbert Hunt opened numbered commodity trading accounts in Bache Halsey's New York home office on June 27 and July 6, 1973, respectively. They immediately established long positions in December 1973 Comex silver.

Although Bache Halsey carried these accounts, Bunker and Herbert Hunt placed orders directly with Brodsky on the Comex floor. Brodsky "gave up" Hunt business to Bache Halsey, which confirmed the trades to the Hunts and became liable to the Comex Clearing Association, Inc. ("Comex Clearing") for margin deposits and the costs of deliveries attributable to the Hunt accounts. Brodsky, as the introducing broker, received a portion of Mattey's commissions on Hunt transactions. This arrangement continued in the Hunt silver accounts at Bache Halsey until the silver crisis terminated the relationship. 30/

In December 1973, the Hunts' futures contracts matured. Rather than closing out these positions or rolling them forward, Bunker and Herbert stood for delivery on the five million ounces of silver represented by the contracts. Bache Halsey, with the approval of its executive committee, agreed to lend to the Hunts $11.25 million, which represented 75% of the cost of these deliveries. The Hunts secured this loan by maintaining on deposit with the firm the warehouse receipts evidencing their ownership of the bullion collateral.

From the inception of the relationship, Bache Halsey set credit limits on the Hunts' accounts. 31/ After several

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30/ After Bunker and Herbert opened their accounts in 1973, Lamar Hunt opened an account in his own name on February 7, 1974. Hunt Minerals International and Great Western Sugar, both Hunt-controlled corporations, opened accounts on February 7, and April 24, 1975, respectively. Each of these accounts traded silver.

31/ Throughout this report the phrases "credit limits", "position limits", "credit line" (or simply, "line") are used interchangeably to indicate the magnitude of the commodity position that a broker-dealer/FCM, will permit a customer to carry. The purpose of these limits is to control the risk to the firm of a customer's failure to make good on losses in his account. Some firms establish position limits in a dollar amount as an upper limit on the amount of initial margin required to carry the customer's

Footnote continued on next page.

changes in the Hunts' limits during the first two years of account activity, Bache Halsey's executive committee in October 1975 established the Hunts' aggregate position limit with the firm at 4,200 contracts, a level Bache Halsey maintained, regardless of fluctuations in silver prices, until it substantially increased the line in September 1979.

In the ensuing four years, during which silver prices remained relatively stable in the range of $4 to $6 per ounce, Bunker and Herbert's positions with Bache Halsey remained comparatively stable, as well. The brothers generally rolled forward their futures positions as they matured. To avoid regulatory capital charges, Bache Group transferred its Hunt loans and the associated bullion collateral from Bache Halsey into a predecessor of Bache Metals, where it rolled over the loans at 89 day intervals in amounts averaging approximately $40 million. Commissions, interest spreads and other revenues to Bache Group attributable to the Hunt relationship totaled approximately $411,000 in fiscal 1978 and approximately $520,000 by the first six months of fiscal 1980.

Although the Hunts effected securities and other non-silver transactions through Bache Halsey, the most significant aspect of the Hunt relationship continued to

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position. Thus, if initial margin requirements in silver are, for example, $10,000 per contract, a $100,000 credit or position limit will permit a customer to carry ten contracts. If margins are thereafter raised to $20,000 per contract, on existing positions, a $100,000 line will permit the customer to carry only five contracts.

Other firms establish position limits in numbers of contracts. If margins are thereafter raised on existing positions, and the customer posts the additional requirements, he can maintain his ten contract position notwithstanding the increase.

As described elsewhere in this report, during 1979 and 1980, Bache Halsey established credit limits for the Hunts in numbers of contracts, except for accounts maintained for Bunker Hunt's daughter Mary and her husband, which were set in dollar amounts.

be silver. 32/ On July 31, 1979, Hunt futures accounts were long 2,549 contracts of CBT and Comex silver, while the firm had lent Bunker, Herbert and Hunt Minerals approximately $33 million collateralized by 1,133 silver bullion warehouse receipts. These positions collectively represented 18,410,000 ounces of silver with a market value (at spot prices) of approximately $167.2 million.

III. THE BUILDUP IN SILVER - AUGUST 1, 1979 THROUGH JANUARY 17, 1980

A. Introduction: Increasing Exposure in the Hunt Accounts

During the five and one half months from August 1, 1979 through January 18, 1980, the price and volatility of silver and the size and value of the Hunt silver positions with Bache Group increased. The silver in the Hunt futures and physical positions continued to climb from 18.4 million ounces on August 1 to a high of 43.5 million ounces at October 31, declining only slightly to 42.2 million ounces by December 31, 1979. Assuming that a position of this magnitude could have been liquidated at or near the spot price, the value of the Hunts' combined physical and futures position with Bache Group rose from $165 million on July 31, 1979, to approximately $1.45 billion at December 31. The equity supporting this position, however, had only risen to $317 million, principally because the Hunts withdrew from their accounts substantially all of the unrealized appreciation on their futures positions. 33/ The equity in the Hunts' accounts with Bache Group on December 31 could then have been eliminated in a drop in the price of silver of $7.47 per ounce. An additional decline of only $3.40 per ounce would have created deficits in Hunt accounts equal to the consolidated book value of Bache Group.

32/ Bache Halsey handled other business for the Hunts. Members of the family and affiliated entities maintained securities accounts at the firm. The firm acted as dealer manager in connection with the Hunts' successful tender offer for Great Western United Corporation and their attempts, aborted in September 1975, to acquire Bates Manufacturing Company, Inc., a New York-based holding company with substantial coal reserves in Virginia, Pennsylvania and Kentucky.

33/ In an arrangement common in large commodity futures accounts, Bache Halsey wired to the Hunts daily amounts representing appreciation in the value of the positions. The Hunts, in turn, wired funds to Bache Halsey when the value of their positions declined.

The degree of Bache Group's exposure to the Hunts in silver was magnified by the volatility of the market. In August 1979, daily price movement in silver futures on the Comex was limited to \$.20 per ounce, while the daily fluctuations in the freely trading spot price of the metal averaged only 1.5% of the prior day's closing price. By January 1980, daily price movement limits on futures contracts had been increased to \$1.00 per ounce, while daily swings in the spot price averaged approximately 9% of the prior day's closing price. Daily movement of more than \$4 per ounce was not uncommon. Meanwhile, average daily volume in silver on Comex declined by 56%, from 17,567 contracts in August to 7,717 contracts in January, and average open interest on that exchange dropped 31%, from 155,072 contracts in August to 106,300 contracts in January. It also became commonly known and widely publicized that the trading activities of the Hunts and other substantial holders had occasioned concern on the part of the Comex governors that market congestion and a possible squeeze were developing in silver. Both exchanges raised margin requirements and the CBT imposed position limits. Bache Halsey was among those opposing these limits on speculative traders.

During this period, Bache Halsey's executive committee approved commodity credit lines for additional Hunt family members, accepted the transfer to Bache Halsey of 4,129 futures contracts that its existing Hunt customers had maintained with other firms, and permitted the Hunts to add 626 new silver futures contracts to their accounts. The executive committee made these decisions without specific or current information as to the Hunts' financial condition, the Hunts' continuing ability to satisfy obligations to Bache Group which would arise were a drop in the price of silver to occur or the extent of the Hunts' potential liabilities or exposure to loss in connection with silver positions maintained with other broker-dealers, FCMs or banks.

Bache Group, because it and its counsel never considered it to be necessary, made no disclosure in its shareholder communications or its filings with either the Commission or the NYSE concerning the magnitude of the firm's exposure to one group of clients in a single commodity or the unavailability of reliable information concerning the client's financial condition.

B. Increases in Hunt Future Positions

1. The Huddleston Accounts

In July 1979 Bunker Hunt's daughter, Mary, and her husband Albert D. Huddleston opened commodities futures accounts with Bache Halsey's Houston, Texas office. 34/ In August 1979, these accounts began trading in silver as well as other commodities and stocks. By the end of August, the Huddlestons' accounts carried 75 silver futures contracts. In the next five months, their position increased until, on January 17, 1980, the accounts held 387 contracts on domestic exchanges and contracts for the forward delivery of 750,000 ounces of silver (the equivalent of 150 domestic contracts) on the London Metal Exchange. The total position represented control of 2.7 million ounces of silver.

An account executive from the Houston office handled the Huddleston accounts during the first five months of their existence. At least until the end of January 1980, the firm's commodity credit committee appears to have considered requests for trading limits for the Huddlestons independently of its deliberations concerning trading limits for the other Hunts. In the July 9, 1979 commodity suitability letter executed in opening their account, Albert and Mary Huddleston disclosed a net worth of $125,000, annual income of $50,000 to $75,000 and total net liquid assets of $25,000 to $50,000. By the end of July, Albert and Mary filed a new suitability letter which stated a net worth of $2 million, an annual income of $200,000 and total net liquid assets of $1.15 million.

On August 23, 1979, after the Huddlestons established an initial 75 contract position, the commodity credit committee approved a margin line of $100,000 for the accounts. One week later the committee increased the line to $300,000 and 19 days thereafter, on September 18, set the Huddlestons' credit limit at $750,000. The committee denied further requests for increases (to $1 million on September 20 and to $1.5 million on November 1 and 29) until January 22, 1980. Even so, Bache Halsey permitted the Huddlestons to maintain positions requiring substantially more initial margin than the $750,000 line approved in September. At

34/ In addition to their joint commodity account, Albert and Mary Huddleston opened two securities accounts at the firm, and accounts were opened in the names of Dale and Gordon Huddleston as well. These accounts will, for convenience, be treated in the aggregate.

month-end November 1979, the Huddleston accounts were net long 230 contracts with required margin of $1.32 million at exchange minimum rates. By December 31, 1979, the position was long 459 contracts, requiring $3.45 million in original margin. Finally, on January 16, 1980, Mattey, who by this time had taken over supervision of the Huddleston accounts, placed an order for the forward purchase, on July 16, 1980, of 750,000 ounces of silver on the London Metal Exchange at prices averaging $46.35 per ounce. On January 31, 1980, the net Huddleston silver position increased to approximately 1.3 million ounces long with a nominal market value well in excess of approximately $45.0 million. Six days later, noting that the Huddlestons' net worth and liquid assets now each exceeded $50 million, the commodity credit committee approved a $15 million trading limit in their account, provided that the Huddlestons maintained silver warehouse receipts with value of $25 million or more on deposit with Bache Halsey. The committee also agreed that the Huddlestons could satisfy any margin calls on their London positions with equity in an account with the Bache-related "MoneyMart Assets" money market fund.

The audit committee of Bache Group's board of directors later concluded that the trading pattern in the Huddleston accounts suggested that the Huddlestons were involved in a "classic pyramiding situation". In the rising market, they used the appreciation in existing positions to make original margin deposits on additional positions. Bache Halsey's executive committee acquiesced in this practice by extending additional commodity credit on the basis of this same appreciation. As audit committee chairman Stanley Shirk put it, "the customers' net worth, presumably, has not been enhanced except through the trading and the commodity transaction." 35/ Bache Halsey, without information

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35/ The Dow Jones-Irwin Guide to Commodities Trading (Dow Jones-Irwin Inc., 1981) defines "pyramiding" as "the use of paper profits on established positions to buy or sell further future contracts." Pyramiding is a recognized trading strategy in the commodity markets.

Harry Sarkisian, then chairman of Bache Halsey's commodity credit committee, described the dangers of pyramiding quite graphically:

> If you have an account who to begin with is not extremely credit worthy, who happens to go into a commodity at a point in time when that commodity is becoming extremely active and volatile and through luck or circumstances or whatever has the good fortune to be on the right side of it and suddenly finds itself making more money than he ever dreamed he could make and continues to plow that back into the same commodity without diversification, that can be dangerous.

concerning the Huddlestons' financial position other than the two July 1979 suitability letters, their other holdings at Bache and knowledge of the market gains they had on their silver positions increased their commodity credit line to 150 times its original value. It required only that the Huddlestons deposit with the firm contracts of physical silver, the fluctuating value of which was also subject to the risks of the volatile silver market. As events demonstrated, the Huddlestons were the first of the Hunts with accounts at Bache Halsey to experience difficulties meeting their financial obligations after the market broke in January.

2. The San Francisco Accounts

During August and September 1979, Bache Halsey hired Scott Kevin McFarland as an account executive in its San Francisco office. McFarland had been employed since the previous year by Loeb Rhoades, where he had handled silver futures transactions in accounts for Bunker Hunt and his children Houston Hunt, Elizabeth Hunt Curnes, Ellen Hunt Flowers and Mary Hunt Huddleston.

After Loeb Rhoades merged with Shearson Hayden Stone, management of the newly combined entity informed McFarland that the Hunt positions would be margined at $20,000 per contract rather than the $5,000 (Comex) and $2,500 (CBT) minimum rates prescribed by the exchanges for existing positions. McFarland and Bunker Hunt decided to move the accounts to Bache Halsey. 36/

At the time McFarland joined Bache Halsey, the Hunt accounts he managed were long 2,252 silver futures contracts. Although the majority of these positions were carried in Bunker Hunt's account, his children's accounts carried an aggregate of 315 contracts requiring original margin of $1.58 million. According to McFarland, Bunker Hunt did not guarantee his children's accounts.

36/ During the time McFarland handled Hunt accounts at Bache Halsey, he obtained financing from Bunker Hunt for his personal silver trading. Between August 1979 and April 1980, Bunker Hunt lent McFarland approximately $4 million to finance silver that McFarland bought from Bunker under an agreement to resell it to Bunker. McFarland purchased from Bunker 250,000 ounces of silver at the market in August 1979 and resold it to him at a higher price in two separate installments. Some of the purchase price of the silver still remains unpaid and McFarland has retained the profit of approximately $630,000 on the transaction. There is no evidence that the firm was aware of these transactions and Bache has denied that it was.

On August 28, 1979, without seeking or reviewing any additional financial information from Bunker Hunt or any information on the financial condition of his children, Bache Halsey's commodity credit committee increased the Hunts' aggregate line of commodity credit in silver to 5000 contracts to accommodate the San Francisco positions. By the end of September 1979, Hunt accounts at Bache Halsey were net long 4,666 silver futures contracts representing 23.3 million ounces of silver, more than double the position at the end of August.

3. Transfers from J. Aron

In early October 1979, less than a month after the San Francisco accounts came to Bache Halsey, the Hunts asked Mattey if Bache Halsey would accept the transfer into their accounts with the firm of 1,877 long silver futures contracts the Hunts were carrying with J. Aron, a large precious metals dealer. The Hunts did not offer any additional information concerning their financial condition or liquidity in connection with this request. According to Mattey, the Hunts were "uncomfortable" carrying their position at J. Aron because it, like other precious metals dealers, was required to post variation margin to maintain the short silver futures positions with which it hedged its physical silver inventories. Because of the rise in silver prices in August and September, J. Aron's obligation to post variation margin had increased by millions of dollars. 37/

37/ At about the same time as the transaction described in the text, Mattey served as an adviser to Bunker and Herbert Hunt in connection with an "exchange for physicals" transaction they arranged between International Metals Investment Co., Ltd. ("IMIC"), a Bermuda corporation owned jointly by the Hunts and two Saudi investors, and Mocatta Metals Corporation, a New York-based precious metals dealer. The Hunts had earlier borrowed approximately $50 million from Mocatta secured by 10.7 million ounces of silver warehouse receipts. Mocatta had, in turn, rehypothecated these receipts to banks to secure a much larger loan it obtained to meet variation margin calls issued on the short silver futures positions with which it hedged its bullion inventories. According to Mattey, this transaction arose because the Hunts were concerned that if Mocatta became insolvent as a result of its silver obligations they would not be able to recover the silver they had pledged against the loan.

Footnote continued on next page.

On October 2, 1979, the commodity credit committee, after a lengthy discussion, unanimously determined to increase the Hunts' commodity credit line to 7,500 contracts to accommodate the J. Aron position, provided the Hunts left on deposit with the firm the 1,133 silver warehouse receipts they had used to collateralize Bache Group's approximately $40 million loan to the Hunts through Bache Metals. 38/ The committee also determined that the line of credit extended by Bache Metals should remain at approximately $40 million. Bache Halsey's executive committee approved this arrangement on the same day. Neither the commodity credit committee nor the executive committee sought any additional information concerning the Hunts' financial condition or liquidity, or the size of their physical or futures silver positions and the related obligations elsewhere.

C. Management Information Concerning the Hunts' Financial Condition and the Volatility of the Silver Market

1. Information About the Hunts

As is evident in the foregoing discussion, Bache Halsey's commodity credit and executive committees, both senior level groups within Bache Group's home office

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Footnote continued from previous page.

In the transaction between IMIC and Mocatta, IMIC purchased in cash 22.9 million ounces of silver from Mocatta and transferred to it 4,583 silver futures contracts. In a related transaction, Mocatta and Bunker and Herbert Hunt terminated the loan from Mocatta to the Hunts and Mocatta returned the Hunts' silver. Relieved of the need to hedge the silver it sold to IMIC, Mocatta was able to close out much of its short futures position by offsetting it with the long position it received from the Hunts, thereby substantially reducing the variation margin payments it had to make on its short hedge.

38/ Bache Metals' loans to the Hunts are described more fully at pages 67 through 76, below.

The market value of that collateral was, at September 30, 1979, approximately $93 million and the Hunts had paid down the earlier $40 million loan to only $2.4 million. The 1,133 silver warehouse receipts were, therefore, as of the October 2 meeting, substantially unencumbered. By October 31, however, the Hunts had drawn on the Bache Metals line for $40 million once again and the excess silver collateral was reduced to $54 million at October 31 prices.

management, made the decision to permit a threefold increase in the Hunts' silver futures positions in 1979. They had available to them, however, little specific or current information concerning the financial condition of Bache Halsey's Hunt clients, the size of the Hunts' overall position in the silver market, or the proportion of the physical or futures markets in silver represented by the Hunts' overall positions. Thus, they had no accurate information concerning the degree of the Hunts' concentration in silver and their concomitant exposure to loss. The audit committee of Bache Group's board of directors reported that:

> As part of this review, the Audit Committee inspected the credit files pertaining to the Hunt accounts and ascertained that they contained very little information of significance. Current financial statements of the Hunts, memorandums [sic] of discussions with them and other input data usually found in a credit file were absent.

From the inception of the Hunt relationship, Bache Group was unable to secure meaningful information concerning the Hunts' financial condition. As early as 1973, according to Mattey, 39/ he sought to have Bunker Hunt provide Bache Halsey with financial information. Mattey testified that he asked Bunker:

39/ It should be noted that Mattey was a member of the commodity credit committee throughout the period of its deliberations on Hunt futures trading line and borrowing requests. Mattey derived approximately 70% of his compensation in 1979 from commissions and participation in interest spreads on Hunt accounts. Mattey testified that he did not participate in discussions concerning his clients' credit limits. Stevenson, however, testified that the commodity credit and executive committees relied heavily on Mattey's expertise and the assurances he gave concerning the liquidity of the silver market. Stevenson also testified that Mattey was enthusiastic in support of Bache Metals' loans to the Hunts, an enthusiasm that Stevenson believes was more pronounced as a result of Mattey's receiving as compensation 40% of the interest spread Bache Metals realized on the Hunt loans. (Mattey waived his participation in the spread on the final increase in Hunt loans late in February 1980.) Bache Group has since removed Mattey from the commodity credit committee.

Would he please ask the officer who was in charge of the Hunt account at the First National Bank in Dallas to take the wraps off and give our credit man who would call him a real good picture of Bunker Hunt's credit worthiness . . . net worth, etc.

Sometime thereafter a Bache Group representative did discuss the Hunts' financial condition with a bank representative, but received no statements of financial condition from the Hunts. A year later, two Bache Group representatives went to Dallas to study the Hunts' financial condition. They came back with a favorable opinion, but without Hunt financials. 40/

From 1973 through 1980, Bache received no additional financial information. As recently as early 1980, after the executive committee determined to seek additional information in connection with increasing Bache Metals' loans to the Hunts, according to Mattey, he requested financials from Bunker Hunt and again was refused. Mattey did not persist. 41/ Because Mattey was Bache's chief source

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40/ Bache's files showed that in 1973, First in Dallas confirmed the Hunts' net worth at more than $50 million.

41/ At the time of Mattey's request, the most recent audited financial statements Herbert and Bunker Hunt had supplied to a bank showed significant concentration in silver as of December 31, 1978. Assets were valued at cost.

	($ million)		
ASSETS:	Bunker	Herbert	Staff Pro Forma Aggregation
Current Assets:			
Investment in Silver Bullion (at cost)	$112.9	$100.1	$213.0
Other	59.8	21.7	81.5
Total	172.7	121.8	294.5
Other Assets (Including non-current notes receivable, investments in property and equipment at cost)	143.1	35.0	178.1
Total Assets	315.8	156.8	472.6

Footnote continued on next page.

of financial information about the Hunts, no more detailed information reached the executive committee or the commodity credit committee.

Footnote continued from previous page.

	Bunker	Herbert	Staff Pro Forma Aggregation
	($ million)		
LIABILITIES			
Current Liabilities			
Bank notes payable	82.9	75.9	158.8
Other	84.4	66.8	151.2
Total	167.3	142.7	310.0
Other Liabilities	20.4	1.8	22.2
Total	187.7	144.5	332.2
*CAPITAL	128.1	12.3	140.4

Each financial statement carried in a footnote the following statement:

(1) Summary of Significant Accounting Policies

(b) Silver Bullion and Commodity Futures Trading

* * *

The Proprietorship has a substantial investment in silver bullion when compared to existing supplies. As a result, it is not possible to determine the effect of liquidation of the Proprietorship's investment on the spot price (whether positive or negative). Accordingly, investment in silver bullion carried at cost is not adjusted for changes in the spot price. At October 23, 1979, aggregate market based upon spot price was approximately $338,600,000 [$290,478,000 at September 24, 1979, for Herbert Hunt]. The investment in silver bullion is pledged to secure certain debt.

* * *

Peat Marwick, Mitchell & Co., auditors, reported on the financial statement as follows:

Footnote continued on next page.

The most significant information unavailable to the commodity credit committee and the executive committee was the Hunts' overall exposure in silver, whether futures, forwards or physicals. Members of these committees uniformly testified that they never considered asking the Hunts the size of their overall position. Fred Horn, Bache Halsey's senior vice president for commodities, explained that "[i]t's not the type of thing you do with a customer." Nor did the committees consider asking other broker-dealers or FCMs about the extent of any positions they carried for the Hunts. Witnesses testified that broker-dealers and FCMs considered that information confidential and not to be divulged to other firms. Nevertheless, senior Bache management was not without some idea of the size of the Hunt futures positions. Mattey told Jacobs late in 1979 that he believed that the Hunts' futures positions with Bache represented approximately one third of the Hunts' overall positions. 42/

The executive committee relied on its general impression of the Hunts' financial condition. Bache Group president H. Virgil Sherrill ("Sherrill") testified that executive committee actions on Hunt credits were based on "the general opinion as to the credit worthiness of the Hunts".

Footnote continued from previous page.

> In our report dated October 25, 1978 [October 16, 1978, as to Herbert Hunt], our opinion on the 1977 financial statements was qualified subject to the effect of such adjustments, if any, as might have been required had we been able to satisfy ourselves as to the net realizable value of the Proprietorship's investment in silver bullion. As explained in note 1(b), the market value of the silver bullion based on spot price has increased significantly in 1979. Accordingly, our present opinion on the 1977 financial statements, as presented herein, is different from that expressed in our previous report.

42/ It is not clear where Mattey got this information. Bache Group president H. Virgil Sherrill also heard figures from Mattey concerning the Hunts' total silver position, but viewed these figures as estimates. The CFTC later reported that Herbert, Bunker and Lamar Hunt had futures positions on domestic exchanges that totaled 15,910 contracts at December 26, 1979. Hunt contracts at Bache Halsey comprised 42% of that number.

> [I]t is not predicated on bank statements. It is not predicated on Dun & Bradstreet. It is not predicated on anything that was in writing or definitive.

Jacobs' testimony was substantially similar to Sherrill's in this regard, although Jacobs stated that one basis for his belief concerning the Hunts' financial responsibility was a personal tour he received of the Hunt offices in Dallas, including tours of the offices of Placid and Penrod Drilling Company ("Penrod"), and discussions with the Hunts of their holdings. Jacobs testified however, that he did not know whether Herbert and Bunker Hunt had access to the resources of Placid and Penrod to satisfy obligations to Bache Group. In fact, each of those entities is owned in part by the William Herbert Hunt, Nelson Bunker Hunt and Lamar Hunt Trust Estates and not by Herbert, Bunker or Lamar, or other family members as individuals. A footnote in each of the financial statements described at note 41 states as to these trusts that "the beneficiary has no right to the corpus of the Trust Estate property, nor any right to call for a partition or division of the same or dissolution of the Trust Estate." Notes of an audit committee interview with Jacobs reflects that he told the committee he did not know Placid Oil was held "in trust".

In summary, it appears that Bache management relied on the Hunts' reputed enormous wealth and the fact that the Hunts had always promptly met their obligations to Bache by wired federal funds. Management also had credit reports it obtained upon the opening of the various Hunt accounts that confirmed a good credit standing. However, as previously noted, Bache never obtained a qualification of the Hunts' net worth which could justify the credit lines extended nor did it receive current information about the amounts or maturities of the Hunts' indebtedness or the magnitude of their overall exposure in the silver market.

2. Information About the Silver Markets

As previously described, 43/ a dramatic increase in both the price level and volatility of the silver market, as well as the markets in gold and other precious metals, occurred during the period in which Bache Halsey's commodity credit and executive committees were authorizing increases in Hunt silver futures positions. Persistent rumors and press reports concerning concentrations of silver in the hands of the Hunts and other large investors accompanied the price climb in silver. As the audit committee of Bache Group's board of directors concluded:

43/ See page 54, above.

> The [executive committee] had available to it information contained in public prints which, from time to time, dealt with the silver situation. During the period from August 31, 1979 to March 30, 1980, the Wall Street Journal contained at least 40 articles on the subject, many of which expressed concerns long before the March 1980 silver crisis.

Commodity credit and executive committee members uniformly testified that they read the financial press and were aware of the extraordinary market activity in silver, but they could not recall this information being discussed in connection with the extension of additional commodity credit to the Hunts. 44/

In addition, Bache Halsey's research department had generated extremely cautious assessments of the silver market during the period in question and reports were furnished to, among others, commodity credit or executive committee members Smith, Horn and Mattey. There is no evidence that either committee considered these reports in arriving at decisions on the Hunt credits. 45/

While Mattey, the Hunt account executive and a member of the commodity credit committee, was a governor of Comex throughout the fall and winter of 1979-1980, he apparently did not alert his colleagues deliberating on the Hunt credit to Comex' concerns regarding the silver market or to the steps it considered throughout the period to curb the buildup of substantial long positions such as the Hunts'. Mattey attributes his silence to a perception on his part that he had a duty not to disclose to his firm information he learned as an exchange governor which he believed to be non-public. Commodity credit and executive committee members acknowledged, however, that they were aware of such concerns through news reports and Comex releases.

44/ The audit committee of Bache Group's board of directors came to similiar conclusions in a report it prepared following the silver crisis:

> . . .The Audit Committee could not determine from [executive committee] minutes whether any of the foregoing data sources [e.g., press reports on silver] were used in arriving at credit decisions. Interviews with individual members of the [executive committee] did not disclose that such was the case.

45/ Again, the audit committee report concurs.

IV. THE MARKET BREAK - JANUARY 22 TO THE CRISIS AT BACHE GROUP

A. Introduction

On January 7, 1980, with spot silver prices at $35.80 per ounce, the Comex board of governors imposed retroactive position limits on large long speculators in silver, requiring the Hunts and others to reduce their positions substantially in the ensuing three months. The market continued to climb rapidly, however, reaching an intraday high of $50.36 on Friday, January 17, 1980. On Monday, January 21, Comex imposed a rule prohibiting new orders in silver futures except those placed for the purpose of liquidating a pre-existing position. The next day the spot price of silver, unhampered by exchange-imposed trading limits, dropped $10 per ounce to close at $34.00. This began a two-month period of decline in silver prices that ended with spot silver settling at $10.80 on March 27, a price level lower than at any time since August 31, 1979.

Bache Halsey, carrying a major portion of the Hunts' futures positions, was among those making daily margin calls on the Hunts. While the Hunts reduced their aggregate future and forward positions by 1,751 contracts from January through February 29, the majority of this reduction was attributable to deliveries of 1,107 contracts, or 5.5 million ounces of silver, in Bunker Hunt's account. He used this silver, with the 1133 warehouse receipts the Hunts already had on deposit with Bache Metals, to secure approximately $19.1 million in new borrowing from the firm. The net reduction in the Hunts' aggregate physical, futures and forward positions during those two months was thus only 644 contracts, or 7.6%. Meanwhile, the ratio of excess collateral value in the Bache Metals loan account declined sharply; from 373% on December 31, 1980 to 68% on February 29. The practical effect of this reduction in the collateral ratios was to increase Bache Metals' exposure in the Hunt loans, raising from $7.15 to $21.00 per ounce the silver price level at which a collateral deficiency would occur.

Bache Group's position was rendered more precarious by a further increase in the volatility of the silver market. In January, average daily swings in the spot price of Comex silver averaged 9% of the previous day's settlement price; in March these swings averaged 12%. The open interest declined as well, falling from an average of 106,300 contracts in January to 59,321 contracts in March. Even as the magnitude of the daily price swings in silver increased, however, the percentage price decline that would carry the Hunts' accounts with Bache into deficit got smaller.

By March 14, 1980, a 27% decline in the price of the metal, assuming the Hunts deposited no further assets, was sufficient to produce a deficit in the accounts. 46/ At January 31, a 44% decline would have been required to produce a deficit. The Bache Halsey executive committee during this period determined to increase Bache Metals' loans to the Hunts. It did so during a rapid decline in the market price of silver and without detailed information concerning the Hunts' current financial condition.

B. Increasing the Bache Metals Loans

1. Background

As described earlier in this report, since 1973, Bache Group had extended a line of credit to Bunker and Herbert Hunt, and later to Hunt Minerals, secured by silver bullion warehouse receipts. Until 1975, Bache Halsey, the broker-dealer, acted as the lender in these transactions. Bache Halsey lent funds against 89-day notes from the Hunts and rolled the loan over at the end of that period. According to Bache witnesses, this enabled the firm to avoid a requirement that it charge the full amount of the loan against its regulatory capital. To avoid this problem, in June 1975 Bache Group established Bacor, Inc. as a wholly-owned subsidiary of Bache Group for the purpose of financing Hunt silver. 47/ Since the new subsidiary was not a registered broker-dealer, it was not subject to the net capital requirements of Commission Rule 15c3-1 and NYSE Rules 325 and 326. By the end of August 1975, Bache Group had Bache Halsey transfer the Hunt receivable, then

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46/ This calculation assumes that silver futures in the accounts are valued at futures prices, which on that date were artificially inflated by approximately $10.72 per ounce as a result of exchange-imposed price movement limitations. See discussion above at pages 10-12 and elsewhere in this report. At spot prices, which represented the true liquidating value of the futures, Hunt accounts were already $35 million in deficit.

47/ Bache Group, the parent, chose not to carry the Hunt receivable because of adverse state tax consequences.

$32.5 million, into the new entity in return for all of its 100 shares of outstanding capital stock. 48/

In 1977, another NYSE policy respecting the capital treatment of Bache Halsey's metal trading activity caused the firm to rearrange its corporate structure again, moving the metals trading activities of the broker-dealer into another Bache Group subsidiary. 49/ As a result, Bache changed Bacor's name to Bache Halsey Stuart Metals Co., Inc. and consolidated in it both the bookkeeping for Bache's bullion trading activities and the Hunt silver financings. The Hunt silver financings continued to be rolled forward in Bache Metals at 89 day intervals until February 1978, when the parties modified the loan agreement to provide that the loans would remain outstanding indefinitely unless cancelled upon 30 day notice by either party. This is the arrangement that continued, with relatively minor modifications, until the silver crisis.

The terms of the loans to the Hunts through January 1980, were that Bache Metals would lend 75% of the market value of the silver represented by warehouse receipts deposited with the firm. 50/ If the amount of the loan exceeded 77 1/2% of the collateral, the Hunts had five (later three) days within which to deposit additional collateral, or pay down the loan, to restore the 75% loan/collateral ratio. Bache Metals charged the Hunts interest on the loans at a rate approximately 1 1/2%

48/ Bacor was a bookkeeping entity. Its personnel were all employed and paid by Bache and its obligations were guaranteed by Bache Group.

49/ According to Bache Halsey, the NYSE reinterpreted its net capital rules in a manner that would have required Bache to charge to capital any deficits in customer accounts carrying forward contracts and to charge an additional amount equivalent to 30% of the market value of the commodity underlying the forward contracts. Bache would have had to charge approximately $5 million against its net capital to continue metals trading in the broker-dealer. According to Bache witnesses, the firm informed NYSE of its intention to form Bache Metals because of the capital charges just described. The Exchange did not object to Bache Group's decision.

50/ The bullion collateral for the loan was unhedged.

higher than the rate at which Bache Metals borrowed the funds it lent. After December 12, 1979, Bache Metals' agreement with the Hunts included cross-default provisions between the Bache Metals loan agreement and the Hunts' customer agreements with Bache Halsey as well as a provision that Bache Halsey could transfer excess funds or other assets from the Hunts' accounts with Bache Halsey to satisfy obligations under the Bache Metals loan agreement.

Bache Metals obtained the funds to lend to the Hunts by borrowing from commercial banks, pledging as collateral the same silver warehouse receipts the Hunts deposited with Bache Metals to secure the loans to them. Langdon Stevenson, Bache Halsey's treasurer and principal liaison with the banking community arranged these loans, which the banks permitted in amounts generally ranging from 65% to 90% of the value of the warehouse receipts Bache Metals pledged as collateral. 51/

2. The Major Line Increases

a. The Hunt Requests and Executive Committee Action

As noted earlier in this report, the Hunts' borrowing from Bache Metals remained comparatively stable at approximately $40 million during the fall and early winter of 1979 and 1980. 52/ Late in January, several days after Comex imposed its position limits and liquidation-only trading rule and silver prices had begun to decline, Hunt Energy assistant treasurer Charles Mercer called Mattey to request that the Hunts be granted additional loans against the 1,133 warehouse receipts they had on deposit with Bache Metals and additional receipts to be deposited with the firm. On January 31, Bache Halsey's executive committee voted to increase Bache Metals' loans to the Hunts to approximately $174 million collateralized by 1,490

51/ It should be noted that wholly apart from the Hunt financings, Bache Metals borrowed from banks to finance its activities as a precious metals dealer. To collateralize loans to Bache Metals against the fully hedged silver warehouse receipts in its own inventory, banks lending to Bache Metals against this inventory permitted the firm to borrow 90% or more of the value of the inventory, reflecting the greater security of hedged, as opposed to unhedged, collateral.

52/ The Hunts paid down the loan to approximately $2.4 million in September 1979, but drew it back up to $39.9 million by the end of October 1979.

warehouse receipts. 53/ The new borrowing was to be no more than 65% of the value of the collateral with additional margin required if the market value of the collateral declined by 30%. The executive committee determined that a condition to the additional lending was a cross-collateralization agreement to permit the application of funds in the metals company against deficits in the Hunts' accounts with Bache Halsey.

Although, according to Mattey, he did not ask, nor did the Hunts inform him, what the purpose of the new financing was, Mattey and at least two members of the executive committee apparently believed that the Hunts would need additional funds to satisfy Comex requirements which, as of February 4, 1980, would require them to increase from $40,000 to $60,000 per contract original margin on their silver futures positions.

Within days of the January 31 executive committee meeting, Mercer again called Mattey to ask for further financing against an additional 750 warehouse receipts. Mattey relayed this request to Bache Halsey executive vice president, Elliot Smith ("Smith"). By the end of February, Bache Metals had extended an additional $74 million in silver loans to the Hunts for a total of $233 million, collateralized by 2,240 warehouse receipts. The executive committee discussed this second increase several times during February and obtained the informal approval of the audit committee of Bache Group's board of directors. 54/

53/ At January 31, the market value of 1,490 warehouse receipts was approximately $258 million, enough to maintain the loan in equity at a silver price as low as $23 per ounce. This represented a substantial increase in Bache Metals' exposure, inasmuch as the earlier $42 million loan would have remained in equity at prices as low as $7.15 per ounce.

54/ The minutes do not reflect the exact date of approval. The executive committee discussed additional financings at its meeting on February 11, 1980. The executive committee proposed certain terms, and it was agreed that Mattey would discuss these terms with the Hunts. The executive committee also requested inside and outside auditors to review the Hunts' accounts to clarify the existence of the collateral, and asked the commodity credit committee to obtain an updated report of information on the Hunts' total assets and any other obligations.

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Even after the additional funds were wired to the Hunts late in the month, the executive committee continued to discuss the terms of the loan. On March 10, 1980, the spot price of silver settled below $30.00 per ounce for the first time in 1980. At its meeting on March 11, 1980, the executive committee discussed various modifications to the loan agreements previously governing the credit, and discussed more stringent margin requirements for the silver loan. 55/ The terms were more favorable to Bache than the previous terms agreed upon, and were instituted mainly at the instance of Sherrill, who believed that Bache needed more protection, given the

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The executive committee again discussed the loan increase at its meeting on February 26, 1980. The committee recommended lending 65% of the market value of 750 additional silver certificates ($82 million), and that additional collateral would be required if the value of the collateral declined by 30%. The committee stated that no decision would be made until after Mattey reviewed the matter with the Hunts, and after the commodity credit committee and audit committee reviewed the matter.

55/ The executive committee agreed that the Hunt loan would not be greater than 60% of the market value of the silver collateral; also, if at any time a decline in the market value of the collateral reduced its value to less than 149% of the loan amount (a loan to collateral ratio of 67%), the Hunts would deposit additional collateral or pay down a portion of the outstanding loan balance. Three modifications to the loan agreement were approved: (1) Bache would accept silver certificates as well as cash if additional collateral were required; (2) the Hunts could withdraw equity in the form of cash or silver certificates, above the levels indicated in the loan agreement; (3) as payments were received to reduce the loan, silver certificates could be withdrawn providing the proper ratios were maintained. The cross default provisions remained as provided in the earlier agreement.

magnitude of the loan. 56/ Bache and the Hunts did not execute the new loan agreements until March 20, 1980. 57/

b. Funding the Increased Hunt Lines - Bache Metals' Borrowing in February 1980

Bache Metals funded the increased Hunt loans by borrowing \$233.2 million from a group of ten banks as set forth in the following table. First Chicago, which at that time had direct loans of approximately \$223 million in other loans outstanding to Hunt interests, provided \$75 million, or 32%, of the total. The other 68% was comprised of loans from nine other banks ranging in amount from \$5 million to \$36 million.

TABLE V

BANKS FINANCING HUNT WAREHOUSE RECEIPTS, FEBRUARY 29, 1980

1.	First Chicago	$75,000,000
2.	Irving Trust	36,025,000
3.	Harris Trust	30,000,000

56/ Senior management stated that the loans provided more security and less risk than carrying an equivalent number of futures positions. According to Jacobs, Bache's position with these loans was more conservative, because Bache had 40% equity on hand in the form of silver certificates. It is his position that with futures, Bache's customers were more highly leveraged because required margins were lower than collateralization ratios on the loans. In addition, according to Jacobs, Bache was in a more liquid position with silver loans because the spot market could absorb sales better than the futures markets. Jacobs' reasoning does not necessarily hold up, however, at least as to the effective collateralization ratios on futures as opposed to bullion loans. Given the \$60,000 per contract Comex margins then in effect, at silver prices above \$30 per ounce, the terms of the silver loans provided for a better collateralization ratio. At silver prices below \$30, however, margin requirements on futures contracts provided greater security.

57/ Bunker and Herbert executed loan agreements for \$221.1 million and \$12.0 million, respectively.

TABLE V - continued

BANKS FINANCING HUNT WAREHOUSE RECEIPTS, FEBRUARY 29, 1980

4.	Northern Trust	25,000,000
5.	Bankers Trust	20,000,000
6.	U.S. Trust Co.	12,175,000
7.	Marine Midland	10,000,000
8.	First National Bank of Oklahoma City	10,000,000
9.	Citizens & Southern National Bank	10,000,000
10.	Barclays International Bank, N.Y.	5,000,000

Bache Metals' loans from the listed banks were on a demand basis guaranteed by Bache Group. While collateralization ratios varied slightly among the various banks, they approximated a loan to collateral ratio of 75%. As the price of silver fell, the banks required Bache Metals to forward additional warehouse receipts, or pay down part of the loans, such that the loan amount never exceeded approximately 75% of the value of the collateral. 58/ The banks charged Bache Metals' interest on the loans at the brokers' loan rate or at prime. Bache Metals re-lent the money to the Hunts at its cost plus one and one-half percent.

Bache Halsey's treasurer, Langdon Stevenson, and its assistant treasurer Kenneth Herr, testified that they disclosed to each bank from whom Bache Metals borrowed

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58/ As previously noted, Bache Metals' loans to the Hunts required that they maintain collateral valued at 167% of the loan amount, i.e., that the value of the loan not exceed 60% of the value of the collateral. The larger amount of collateral Bache Metals required of the Hunts left it from time to time with surplus receipts after it had pledged what was required by the banks. Bache Metals did not monitor the collateral position on the bank loans; rather, it relied upon each bank to monitor the collateral and call it for additional deposits as required.

on the Hunts' behalf that the proceeds of its loan would be used to finance a "customer long position" in silver, a phrase that Stevenson and Herr both stated is commonly used to mean that the customer's position is net long--i.e., unhedged. 59/ The collateral rate (75%) that the banks required Bache Metals to maintain in connection with these loans is consistent with Stevenson and Herr's position. Banks ordinarily permit borrowing up to 90% of collateral value where the commodity collateralizing the loan is fully hedged. Neither Stevenson nor Herr, however, disclosed the identity

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59/ Two banks, Harris Trust & Savings Bank ("Harris") and First National Bank of Chicago ("First Chicago"), claim that they were unaware that the collateral supporting their loans to Bache Metals was unhedged. Frank Mignano, the Harris officer on the credit, knew that the loan proceeds would be used by Bache Metals' customers to meet Comex "supermargin" requirements in silver. Harris also agreed to lend only 65% of the value of the collateral, far below rates customary for hedged collateral. Nevertheless, Mignano testified that Stevenson told him on February 5, 1980, that the customer positions were hedged, testimony corroborated by notes Mignano made at the time of the call.

First Chicago representatives testified in the investigation, and First Chicago president Richard Thomas testified before Congress, that the bank believed the collateral was hedged and that it was unaware that the warehouse receipts pledged for the loan to Bache Metals represented a customer position. First Chicago claims that Bache Metals surreptitiously substituted unhedged customer warehouse receipt collateral for the hedged firm inventory positions First Chicago had previously financed. The circumstances of the loans and the testimony of Bache Halsey personnel, however, suggest that First Chicago personnel knew (1) that the loan to Bache Metals was against unhedged customer silver, (2) that the proceeds of the loan were being re-lent to customers to meet margin requirements and (3) that the Hunts were the Bache Metals customers involved.

of Bache Metals' customer, 60/ nor did they inform each bank that it was part of a much larger, $233 million credit package. 61/

Notwithstanding the credit restraint program initiated by the Fed 62/ in October 1979, most of Bache Metals' lenders

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60/ It appears that several banks in addition to First Chicago knew or suspected the identity of Bache Metals' customers. Irving Trust was the concentration bank for the loans. Bache concentrated its bank loans at Irving and instructed Irving to wire funds for the account of Bunker Hunt or Herbert Hunt. Herr also thinks Marine Midland knew who the "customer" was: "I remember certain conversations with Marine Midland and we both kiddingly joked about the large holding of silver by certain individuals out of Texas." Herr claims, however, that the the Hunts' names were never mentioned, so he cannot be sure that Marine Midland knew it was the Hunts. According to Herr, Citizens and Southern's representative, Rodney Knowles, also knew the Hunts' identity as Bache Metals' customer. In the course of conversation with Herr, Knowles indicated that it was obvious to him who could borrow this amount of money against that much silver and that he also went to school with a Hunt in-law. Herr testified that he never confirmed or denied that the customers were the Hunts.

61/ When asked why Bache Halsey had not financed the Hunt loans through a syndicated credit to Bache Metals, Herr testified that he and Stevenson rejected the idea because a syndication was expensive and time-consuming, and unnecessary in view of the extensiveness of Bache Halsey's existing bank contacts.

62/ In an announcement dated October 6, 1979, the Fed "stressed that banks should avoid loan activity in gold, commodity and foreign exchange markets." Board of Governors of the Federal Reserve System, Bulletin (November 1979) at 830.

went forward with unhedged commodity loans to Bache Metals. 63/ Stevenson and Herr encountered resistance to the loan, however, from Continental Illinois National Bank & Trust Co. of Chicago ("Continental"). In November 1979, and again on January 31, 1980, Continental refused to lend to Bache Metals secured by unhedged silver warehouse receipts, because of the Fed's credit restraint program. Continental agreed, however, to lend to Bache Metals to fund its advances to smelters and refiners, loans collateralized by fully hedged physical silver. This loan enabled Bache Metals to finance the Hunt position by freeing borrowing capacity with First Chicago previously devoted to funding producer loans.

C. Early Indications of Problems in the Hunt Accounts

Meanwhile, as Bache Metals went forward with additional credit to the Hunts, two matters came to the attention of certain members of management that suggested that certain Hunt family members might have less ability to maintain their substantial silver positions than management believed. The first of these was Albert and Mary Huddleston's failure to meet a margin call issued in their account on January 24, 1980. The second was Bunker and Herbert Hunt's intensive efforts in early March to obtain financing from European banks to maintain their silver position in the face of a rapidly declining market.

1. The Huddleston Margin Call

On Thursday, January 24, 1980, after three days of limit down price movement in the silver futures markets, Bache Halsey issued a margin call for $19 million in the Albert and Mary Huddleston silver account. The Huddlestons did not meet the call and did not give Bache Halsey an order to sell any of the silver futures contracts in their account. Accordingly, Horn planned to liquidate the Huddlestons' silver positions to meet the call on Monday morning. On Sunday,

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63/ Banks that made loans to Bache Metals, collateralized by silver certificates, claim that they conformed with the Fed's guidelines. For example, Irving Trust and Northern Trust offer similar explanations: that the bank's money was being used to meet margin requirements on positions already in existence, not to acquire new positions. First Chicago takes the position that they thought the collateral was hedged. According to Stevenson, Marine Midland agreed to lend up to the amount of the line already in existence. The bank indicated that a loan in excess of the existing line could be contrary to Fed guidelines.

January 26, Mattey spoke with Albert Huddleston and his father-in-law, Bunker Hunt. According to Bache Halsey witnesses, Bunker Hunt told Mattey that the margin call would be met and, at Mattey's request, orally guaranteed the Huddlestons' further obligations. Bunker Hunt declined to guarantee the Huddleston account in writing because he did not want the Huddleston silver positions aggregated with his for position limit purposes. On Monday, January 27, Hunt Energy Corporation wired funds to meet the Huddleston margin call.

2. Bache Halsey's Knowledge of the Hunts' Efforts to Obtain Financing

In mid-March 1980, during a period of rapidly declining silver prices and just prior to the crisis period at Bache, Stevenson spoke with David Mann, an official of Barclays Bank in London. Mann told Stevenson that the Hunts were in London seeking loans against their silver position, but were being turned down. Mann said that the Hunts had been refused a loan at Barclays. Mann told Stevenson that the reason that Barclays and other banks were refusing to lend to the Hunts against their silver positions was because the silver markets were illiquid and could not absorb the collateral offered by the Hunts if it had to be sold, although Mann believed that the Hunts would probably obtain financing in Switzerland. Stevenson did not call New York with this information. 64/

D. The Hunt Accounts on the Eve of the Crisis

By Friday, March 14, 1980, the market value of the Hunts' silver futures contracts in accounts at Bache Halsey, computed at the spot price, 65/ stood at $481 million and the account had unrealized losses of $429 million. The Hunts had borrowed $233 million from Bache Metals and posted 2,992 warehouse receipts to secure the loan. At spot prices, the Hunts' accounts with Bache Halsey were already $108 million in deficit, although the Bache Metals loan account held $81 million in excess collateral.

64/ Stevenson testified that the conversation with Mann was "the first time it really sunk in" that there was a liquidity problem in the silver market.

65/ Futures prices on March 14 should not be considered as an accurate measure of the value of the Hunts' silver futures positions. The exchange imposed $1.00 per ounce daily price limitations in futures contracts, but the spot price of silver lacked any such restrictions. The spot price of silver on Comex had fallen to $21.00 per ounce, $10.72 below average futures prices.

V. THE CRISIS AT BACHE GROUP--MARCH 17 THROUGH APRIL 8, 1980

A. Overview

In mid-March, futures prices in Comex and CBT silver fell daily the amount of the price movement limits established by those exchanges. On March 17, 1980, Bache Halsey issued $44 million in "house" margin calls in the Hunt accounts. 66/ The Hunts did not meet the Bache Halsey calls. They informed the firm that they expected to meet the calls at some time in the future but that they did not know when or how.

Rather than liquidate the Hunt accounts, Bache Halsey during the week of March 17 and on March 24 and 25 accepted from the Hunts, in lieu of cash margin, warehouse receipts for silver stored with various bullion dealers in London. Notwithstanding that it could not post this bullion as variation margin with exchange clearing corporations, Bache Halsey did not liquidate the bullion to cash because of management's view that, among other things, the market would not absorb a substantial liquidation. Thereafter, on the evening of March 25, Herbert Hunt told Harry Jacobs, Bache Group's chairman, that the Hunts not only remained without cash, but had no more collateral to deposit with the firm.

66/ The variation margin calls on March 17 were so-called "house calls" generated in Hunt accounts when a market decline caused an unrealized loss in the accounts that caused equity in the account to fall below 90% of required original margin of $60,000 per contract. Comex and CBT rules relating to variation margin are more lenient, requiring an account to be called for variation margin only when a market decline causes an unrealized loss that reduces equity in the account below 75% of the original margin requirements. The first of these "rule calls" were generated in the Hunts' accounts with Bache on Wednesday, March 19, and totalled $44.5 million. It should be noted that, in accordance with industry practice, Bache Halsey computed these calls based on futures prices rather than on spot prices, which on March 17 averaged $14.20 per ounce lower. In a limit-down market such as existed at the time, spot prices represented the true market value of the Hunts' futures contracts. Using spot prices to compute margin calls would have generated much larger calls far earlier than actually occurred.

Meanwhile, the spot price of silver, which had fallen from $35.30 to $17.40 during the first two weeks of the month, stabilized in the $20 range through Tuesday, March 25. Futures prices, however, were limit-down every day during the same period, falling from an average $31.60 on March 17 to $25.78 on March 25. 67/ Losses in the Hunt futures accounts increased by approximately $22.3 million daily. Bache Halsey continued to pay in cash to Comex and CBT clearinghouses, as a part of the daily variation margin deposit attributable to all of its customer positions, $22.3 million in margin to support the Hunt positions. This continuing requirement that Bache Halsey make variation margin deposits placed a severe cash drain on the firm. By the morning of March 26, Bache Halsey had paid approximately $156 million to clearinghouses to support the Hunt accounts without receiving any cash from the Hunts. This situation continued until Bache Halsey liquidated the Hunt futures positions on March 27 and 28.

On March 26 and 27, the spot price of silver fell from $20.20 to $10.80. At spot prices at the close on March 27, notwithstanding Bache Halsey's liquidation of some of the Hunt futures and spot positions, the unsecured debit balance in the Hunt accounts, on a firm-wide basis, was $122 million. This deficit, had it been realized and charged against Bache Group's assets, would have reduced Bache Group's net worth by 84%, from approximately $146 million to approximately $24 million.

Bache Group's principal concern was with the continued viability of the Bache Halsey subsidiary. As described earlier in this report, Bache Halsey was required to remain in continuous compliance with the financial responsibility requirements embodied in Commission Rule 15c3-1 and NYSE Rule 325. These rules provide that unmet margin calls on customers must be charged to capital if outstanding for five days or more and the amount of any liquidating deficits in these accounts must be charged immediately.

On March 24, 1980, after borrowing $10.5 million in subordinated capital on the 21st and 24th, Bache Halsey had approximately $51.8 million in net capital in excess of the 4% level and $17.3 million in excess of the 7% "early warning" level. As the Hunt margin calls remained unmet, and as the

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67/ Futures prices cited here are an unweighted average of Comex prices in the May, July, September and December 1980, and March 1981, contracts.

falling price of silver threatened to carry the Hunt accounts into deficit, management became concerned that it would have to charge these amounts to capital. Largely because Bache Halsey, in accordance with accepted industry practice, computed margin calls and liquidating deficits in commodity futures accounts using futures prices in silver rather than the spot prices, this result did not occur. In addition, by requesting Comex to reduce silver margins by 33%, allocating collateral to Bache Halsey from among the warehouse receipts the Hunts had deposited as collateral for their Bache Metals loans and reledgering the Huddlestons' forward positions from Bache Halsey into Bache Group's London subsidiary, Bache Group was able to further reduce the Hunt-related deficits potentially chargeable to Bache Halsey. As a result, on a liquidating basis Bache Halsey had capital deficiencies below the required minimum capital in the amount of approximately $69 million on March 14 and $12 million on March 27. By operation of industry practice in valuing futures accounts in limit-down markets, however, Bache Halsey remained in continuous compliance with the financial responsibility requirements as the industry and the exchanges had always applied them.

At the same time, Bache Metals' creditors, the banks lending to it against the Hunts' silver warehouse receipts, began on March 27 to request that Bache Metals post additional warehouse receipts to maintain required collateralization ratios. Bache Metals informed the banks that it had no more collateral to supply. On March 27 and March 28, the loans exceeded by $33 million and $23 million, respectively, the value of the collateral. This information touched off a second crisis, as Bache Metals' banks with excess collateral ("long banks") threatened to call their loans and sell silver to recoup their loans, thus creating the potential for further decline in the market. Bache Group did not resolve this problem until the early morning hours of April 1, when the banks with inadequate collateral ("short banks") agreed to buy out the long banks and establish a repayment schedule to work out the loan.

B. Bache Accepts Silver Collateral in Lieu of Cash Margin

On or about March 17, shortly after Mercer told Mattey the Hunts would make no remittance on the margin call just issued in their accounts, Sherrill telephoned Herbert Hunt. 68/ Sherrill told Herbert Hunt that it was essential that the call be met, and asked Hunt what he planned to do about the call. Hunt said he understood and would do anything he could to remedy the situation. According to Sherrill, at no

68/ Sherrill cannot recall whether he spoke with Herbert Hunt on Monday, March 17, or Tuesday, March 18.

time in that conversation, or during any other conversation with the Hunts until the end of the next week, did the Hunts make a representation that cash was forthcoming on a specific day. Hunt told Sherrill that the nature of the problem was "a shortage of cash." 69/ Over the next several days, the Hunts described various ideas they had to raise cash. Sherrill arranged a meeting with the Hunts for Wednesday, March 19, to discuss what steps the Hunts could take to meet their obligations at Bache.

On Wednesday afternoon, Bache Group general counsel John Curran ("Curran") and Sherrill met with Bunker Hunt, Herbert Hunt and Hunt Energy vice president Jim Parker. The Hunts said they were going to be busy in the next few days trying to raise funds. Bunker was going to Europe and had contacts there. The Hunts told Sherrill and Curran that they had no cash available on that day and that they did not foresee having cash available for the rest of that week. The Bache Group representatives told the Hunts that with silver between \$20-\$22 an ounce, the Hunts would owe Bache approximately \$20 million a day for the next two to three days. 70/ The Hunts told Bache Group representatives they had nine million ounces of unencumbered bullion stored in London and offered three million ounces to Bache Group in lieu of margin, which Bache Group accepted. Sherrill requested all nine million ounces of silver. Between March 19 and March 25, Bache did receive an additional 3.6 million ounces of silver bullion, bringing the total bullion deposits

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69/ Sherrill had no specific information from Hunt as to what had caused the "liquidity problem." "My good senses told me it was caused by the very sharp decline in the price of silver."

70/ During the course of the hour-long meeting with the Hunts, Sherrill inferred the impression that the Hunts had problems elsewhere, but does not remember their saying specifically that they were meeting with other financial institutions. Bunker said he was going to Switzerland, and alluded to the later publicized proposal to sell silver-backed bonds.

The Hunts told Bache that they had substantial assets. Sherrill was always under the impression that the Hunts would pay Bache. In Sherrill's opinion, he thought that Bunker Hunt gave adequate assurance that he would be successful raising cash in Europe.

to 6.6 million ounces. Bache Group did not liquidate the silver until after it learned, late on March 25, that no more bullion was forthcoming.

Sherrill described Bache Group's decision to accept silver bullion instead of cash as collateral for the variation margin call:

> The attitude John Curran and I had was we believed them; that on that particular day there was no more cash. We believed there was a strong possibility at a future date that there would be cash available, but in the meantime we were going to latch on to whatever was the most liquid asset that they had that we could get our hands on.

Sherrill wanted to cooperate fully with the Hunts so that whatever additional obligations became due, Bache would be paid:

> We wanted to do whatever we could to insure Bache having the best chance to get complete recovery of whatever the obligations were due us from the Hunts. A decision was made at that time that we would go along with the Hunts because they had presented us with very substantial and adequate collateral for the obligation they owed us on that particular day.

Meanwhile, Curran was anxious to have the Hunts sign the loan agreements embodying the terms of Bache Metals' February 1980 loans to the Hunts. Notwithstanding that the money had been advanced before the end of February, Bache Halsey's executive committee had not completed its deliberations on the terms of the loans and now, on March 20, did not have executed agreements with the additional safety provisions sought by the executive committee. Sherrill obtained Bunker's signature on the agreement at a meeting on Thursday, March 20. Later that day, Mattey and Curran met at the Drake Hotel with several Hunt lawyers. Herbert Hunt joined the meeting and signed the loan agreement. Sherrill talked again with Herbert Hunt on Friday, March 21, stressing Bache's need for more collateral. Hunt said they were still working on getting cash or collateral, although he did not say when he would know whether the Hunts were successful.

Bache Group's next communication with the Hunts occurred on Tuesday, March 25. The spot price of silver had resumed its decline, falling by more than $1 per ounce on Monday to close on Comex at $21.25. During the day on Tuesday, Jacobs, Horn and other Bache Group personnel spoke with Herbert Hunt. Jacobs asked Hunt for another 2 million ounces of bullion and for cash to meet margin calls. Jacobs inquired of Hunt whether Hunt wanted the firm to liquidate futures positions. Hunt replied to each question that he would talk to Bunker and call back. That evening, Herbert Hunt called Jacobs at home and told him that the Hunts had no cash and no more collateral, a temporary liquidity bind. Jacobs told Hunt that was "an extremely grave and unsatisfactory response."

On Wednesday morning, Jacobs again spoke with Herbert Hunt. He told Hunt that they (the Hunts) had not met their margin requirements and that Bache had no choice but to sell out the silver positions. According to Bache witnesses, Jacobs asked Hunt whether other firms had been receiving cash instead of bullion, to which Hunt replied, "absolutely not", and told Jacobs that Merrill Lynch had been receiving warehouse receipts as margin before March 20. 71/ Bache advised Hunt to come to New York from Dallas as soon as possible. An arrangement was worked out whereby Merrill Lynch and other brokers were advised to attend a meeting with Hunt.

After the Wednesday morning telephone call with Herbert Hunt, Bache prepared telegrams for each Hunt account announcing Bache's intention of liquidating Hunt silver positions. 72/ The firm began liquidating the physical silver collateral the Hunts' had deposited. That evening, various members of Bache management went to the Drake Hotel to meet with Herbert Hunt and representatives of several other firms.

71/ As described elsewhere in this report, the Hunts paid cash to broker-dealers other than Bache Halsey through March 25.

72/ Bache Halsey prepared telegrams for William Herbert Hunt (Account No. 80-47094); Houston B. Hunt (Account No. SF-31204); Nelson Bunker Hunt (Account Nos. SF-31200 and 80-47093); Lamar Hunt (Account No. 80-47147); and Hunt Minerals International Ltd. (Account No. 80-95886). Bache sent the same telegram to each account:

> Confirming our advice to you today, we require 135 million immediately. In view of your telephone reply today that you were unable to furnish it and that you have no objection of our trying to sell silver, we are commencing efforts immediately to liquidate silver and, in our discretion futures positions to meet this call.
>
> (Signed) Bache Halsey Stuart Shields, Inc.

At the meeting, according to Bache witnesses, Herbert Hunt said that the Hunts had no resources immediately available and that the firms had to do whatever was necessary to take care of the problems. In addition, Hunt told the group the amount of the Hunts' outstanding margin calls at various other firms. Herbert stated that, although Bunker was still trying to arrange financing, as of that moment, they had no resources immediately available.

C. Financial Implications of the Crisis

1. Status of Hunt Accounts During the Crisis

As the price of silver declined during the crisis period the Hunts' accounts with Bache Halsey, Bache Metals and Bache London developed substantial unsecured debit balances. 73/ In Bache London, the unsecured debit balance in the Huddlestons' 750,000 ounce long forward position increased from $19.6 million on March 25 to $21.2 million on March 26 and was locked in at $22.8 million when Bache effectively hedged it with an offsetting short position on March 27.

Meanwhile, the declining value of the silver collateral the Hunts had posted rendered Bache Metals' loans to them undercollateralized, thus generating an unsecured debit balance in the Hunts' accounts with that subsidiary. The following table illustrates the status of the Bache Metals loans accounts during the six business days from March 25 through April 1, 1980:

73/ The existence of an "unsecured debit balance" or "deficit" in a customer account means that following an actual or hypothetical liquidation of the holdings in the account at prevailing prices, a balance, not secured by other assets, would be payable to the broker from the customer. Under rules prevailing at the time of the crisis an unsecured debit balance was required to be charged to a broker-dealer's capital if not collected from the customer by the close of business on the third business day after being generated in an account.

TABLE VI

BACHE METALS LOANS
Outstanding Amounts and Collateral Value
($ Millions)

Date	Loans Outstanding 74/	Collateral Value	Liquidating Value Equity (Deficit)
Mar. 25 75/	233	372	139
Mar. 26	233	271	38
Mar. 27	155	122	(33)
Mar. 28	106	82.3	(23)
Mar. 31 76/	97	90.2	(6.8)
Apr. 1	41.9	32.2	(9.7)

Assessing the status of the Hunts' accounts with Bache Halsey is rendered more difficult because of the account valuation practice prevailing in the industry. Silver futures contracts constituted the most significant holdings in the Hunts' accounts with the broker-dealer. As noted elsewhere throughout this report, in valuing a customer's futures account, both for customer accounting and net capital purposes, industry practice has been to use the settlement price quoted daily by commodity exchanges for each futures contract in the account. This practice has been followed even in limit-down markets, in which, with respect to net long positions, such a practice produces an unrealistically high "market" value for the account. The self-regulatory organizations and the two federal regulatory agencies involved have been aware of this practice and have acquiesced in its continuation. Bache and the other five firms described in this report thus valued Hunt accounts during the crisis at futures prices for accounting and net capital purposes. However, to assess the firm's exposure during the period, Bache personnel informally calculated the value of the Hunt accounts using spot prices, which represented much more closely the realizable value of the accounts in liquidation.

74/ Credit against loan amounts for the value of silver liquidated has been given as of the trade date.

75/ Includes value of 1.25 million ounces of bullion subsequently allocated to Bache Halsey.

76/ Includes $7 million allocated to Bache Metals from a $17 million deposit by Placid Oil on March 31.

Although Hunt accounts at Bache Halsey remained in equity through March 27 when valued at futures prices, at the spot prices more likely to be realized in liquidation Hunt accounts held unsecured debit balances at least as early as March 14. The following table illustrates the approximate status of the Hunts' accounts with Bache Halsey on selected days during the crisis period:

TABLE VII

HUNT ACCOUNTS WITH BACHE HALSEY
Liquidating Value During the Crisis
Equity (Deficit) ($ Millions)

Date	Spot Prices	Futures Prices
March 14 77/	(107)	130
March 25 78/ 79/	127	260
March 26 80/	34.3	231
March 27	(64.7)	177
March 28	(10)	(10)
March 31 81/	- 0 -	- 0 -

77/ Includes the Huddlestons' 750,000 ounce LME forward position, which was removed from Bache Halsey's books on March 24. See discussion below at pages 89-90.

78/ On and after March 20, equity includes value at spot of 3.0 million ounces of bullion deposited by the Hunts on March 19.

79/ On and after March 25, equity includes value at spot of additional 3.6 million ounces of bullion deposited on March 24.

80/ On and after March 26, equity includes 1.25 million ounces of bullion obtained from Bache Metals. See discussion below at page 94.

81/ Includes $10 million of a $17 million deposit to the Hunts' accounts on March 31.

As the table makes apparent, unsecured debit balances in the Hunt accounts on a liquidating basis, computed at spot prices, exceeded Bache Halsey's excess net capital at least as early as March 14 and again on March 27. At futures prices, however, no unsecured debit balances developed in the accounts until March 28, when the liquidation of most of the Hunt futures positions at or near spot prices produced a deficit, according to Bache's contemporaneous calculations, of $10 million. Accordingly, under prevailing practice, Bache Halsey was required to take no charges to regulatory capital prior to March 28 because no unsecured debit balances were produced at futures prices. The unsecured debit balance on March 28 was repaid by Placid Oil, as described elsewhere in this report, on March 31.

As the foregoing discussion indicates, the magnitude of the unsecured debit balances that developed in the Hunts' accounts as the price of silver declined carried the potential for losses to Bache Group that were very substantial in relation to its overall financial resources. As noted earlier on March 27, at the low point in silver prices during the crisis, an immediate liquidation of Hunt accounts would have produced unsecured debit balances in Bache Halsey, Bache Metals and Bache London of $122 million. If not recovered from the Hunts, such a loss would have amounted to approximately 2.5 times the pretax income it reported for fiscal 1980. These potential losses were ultimately averted because (1) silver prices stabilized after March 27; (2) the Hunts obtained credit from Placid to enable them to repay the March 28 deficit on March 31; and (3) banks were willing to refinance the Hunts' obligations to all of their creditors through credits to Placid Oil. 82/

The crisis carried an equally serious potential for impairment of the regulatory capital required to be maintained by Bache Group's broker-dealer subsidiary. Bache Halsey's internal pro forma capital computation as of Friday, March 14, 1980, showed it to have $37.7 million of Rule 15c3-1 capital in excess of its minimum requirements and $500,000 of Rule 326 capital above the NYSE's "early warning" level. On March 21 and March 24, Bache Halsey borrowed a total of $10.5 million in subordinated loans pursuant to a line of credit it maintained with a group of five banks.

82/ From Bache Group's perspective, events described in the accompanying text were fortuitous. For that reason it is important to an understanding of the crisis to assess the potential impact on Bache and the other firms involved if, as was entirely possible, no price stabilization or refinancing of Hunt obligations had occurred.

Bache's Rule 15c3-1 capital at March 24 was thus $51.8 million in excess of minimum requirements and Rule 326 capital was $41.6 million above the "early warning" level. This continued to be the firm's approximate regulatory capitalization for the remainder of the crisis period. As Table VII makes apparent, unsecured debit balances in the Hunt accounts computed at spot prices exceeded Bache Halsey's excess net capital at least as early as March 14, for the two business days thereafter, and again on March 27. Under prevailing industry and regulatory practice, Bache Halsey was not required to recognize and charge to capital the debit balances so computed. The computation of these deficits at spot prices however, represents far more closely than a computation at futures prices, the actual liquidating value of the accounts. 83/ The magnitude of the unsecured debit balances computed at spot prices thus suggests a significant potential for capital impairment had Bache Halsey been required to charge to capital on the basis of such a computation. 84/

Apart from the unsecured debit balances that developed in Hunt accounts, two other aspects of the silver crisis carried the potential for net capital impairment in the broker-dealer or for significant adverse financial impact on Bache Group. First, by March 26, the time approached at which Bache Halsey would have been required to charge to net capital "rule" variation margin calls that had remained unmet after March 19. Second, the limit-down daily decline in silver prices created a negative cash flow in Bache Halsey of approximately $22 million per day. Exchange clearinghouses charged Bache Halsey's clearing balance daily the full amount of the price decline in the Hunt positions, but Bache Halsey received no cash from the Hunts. Because clearinghouses will

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83/ In limit-down trading markets it is, as a practical matter, impossible to dispose of a futures position at the futures price. A liquidation under these circumstances requires a complex transaction sometimes referred to as a "switch", the net effect of which is to permit the disposition of the long futures contract at the much lower spot price, less a premium benefitting the "switch broker" on the other side of the transaction. Accordingly, the true market value of long futures positions in limit-down markets is the spot price, rather than the artificially restrained futures price.

84/ In addition, the deficits illustrated on Table VII after March 26 take into account three other events, described more fully in the following section, that reduced the potential for capital impairment in the broker-dealer. See discussion below at pages 89 through 94.

not accept bullion or warehouse receipts in satisfaction of variation margin calls on clearing members, the Hunts' two bullion deposits with the firm did nothing to alleviate the cash drain associated with their failure to meet calls.

2. Steps to Maintain Net Capital Compliance

As previously described, the possibility that Bache Halsey would suffer regulatory capital impairment as a result of the Hunts' default was substantially reduced because of the industry practices of computing margin requirements and liquidating deficits in commodity futures accounts using futures prices rather than spot prices.

Nevertheless, Bache Halsey took several other steps that reduced the potential for capital impairment. These included (1) reledgering to Bache London the $22.8 million deficit in the Huddlestons' forward position, (2) allocating to Bache Halsey silver bar warehouse receipts held as collateral for the Bache Metals loans but not yet pledged to banks, and (3) successfully requesting that Comex reduce margin requirements in silver, thereby freeing, for application to clearinghouse variation calls, cash which under CFTC regulations Bache Halsey was otherwise obligated to maintain in customer segregation accounts.

a. Reledgering the Huddleston Deficits

As described earlier in this report, on January 16, 1980, Albert and Mary Huddleston entered through their account with Bache Halsey's Houston office, 85/ contracts for the forward purchase of 750,000 ounces of silver on the London Metal Exchange. Bache Halsey carried the position in an omnibus account it maintained with Bache London. The Huddlestons purchased the forward positions at an average price of $46.35 per ounce for a total obligation, due on July 16, 1980, of $34.8 million. By the close of business on Friday, March 21, the Huddlestons had unrealized losses of $18.4 million on these positions.

From March 20 through 25, Mattey sold out all of the non-silver assets in the Huddlestons' account. Meanwhile, in order to eliminate the possibility that losses on the London position would have to be charged to Bache Halsey's capital, Frank Geremia ("Geremia"), head of Bache Halsey's

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85/ Mattey, who by this time had assumed account responsibility for the Huddlestons, placed the order.

commodity operations, on March 24 had the Huddlestons' London forward position, and the associated losses, reledgered from Bache Halsey's omnibus account into an individual account with Bache London. 86/

On March 27, Bache Group had Bache London liquidate the Huddleston position in offsetting transactions to settle at $15.15 per ounce, a loss of approximately $22.8 million.

b. The Approach to Comex

Bache Group chairman Harry Jacobs returned from an Austrian vacation on Monday, March 24. On reviewing the situation, he formed the opinion that the silver crisis was serious enough to warrant that the commodity exchanges declare the existence of what Jacobs described as a "force majeure" which would thereby justify closing the silver markets. Jacobs contemplated that the Comex would shut down trading in silver and settle all the contracts at a stipulated price. 87/

86/ There is conflicting testimony from witnesses as to (1) whether Bache Halsey would have been charged with deficits from the Huddlestons' London position if that position had remained in Bache Halsey's omnibus account with Bache London and (2) whether in fact the reledgering was motivated by net capital concerns. The answer to the first question appears to depend on whether, in the event of a default by Bache London, the LME dealer on the other side of these contracts would have had recourse to Bache Halsey as the owner of the omnibus account. Art Regel, manager of the Bache Halsey department that manages the omnibus account with Bache London, testified that carrying the position in the Houston account would have automatically triggered a capital charge by operation of Bache Halsey's automated accounting system. Both Geremia and Bache Halsey controller, Alan Hogan testified that the LME position had been carried in the Huddlestons' Houston account "by mistake" and that its removal from the omnibus account merely corrected the "error". Sherrill, however, testified, and the audit committee of Bache Group's board of directors concluded, that Bache Halsey effected the reledgering to avoid capital charges.

87/ Jacobs testified he formed his opinion concerning the existence of a market emergency because he believed that the silver market was illiquid.

On Tuesday morning, Jacobs, Sherrill and other members of Bache Group management met with Lee Berendt, President of the Comex, and Mark Buckstein, Comex counsel. Bache Group personnel explained Bache Group's situation vis-a-vis the Hunt accounts, including the fact that Bache Halsey had received bullion instead of cash for variation margin calls. The Bache Group representatives proposed closing the market or lowering the margin requirements. Berendt and Buckstein expressed opposition to the proposal that the market be closed, but told the Bache Group personnel that a Comex margin committee meeting was scheduled for the next day. Berendt and Buckstein said that if Bache Group felt it was necessary, they would confer concerning Bache Group's problems with Comex' board of governors.

On Wednesday morning, some hours after Herbert Hunt's late evening call to Jacobs explaining that the Hunts had no more cash or bullion, Berendt and Buckstein came to Bache Group's offices. Berendt and Buckstein told Bache that trading in the market would not be suspended, because the Comex had called a number of other firms where they knew the Hunts had positions and those firms were still receiving cash from the Hunts. 88/ The Comex officials also said they thought the market did have liquidity, and told the Bache Group representatives that Henry Jarecki, chairman of Mocatta Metals, would buy a substantial amount of silver from Bache. 89/ Finally, Berendt and Buckstein told the Bache officials that the morning margin committee meeting had been cancelled. Bache Group officials were, according to Jacobs, irate at the latter piece of information.

At about 12:15 that afternoon, Jacobs telephoned Fed chairman, Paul Volcker, because, as he stated:

88/ Berendt and Buckstein said that based on the fact that other houses were receiving wire transfers, it was not necessary to close trading. Berendt and Buckstein did not reveal to Bache which other houses Comex had contacted.

89/ Jacobs considered it "astonishing and unusual" that Berendt and Buckstein told him that if Bache wanted to sell out silver, those sales would meet with broad liquidity in the market. According to Jacobs: "In my dealings with stock exchange officials over the years when we have blocks of securities to buy or sell, I have never been advised by stock exchange officials where to go. I thought that they were, you know, structuring a market place."

> First, I thought that there was an extremely illiquid situation developing there and it was in the National (sic) interest that I call him as the senior, central banker of the world.
>
> Secondly, I guess from a more parochial point of view we thought it would help put pressure on the Comex.

In Jacobs' words,

> I told him that there was a matter that I thought was extremely grave and that there was a great illiquidity in the silver market and that we had proposed a twin approach to the Comex of either a force majeure, which they didn't seem interested in, and/or reducing margin requirements.

Approximately an hour after Jacob's call to Volcker, Volcker returned the call. Volcker wanted to know the identity of the banks lending to Bache Metals against silver collateral. Jacobs identified the banks. According to Jacobs, Volcker was "not pleased" to learn of the silver loans and expressed surprise at the total amount of the loans.

Not long after Jacobs' second conversation with Volcker, Berendt phoned Jacobs. According to Jacobs, Berendt was "very annoyed" and wanted to know, "Why the hell did I call Paul Volcker." Jacobs testified that Berendt was upset that "I was putting pressure on him to either have a force majeure or get margins reduced."

That afternoon the Comex board of governors met on an emergency basis while Bache officials, including Sherrill, and others, waited outside the meeting. According to Mattey, he attended the meeting in his capacity as a governor of the exchange after Berendt and Lowell A. Mintz ("Mintz"), board chairman, permitted him to do so. Mattey testified, however, that Mintz directed that he not participate in the discussion or vote. Mattey recalled that Berendt told the governors that Bache Group had requested the market be closed and that the request had been denied. There was no further discussion of the Bache Group request, nor any voting. 90/

The governors did vote on Bache's request to reduce margin requirements. The board learned that Bache Halsey was seeking relief from a cash flow problem caused by Bache's obligation to deposit large sums of variation margin. Mocatta

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90/ Mattey says that no reason was given for denying Bache's request, and no governor raised any objections to the procedure followed for acting on it.

Metals chairman Henry Jarecki moved to reduce the margin requirements, and the Board voted to reduce original margin from $60,000 to $40,000 per contract.

As noted in Comex' chronology of its activities before and during the crisis, 91/ the reduction in original margins had the effect of "[freeing] up" approximately $80 million in original margin deposits for Bache Halsey to apply to variation margin calls issued by the clearinghouses. The reduction of original margin requirements, moreover, reduced maintenance margins, which exchange rules set at 75% of original margin, from $45,000 to $30,000 per contract, thereby substantially reducing the degree of undermargining in the Hunt accounts. The Comex action had a two-fold beneficial effect on Bache Halsey's financial condition: (1) By freeing $80 million from the segregation account, the original margin reduction obtained for Bache Halsey cash needed to meet variation margin calls at the exchange clearinghouse, 92/ and (2) The concomitant reduction of maintenance margin levels eliminated the oldest outstanding margin calls, thereby avoiding the requirement that these aged calls be charged to capital.

91/ Commodity Exchange, Inc., Chronology of Activities Relating to the Silver Market from September 1979 through March 1980 (April 14, 1980) at 43.

92/ "Under the segregation provisions of the Commodity Exchange Act, an FCM is prohibited from using the equity in one customer's account to offset a deficit in another customer's account. The Commodity Exchange Act requires that funds received by an FCM for margining customer trades must be accounted for separately and must be segregated from the operating funds of the FCM. Under Commission regulations, if an individual customer's account has a deficit balance, the carrying FCM must deposit its own funds to compensate for the deficiency, thus, any customer's losses that exceed the level of deposits or equity in the customer's account and result in a deficit balance must be paid to the clearinghouse by the FCM from its own funds." CFTC Study, Part Two at page 11 (Footnote omitted).

c. Allocating Collateral from the Bache Metals Loans to Bache Halsey

On March 26, the spot price of silver fell $4.40 per ounce to close at $15.80. That morning Bache Halsey had begun to liquidate the bullion that the Hunts had deposited earlier in lieu of margin in the Hunts' futures accounts. Among other positions, Bache Halsey sold short in Bunker Hunt's account 250 contracts of March silver and credited Hunt's account with the $19.5 million in proceeds. To cover this position, Frank Geremia went to the office of Art Regel, the assistant vice president in charge of Bache Halsey's spot commodity department, and inquired as to the number of warehouse receipts in the Hunt loan accounts with Bache Metals that had not been transmitted to banks to collateralize Bache Metals' borrowings. Regel told him there were approximately 263 receipts in the account. Geremia told Regel to prepare the receipts for delivery against the short position in Bunker Hunt's account. Regel did so and that evening the firm tendered delivery notices on 250 contracts of Comex silver. When bankers the next day began requesting additional collateral for the Bache Metals loans, Stevenson and Herr informed them that none was available.

D. Liquidation, Loss and Recovery

1. The Liquidations

On Wednesday morning, March 26, Jacobs and other Bache Group personnel called Herbert Hunt. They told him that the Hunts' inability to meet margin calls or deposit bullion left Bache with no choice but to liquidate the Hunts' silver positions. They asked his permission to do so. Hunt told them that Bache could proceed.

After the call Horn began liquidating physical silver, beginning with the 6.5 million ounces Bache Halsey had received from the Hunts in lieu of margin and the 1.25 million ounces it had received from the Hunts' account with Bache Metals. On March 27, Horn began liquidating domestic silver futures positions, silver bullion deposited as collateral for the Bache Metals loans and the Huddlestons' London forward position. By the close of business on Friday, March 28, Bache Group had executed transactions liquidating all of the Hunts' silver positions except, according to Bache, approximately 7.5 million ounces of bullion pledged to Bache Metals to secure its loan to the Hunts and 118 futures contracts. 93/ At the price prevailing at the close on March 28, on a liquidating basis, the Hunts' futures accounts with Bache Halsey had, according to later

93/ An audit by Commission staff of available documentation on these transactions suggests that 6.9 million ounces of bullion remained unsold on March 28. We are attempting to reconcile the differences in these numbers.

Bache reports, approximately $10 million in unsecured debit balances. The amount of Bache Metals' remaining obligations on demand notes held by the banks from whom it had borrowed to finance Hunt silver was approximately $105 million, which exceeded by approximately $22 million the value of the unliquidated silver collateral. The Huddleston forward position that had been reledgered into Bache London had been offset by a short forward transaction leaving a deficit of approximately $22.8 million. 94/

The $10 million deficit in the Hunt accounts at Bache Halsey was potentially the most serious problem for the firm. With silver futures contracts for 590,000 ounces remaining on its books, Bache Halsey had only $10.6 million in Rule 326 capital above the 7% "early warning" level. Charging the Hunt deficits against that amount would have reduced Bache Halsey's Rule 326 capital to within $500,000 of the 7% threshold. 95/ Although Bache Halsey held in Hunt accounts

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94/ Bache sold 834,399 ounces of silver to retail customers beginning Friday, March 28. Using the Bache Halsey retail network, Bache senior vice president Elliot Smith ("Smith") and Bache Halsey's syndicate department conducted what Smith described as a "spot secondary distribution" of silver. Smith had Bache Metals buy a block of silver from the Hunts' account. He drafted a "spot secondary" announcement which was disseminated over the Bache Halsey branch wires. According to Smith, Bache filled approximately 1,000 orders for retail silver on Friday, March 28 compared with ordinary retail volume of 30-40 orders per day. According to Smith, Bache Halsey account executives were not requested to solicit orders from their customers for silver bars, and the second version of the wire, disseminated the following week, directed Bache personnel not to solicit retail orders.

95/ It should be noted that in a holding company such as Bache Group in which the broker-dealer subsidiary is the principal asset, impairment of broker-dealer capital below the Rule 326 level can introduce an element of financial instability. If broker-dealer capital falls below the early warning level the parent can no longer upstream assets to cover the obligations of other subsidiaries that may be, as in the case of Bache Metals and Bache London, guaranteed by the parent.

576,600 shares of Bache Group stock, trading in those securities had been suspended by the NYSE and the Commission the day before 96/ and counsel had advised, in any event, that the stock not be sold.

96/ Securities Exchange Act Release No. 16703 (March 27, 1980). As discussed more fully at pages 110 through 111, Bache Group issued a press release at about 4:00 on Friday afternoon, March 28, reporting that "Bache" had liquidated Hunt silver without a loss. That release was obviously inconsistent with the facts as later acknowledged by Bache. Bache Group personnel involved in the preparation of the press release, however, have uniformly testified that they did not learn of the potential losses described in the text until sometime over the weekend of March 29-30. There are circumstances that suggest that other Bache Group personnel knew or should have known of these losses at or before the time of the March 28 release.

(1) The broker-dealer losses: (a) Bache later attributed $5 million of the broker-dealer deficits to liquidating deficits in the Huddlestons' domestic account. Bache personnel have testified that the Huddleston accounts were overlooked in computing the status of the accounts on Friday, even though (1) as recently as March 19, Bunker Hunt had renewed his oral guarantee of the account, (2) members of management testified that there were discussions of the account as late as March 26 among Bache Group personnel responsible for the situation and (3) the liquidations of the Huddleston domestic silver positions began on March 26. (b) Bache attributed the other $5 million of broker-dealer losses to transactions costs that had the effect of reducing the effective price Bache Halsey received on the liquidations. According to Geremia, he learned on Saturday that the switches Bache Halsey used to effect liquidations of the futures accounts were done at spreads of cost $.675 per ounce below spot rather than the $.275 Bache Halsey had estimated when computing the results of the liquidation on Friday. While Geremia claims it was necessary to await paperwork confirming the trades to learn this information, traders from other firms testified that transaction costs are known immediately because they are part of the spread on the switch.

Footnote continued on next page.

On Sunday, March 30, Jacobs urgently telephoned Herbert Hunt and informed him of the problem, saying that Bache Group needed funds immediately. The next day, Placid wired $17 million to Bache Group for the Hunts' accounts. Bache Group applied $10 million of that amount to eliminate the deficits in the Hunts' accounts with Bache Halsey and $7 million to reduce the amounts outstanding on the silver loans. Bache Halsey also liquidated the 118 contracts remaining in the Hunt accounts with no further loss. At the end of the day on Monday, March 31, the Bache Metals loans remained under-collateralized by approximately $7 million and Bache London continued to carry an unsecured receivable from Albert and Mary Huddleston totalling $22.8 million. Bache Metals sold the remaining silver bullion over the next month and on April 8 and 24 received additional cash from the Hunts totaling $27.7 million. By April 29, 1980, except for minor amounts for interest, storage charges and legal expenses, the Hunt losses had been recovered.

2. The Banking Problem

On March 27, news concerning Bache Group's difficulties with the Hunts reached the financial community at large. Bache Halsey treasurer Langdon Stevenson and assistant treasurer Kenneth Herr began receiving calls from Bache Halsey and Bache Metals' lenders requesting information concerning the firms' financial condition or, in the case of Bache Metals' banks, asking for more silver collateral to support loans. Three groups of bank lenders were important to the firm on March 27 and thereafter. These were (1) Bache Halsey's subordinated lenders, whose lines of credit the broker-dealer depended upon for availability of subordinated debt should it require additional regulatory capital; (2) the

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Footnote continued from previous page.

(2) The Huddleston London losses: Again, Bache Group witnesses testified that they forgot about the Huddleston London position while reviewing the Firm's position on Friday.

(3) The Bache Metals deficit: Bache Group personnel testified they had no idea until Sunday, March 30, that the Bache Metals loans were, as a group, undercollateralized. One banker, however, testified that he had been so informed by a Bache representative during the day on March 28. Geremia, moreover, had personally ordered 250 warehouse receipts to be removed from the collateral pool and sold through the broker-dealer on March 26.

lenders that provided Bache Metals with funds to advance to the Hunts against silver warehouse receipts; and (3) lenders providing broker loans to Bache Halsey secured by customer marginable securities. Actions or positions taken by banks within each group of lenders deepened the crisis at the firm on and after March 27.

a. Subordinated Lenders

As of March 27, Bache Halsey had outstanding a total of $39 million in subordinated loans from the Royal Bank of Canada ("RBC") and from a group comprised of Chemical Bank, Bankers Trust, Security Pacific National Bank and Trust ("Security Pacific"), Northern Trust Company of Chicago and Continental Illinois National Bank and Trust Co. (the "Continental Group"). Continental served as agent for the Continental Group on the Bache Halsey subordinated credit. The banks had made the subordinated loans pursuant to term loan and revolving credit agreements. $24 million remained committed but not yet outstanding under the two revolving loan agreements, assuming Bache Halsey could certify compliance with the terms of the credit agreement.

On March 27, Stevenson called Ford Pearson ("Pearson"), the Continental Illinois officer assigned to Bache Halsey's account, and told him of the problem in the Hunt accounts and the liquidations then underway. Stevenson asked whether the subordinated lenders were willing to extend additional loans under the subordinated credit. 97/ Pearson advised Stevenson not to request a draw under the subordinated loan, but rather to hold a meeting of all the subordinated lenders the next morning in New York. 98/ On Thursday afternoon,

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97/ Under the terms and conditions of the subordinated loans, provided that Bache met all the requirements, the banks were obligated to extend the credit. Pearson polled the other subordinated lenders because, under the terms of the subordinated loan agreement, there was room for debate as to whether Bache met all the terms and conditions. In particular, certain banks were concerned about the "material adverse change" clause. Under this clause, Bache had to warrant that there was no material adverse change in its financial condition before a draw-down. Given Bache's situation with the Hunts, there was the possibility that Bache could not warrant that no material adverse change had occurred, or that the banks could challenge such a warranty if given.

98/ Pearson advised Stevenson not to request a draw because the situation was in a state of flux. Nobody knew how serious the problem was, and certain banks did not fully understand the situation. Pearson thought Stevenson had to quantify more specifically the impact of the problem on Bache's financial condition.

Stevenson told the subordinated lenders and certain of its operating banks that Bache Halsey would hold a meeting with its subordinated lenders and other key banks the next morning.

Friday morning, March 28, representatives of Bache Halsey's subordinated lenders and several other banks met at Bache Group headquarters. 99/ Various Bache Group personnel made presentations concerning Bache's financial condition, the Hunt silver positions and the liquidations. 100/ The meeting continued into the afternoon as Bache Group officials brought the bankers periodic updates on the progress of the firm's liquidation of the Hunt positions. Finally, sometime in mid-afternoon, Bache Group reported (erroneously, as it turned out) that it had completed its liquidation of the accounts with no loss to the firm.

Meanwhile, Bache Group officers were quite concerned about the impact on the firm's operations of a trading suspension in Bache Group common stock entered by the Commission on March 27. The suspension by its terms was to continue until midnight on April 5, 1980, although the Commission left open the possibility that it would lift the suspension earlier

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99/ The banks represented at the meeting were: Continental, Chemical, Security Pacific, Northern Trust, Bankers Trust, and Royal Bank of Canada, all subordinated lenders; and First Chicago, Morgan Guaranty, and Irving Trust. In addition, Morgan Guaranty officer, Tony Cutler remembers that a representative from Citizens and Southern Bank was present, although that bank is not listed as attending in the handout from the meeting.

100/ The substance of the meeting was described extensively in testimony. Jacobs, Sherrill, Hogan and Geremia were the key Bache people making presentations at the meeting. Steve West, of Sullivan and Cromwell, Stevenson and others also made comments and responded to questions. Each person testifying about the meeting had a slightly different recollection as to what specifically was said and by whom. The bankers were informed about the total number of ounces of Hunt silver held by Bache; the history of the Hunt relationship; the fact that unmet margin calls occurred; Bache's approach to the Comex to close the market; the financial impact of the liquidation on the broker-dealer's net capital at 7% and 4%; the break-even price for the silver liquidations; Bache's compliance with the terms of its loan agreements and the regulatory requirements of the SEC, CFTC and NYSE; Bache's difficulty in financing its daily operations; and the upsurge in retail demand for silver.

if appropriate. Bache Group management perceived the suspension as having a material adverse impact on Bache Group's customers, its banks and the financial community generally, and was accordingly under intense pressure to release information sufficient to induce the Commission to lift the suspension to permit the resumption of trading on Monday morning.

Bache Group's general counsel, John Curran, its outside counsel, Sullivan & Cromwell, and the firm's public relations personnel drafted a press release Friday afternoon that "Bache" (the release did not specify whether it covered all of the Bache Group subsidiaries with Hunt accounts or only Bache Halsey) had liquidated the Hunt positions with no loss to the firm. The release also reported that the firm was in compliance with applicable regulatory requirements and that its subordinated lenders had confirmed that the $24 million committed, but not yet outstanding from its subordinated lenders, remained available.

Bache Group regarded the latter statement as an important expression of confidence from its bankers and on Friday afternoon requested that the subordinated lenders, still assembled at Bache, accede to the language. The subordinated lenders met by themselves with a draft of the release. After the officers present telephoned their respective superiors for clearance, they agreed to permit Bache Group to issue the statment concerning the continued availability of subordinated capital.

As Bache Group management knew at the time, however, the continued availability of subordinated capital was not unqualified. It was based on Bache Group's representations that (1) the firm had liquidated the Hunt positions without a loss; (2) Bache Halsey's regulatory capital continued in excess of the "early warning" level; and (3) that Bache Halsey would not request a draw. The latter representation, as Royal Bank of Canada officer Gordon MacIvor confirmed, appears to have been a key factor in the banks' decision. Perry Pero, an official of Northern Trust, also noted that his bank agreed to the press release based on Bache's representations that it did not need a draw. The general consensus of the banks as of Friday was that, based on the information provided by Bache counsel, the status of the firm was acceptable, the futures were unwound and Bache Halsey's capital was unimpaired. These factors, coupled with Bache's desire for an expression of confidence from the banking community, contributed to the banks' willingness to approve a press release.

Bache Group officials deposed by the staff deny knowledge that the banks acceded to the press release based upon Bache's representations that it would not request a draw. However, according to Pero, for example, Bache counsel "was certainly aware of the fact that his comment that there would be no need for a draw had a material impact on us." In addition, as a result of stating that there would be no draw, Bache Halsey did not have to make any specific representations under the covenant provisions of the subordinated loan agreement. Bache Halsey did make a general representation, however, that it was not in violation of key financial covenants.

Pearson stated that Continental would have accepted at face value any representations made by Bache as to its conformity with financial covenants of the subordinated loan. However, other banks would have required special verification before accepting Bache's warranties.

Bache Group nevertheless issued the press release as drafted on March 28. At the time it was issued, Bache Halsey's liquidation of the Hunt position had left $10 million in deficits in the Hunt accounts; 6.9 million ounces of Hunt silver remained in Bache Metals and was worth $22 million less than the amount Bache Metals owed the banks that had done the financing; and the Huddleston forward postions that Bache Halsey had reledgered to Bache London had liquidated to an unsecured deficit of $23 million.

Bache Group disclosed substantially the foregoing information to its lenders on March 30 and 31 and the announcement caused consternation in the bank group. At a lunch meeting on Tuesday, April 1, Stevenson again asked Pearson whether Bache Halsey had available to it the $24 million in undrawn credit lines under the subordinated credit agreements. Pearson told Stevenson that losses, particularly after the firm had sounded the "all clear" on March 28, made it inadvisable for Bache Halsey to request a draw at that time. Bache Halsey determined not to request a draw.

b. <u>The "Silver Banks"</u>

At the same time Bache Group sought to reassure its subordinated lenders, the banks lending to Bache Metals against the Hunts' silver warehouse receipts ("silver banks") on March 27, began calling Stevenson and Herr requesting additional collateral to maintain required ratios in the wake of the price decline in silver on March 25 and 26. Stevenson and Herr told the silver banks that there was no more collateral. Some of the banks began to raise the possibility that they would call for repayment on the demand notes evidencing the loans. To address the problems, Stevenson and Herr scheduled a meeting for the silver banks as a group in Bache Group's headquarters offices on Monday morning, March 31. Meanwhile, Bache Group's Friday press release eased the situation somewhat; a number of silver bankers testified that they went home on Friday evening believing that the crisis was over.

At the Monday morning meeting, however, Bache Group told the silver bankers of the approximately $50 million in potential losses that it had discovered over the weekend.

Pearson termed the Monday meeting a "fiasco," and the testimony of other bankers corroborates the disorganized, highly emotional character of the meeting. Bache's outside counsel chaired the meeting for Bache, and served as the primary funnel of information from Bache to the bankers. Part of the problem arose because Bache Group had disseminated optimistic information on Friday. On Monday, with news of the approximately $50 million in unsecured deficits, Bache's credibility with the bankers was severely impaired. In addition, some of the banks were meeting with Bache for the first time and had to be provided with initial financial and technical information.

Soon after the meeting began, the banks polarized into two groups: the "long" banks and the "short" banks. The "long" banks (Citizens and Southern, Barclays, Bankers Trust and First of Oklahoma) had excess collateral at the current market price to liquidate and pay down their loans. The other six "short" banks, (First of Chicago, Irving Trust, Harris, Northern Trust, Marine Midland, and U.S. Trust) had insufficient silver collateral at current market prices to liquidate and pay down their loans. Irving Trust's representative was adamant throughout most of the day in the position that all the collateral for all the banks be pooled, and that pro rata pay downs be made to each bank as the silver was sold. The Citizens and Southern representative on the other hand, was equally adamant in his position that his bank would not forego its fully collateralized position. As the meeting progressed, the Citizens and Southern representative, speaking for the four long banks, took the position that unless the long banks were paid that day, they would sell their collateral in sales at below market prices. In fact, Citizens and Southern had arranged a private sale of the bank's collateral which could have been executed the next day.

The problems were further compounded by the fact that Bache Group had already sold a substantial amount of the banks' silver collateral. Beginning Monday, Bache had to make delivery of the silver in order to effect these sales.

Certain banks, such as Irving Trust, were unwilling to release the warehouse receipts in their possession to enable Bache Halsey to make delivery on the street. 101/ Bache Group's determination to apply $10 million of Placid Oil's payment to Bache Halsey created further conflict because some of the bankers wanted the entire $17 million to reduce the silver loans outstanding. According to First Chicago representative Robert Yohanan ("Yohanan"), he suggested that Bache Halsey draw down the remaining subordinated money available to it, then lend the proceeds to Bache Metals, enabling it to pay down the silver banks. Yohanan testified that Bache counsel told him that Bache Halsey was not certain the subordinated money was available to it.

The disputes among the long and short banks continued until shortly after midnight on April 1, when the short banks agreed to buy out the long banks, pool the silver collateral and refinance the loan. Bache Metals pledged additional collateral in connection with the refinancing comprised of 6,000 ounces of gold, the equity in Bache Metals' short hedge position in the futures markets maintained in accounts with Bache Halsey, Bache Group's stock in its Albert Bender insurance subsidiary and the Hunts' holdings of Bache Group stock. 102/ The outlines of the agreement were embodied in a handwritten document executed during the early morning hours of April 1. Bache Metals thereafter repaid the refinanced obligations the next month out of the proceeds of the liquidation of the remaining silver bullion.

c. Bache Halsey's "Line Banks"

The crisis in confidence arising from the events of the silver crisis and Bache Group's difficulties with the silver bank and subordinated lenders had an impact, as well, on the banking relationships which were integral to Bache Halsey's ordinary operations.

101/ The problem was solved in two ways. Several banks volunteered warehouse receipts for the delivery. In addition, Stanley Shirk, chairman of Bache Group's audit committee, phoned the president of Irving Trust and convinced him to direct the bank to release the warehouse receipts for delivery.

102/ On March 31, Bache Metals' equity in its futures accounts with Bache Halsey was $20.1 million. Bache attorneys have advised the staff that Continental, which had loans outstanding to Bache Metals against its hedged silver inventory, understood that Bache Metals was pledging the equity in the short futures position hedging the inventory collateral and did not object.

Beginning on Thursday, March 27, the broker-dealer began to experience obstacles to arranging financing and conducting its routine operations. 103/ These problems created abnormally high borrowing needs which continued well into April. According to Herr, Bache Halsey borrowing increased from approximately $100 million to approximately $600 million in three days.

Bache Halsey's cash flow problems had several causes. First, Bache Halsey was required to wire funds to the commodity clearinghouses without receiving funds from the Hunts. It borrowed from line banks to do so.

Second, banks cut off the "interest equivalent programs" normally available to Bache Halsey. The "interest equivalent program" is a complicated cash management technique that certain broker-dealers use, at a very low interest rate, to obtain an amount of funds equivalent to that in their commodity customer segregated funds accounts. Under CFTC regulations, a broker-dealer must maintain customers' commodity funds in a segregated account. The broker has two choices as to the use of the segregated funds: either invest in T-bills and earn interest on the funds or leave the funds on deposit with a bank in a segregated account permitting the broker to withdraw federal funds from another account of the bank in an amount equal to the segregated account. In the latter instance, the bank has no right of offset against the segregated account. This system, also called "interest offset", or "uncollecting", permits a broker-dealer to have an opening cash flow of federal funds good immediately. The broker-dealer then covers the federal fund withdrawal with a clearinghouse check, good the next day. The bank has a credit risk in the interim since it has no right to offset against the segregated account. Borrowing money for daily cash flow, as opposed to using the interest equivalent program, is expensive; Bache Halsey paid only 1/4% on an annualized basis for funds it used in the interest equivalent program, whereas it paid the broker loan rate, at that time approximately 15%, for ordinary borrowing. As banks withdrew Bache Halsey's "interest equivalent program" privileges, the firm had to replace the funds it had previously obtained with new borrowing in an amount equivalent to its segregated funds account. 104/

103/ Herr described the situation at Bache Halsey on Thursday as having the day-to-day operations of the treasurer's department "severely impaired" due to the rumors spreading in the financial community.

104/ Chemical Bank, Chase Manhattan and Bankers Trust cancelled or curtailed the interest equivalent program as of March 27. Morgan Guaranty, Citibank and Marine Midland permitted Bache to continue the interest equivalent program.

In addition, commodities exchanges' clearing organizations requested additional cash deposits. The Chicago Board of Trade Clearing Corporation requested a $40 million "special margin" deposit on March 26, which it reduced to $20 million on March 27. Bache Halsey was required to maintain the special margin on deposit with CBT at least through April 3.

Meanwhile, as Bache Halsey's borrowing needs increased, certain of its regular lenders suspended or restricted its borrowing privileges. Two banks, Credit Italiano and Credit Lyonnais, demanded repayment of their loans. Other banks required Bache Halsey to secure letters of credit, certified checks, foreign exchange lines and agreement to pledge facilities, requiring the physical deposit of collateral (i.e., stock certificates) with the Depository Trust Company or the bank itself. The need to secure all its bank lines strained Bache's normal operating procedures; and, ironically, further increased its borrowing requirements. Bache Halsey found itself in a "Catch-22" situation. As Herr explained:

> We found ourselves in a situation asking a bank to release collateral to us so that we could in turn make a delivery on the street and get paid and in turn pay the loan down. The banks were not releasing the collateral to us unless they got a loan pay down prior to their releasing the collateral or they got collateral that they could readily substitute.

In short, Bache Halsey could not get paid for stock without presenting the stock; it could not present the stock without paying for its release. As a solution, Bache greatly increased its stock loan activity. Herr continued:

> So as a result I was forced to use every bit of collateral that Bache had -- the collateral mainly being . . . customer marginable securities -- to borrow every dollar I could get my hands on to meet our day to day cash flows. 105/

Herr described that he had borrowed against all collateral blocks of $100,000 or more and had begun to pledge smaller blocks that Bache ordinarily would not use because of depository charges. Bache also had a logistical problem in moving large blocks of collateral to secure the various bank

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105/ The Commission staff tested Bache Halsey's control and possession of customers' fully-paid-for securities. The staff concluded that Bache Halsey did not pledge customers' fully-paid-for securities and abided by the requirements concerning their control and possession.

instruments. 106/ At the peak, Bache used $1.1 billion in collateral to support $600 million in loans. Bache's borrowings remained abnormally high until the end of April 1980.

Another consequence of using customer marginable securities to collateralize bank facilities, according to Herr, was that it increased Bache's reserves required pursuant to SEC Rule 15c3-3, which eventually reached $120 million. Bache Halsey had to borrow the funds to put in the account, thereby further increasing its credit requirements. Bache found itself in another "Catch 22" in relation to its customer reserve formula: once it borrowed money for its customer reserve, these borrowings became "customer loans" and were calculated into the reserve formula. 107/

VI. AFTER THE CRISIS

Following the liquidation of the Hunts' positions, Bache Group moved (1) to examine how the silver crisis had arisen to determine what, if any, prophylactic measures it should consider and (2) to rebuild the confidence of the banking community in Bache Group. These measures fall in three categories. First, Bache Group directed the audit committee of its board, consisting of three non-management directors, to review events before and during the silver crisis. Certain audit committee findings have been noted elsewhere in this report. Second, Bache Group's executive committee implemented changes in the firm's commodity credit personnel and procedures. Finally, Stevenson arranged meetings with Bache Halsey's subordinated lenders and other bankers to report on the crisis and the steps taken by Bache Group to avoid a repetition.

A. The Audit Committee Report

On June 12, 1980, the audit committee of Bache Group's board of directors completed its review of Hunt-related activities at the company from August 1, 1979, through August 10, 1980. The committee was charged with evaluating whether

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106/ Officials in Bache's cash management office are informed daily as to the amount of collateral, both customer and firm, and what the borrowing capacity is with that collateral.

107/ Whereas unsecured loans are not calculated in the formula, loans secured by customer marginable securities are computed in the formula under "customer loans." Therefore, Bache increased its reserve under the formula to correspond to the increased amount of customer loans.

Bache Group's "procedures and controls" were "adequate", whether "established procedures [had been] followed," and whether there were "evidences [sic] of conflicts of interest influencing the judgment of key personnel." The following are the principal findings of the committee.

1. Concerning Bache Halsey's Accepting Silver in Lieu of Margin

The audit committee concluded that by accepting silver bullion in lieu of margin from March 17 through March 25, Bache Group management in the Hunt situation overrode Bache Halsey's established internal procedures regarding satisfaction of variation margin requirements and sellout procedures, but did so to "shore up" Bache Halsey's collateral position pursuant to a "business judgment" based on "its own prior experience, that the Hunts would obtain and remit cash or additional collateral, and its desire to be within legal bounds."

2. Concerning the March 28 Press Release

The Committee stated that the March 28 press release "served little purpose in its timing, was premature and erroneous as to its facts and therefore must be deemed ill-advised."

3. Concerning the Credit Decision

The Committee noted:

(1) The Hunt credit files "contained very little information of significance" and such a situation "is not unusual in the case of a nonpublic client."

(2) "The Audit Committee could find no evidence that the [executive committee] had real knowledge of the Hunt commodities silver activities worldwide so that it could assess total Hunt exposure."

(3) The basis for the executive committee's decisions to increase the Hunts' trading limits were (a) beliefs concerning the magnitude of the Hunts' resources, (b) that the Hunts had never missed a margin call, (c) that the silver market was very liquid, (d) that warehouse receipt financing was more secure than carrying futures positions, (e) that Comex margin requirements were high enough to protect the firm, and (f) that all Hunt accounts activities were in fact "secured" financings.

4. Concerning the Huddleston Accounts

The Huddlestons' trading, according to the Committee, represented a "classic pyramiding situation" concerning which Bache Group had no written policy.

5. Concerning Whether the Hunts had Received Preferential Treatment as a Result of Their Bache Group Stock Ownership

(1) "Although it is not practical . . . to determine the subconscious bias of people's minds and the effect that such bias might have had on close decisions, it is quite clear from the records of [Bache Group] that the Hunts' ownership of a significant block of the stock of [Bache Group] did not result in their having received preferential treatment in such tangible areas as commissions, house margins (both initial and warehouse) and interest rates." 108/

(2) "With respect to intangible aspects such as management's acceptance of silver pending receipt of cash to meet house margin calls and the time of the overall liquidation, the audit committee has no reason to believe these actions were influenced by conflict of interest considerations. However, because the subtlety of the matters discussed falls into the subconscious bias category, which is difficult to delineate as to occurrence, in the absence of evidentiary matter the audit committee is unable to reach a final determination."

108/ The audit committee cites as evidence for non-preferential treatment that (1) the Hunts were required to post "house" original margins, rather than exchange minimum margin, to support their silver futures positions; (2) the Hunts were called for variation margin after a 10% impairment of original margin, rather than the 25% permitted by exchanges; (3) the silver loans were profitable for Bache; (4) Bache liquidated the Hunt accounts immediately after learning, on March 25, that the Hunts had no more cash or bullion; and (5) the executive committee's decision concerning the increase from 5,000 to 7,500 contracts in the Hunts' future trading line occurred before the Hunts began buying Bache Group stock. The audit committee did not, however, refer to the fact that within a week of Jacobs' successful trip to Dallas to solicit the Hunts' "white knight" Bache Group stock purchases, the executive committee approved doubling the Hunts' Bache Metals loans from $40 million to $80 million against $110 million in warehouse receipts. The additional loan was not advanced that month because the Hunts advised they did not require the additional financing.

B. Changes in Commodity Credit Procedures

Since the silver crisis, Bache Group has changed its commodity credit procedures. It has consolidated its credit analysis into a single department reporting to Stevenson as principal credit officer. The commodities and securities credit committees also report to Stevenson. The firm also expanded membership on the commodity credit committee to include additional non-commodities personnel. Mattey is no longer on the committee.

The firm has established a policy which prohibits lending, to any one client or group of related clients, funds in excess of 15% of Bache Group's total equity capital in a commodities account, or 20% of equity capital in a securities account with a diversified portfolio. The new policy also limits to 15% of equity capital the amount of financing Bache will extend against a single commodity. Finally, the firm's aggregate customer overall margin positions in a single security may not exceed 10% of the outstanding shares of that security; and, in a single commodity, no more than 20% of the open interest.

VII. DISCLOSURE OF EVENTS

Prior to the silver crisis, Bache Group did not disclose or acknowledge in any annual, periodic or interim report filed with the Commission or disseminated to the public, or in any press release, the existence or magnitude of the Hunts' physical or future silver positions with its Bache Halsey and Bache Metals subsidiaries, nor did Bache Halsey make known to the Commission or the NYSE, in its annual, quarterly or monthly FOCUS reports or otherwise, the existence or magnitude of the Hunts' future and forward silver positions with the firm. The first public disclosure or acknowledgement of the existence of the Hunt positions occurred in an announcement on March 27, 1980. Bache Group later elaborated on the announcement in a series of press releases during and after the crisis period, a letter to customers late in April, a newspaper advertisement, in annual, periodic and interim reports pursuant to the Exchange Act and in Securities Act registration statements and the accompanying prospectuses filed pursuant to the Securities Act.

A. Crisis Period Press Announcements

1. The March 27 Announcement

On March 27, responding to widespread rumors concerning the Hunts' failure to meet Bache Halsey margin calls, Bache Group announced shortly after the Commission suspended trading in its stock that "the abrupt decline in the silver market has resulted in substantial margin calls to certain customers of its wholly-owned subsidiary, [Bache Halsey], which the customers have failed to meet and may be unable to meet." The announcement did not identify the Hunts by name. Concerning Bache's financial condition, the announcement stated:

> A continuing decline in the silver markets could have a negative impact on Bache's financial position.

In fact, at the time the release was issued, the silver market decline had already produced unsecured debit balances in the Hunts' accounts with Bache Halsey, Bache Metals and Bache London that were quite substantial in relation to both Bache Group's reported net worth and what it ultimately reported as its earning for the third quarter of fiscal 1980.

2. The March 28 Press Release

On the afternoon of March 28, Bache Group issued a press release reporting that Bache Halsey that day "completed liquidation on the Comex of all of the silver commodity futures contracts it held for the Hunt accounts, and that "Bache had previously completed liquidation of all of the silver bullion it held as collateral for the Hunt futures accounts and . . . it now owned modest amounts of bouillon [sic]." The release went on to state that "[t]he liquidation did not result in any loss to Bache," that its "capital position remains unimpaired" and that "it complies in all respects with the rules of the regulatory authorities." The Friday release did not mention, and Bache Group did not disclose at that time, Bache Metals' $233 million loan to the Hunts, or that Bache Metals and Bache Group's corresponding obligation to the silver banks was undercollateralized by what its calculations indicated was approximately $17 million.

The statement in the release that the liquidation had occurred without loss to Bache is erroneous, even assuming that the "Bache" to which the release refers is Bache Halsey alone and did not include Bache Metals or Bache London (where the Huddleston accounts had by this time been liquidated to a deficit of approximately $23 million). In fact, as of the close on March 28, according to Bache's later reports, there were $10 million in unsecured debit balances in the broker-dealer. As described earlier in this report, Bache Halsey officials testified that they overlooked $5 million in deficits in the Huddlestons' domestic futures account that Friday and were otherwise unaware of $5 million in deficits in the other Hunt accounts.

The March 28 release also stated that Bache Halsey's subordinated lenders had "confirmed that $24 million of pre-existing subordinated stand-by loan arrangements remain available to be drawn by Bache on demand." The release did not disclose that the subordinated lending banks had acquiesced in the appearance of the foregoing statement in the March 28 release only after Bache Halsey officials told them the firm did not intend to seek a draw on the subordinated line.

3. The March 31 Releases

As described in note 96, over the weekend of March 29-30 Bache Group discovered $10 million in unsecured deficits in the Hunt accounts with Bache Halsey, $23 million in the Huddlestons' account with Bache London and what it computed to be $17 million in debts to the silver banks in excess of the remaining collateral. 109/ On Monday morning, March 31, Bache Group issued another press release concerning the Hunt situation. Without alluding to the March 28 release, the March 31 document began:

> Bache Group Inc. said today that the capital position of its brokerage subsidiary, Bache Halsey Stuart Shields Incorporated, remains in complete compliance with the rules of all regulatory agencies despite a potential loss of $10 million in the Hunt accounts. Bache said that this potential loss is partially secured by 560,000 shares of Bache Group Inc. stock, that the firm is conducting business in the usual manner, and that it has excess capital over and above the New York Stock Exchange 7% formula.

The release also recounted that "Bache is in the process of verifying figures particularly those of . . . [Bache Metals] and [Bache London]," and stated that "[t]here now appears to be approximately $40 million in potential losses in Hunt family accounts maintained in these subsidiaries." Bache Group stated in its release that its pre-tax earnings for the seven months ended February 29, 1980, were $35.4 million. The release also stated that "any loss sustained by [Bache Metals] or [Bache London] will not in any way affect [Bache Halsey's] ability to continue to conduct business and service to its clients."

109/ In letters to the Commission staff dated March 30 and 31, 1980, Bache Group described the circumstances surrounding discovery of these losses. The staff's contact with Bache and other broker-dealers during the crisis has been amply discussed in its contribution to the CFTC report and need not be repeated here.

Later that day, after Placid Oil paid Bache Group $17 million toward satisfaction of the Hunts' obligations, Bache Group announced receipt of "$17 million from the Hunts for credit to their accounts," and stated that $10 million of these funds would be applied to the Hunts' accounts with Bache Halsey while the remaining $7 million were to be applied "to accounts of other non-broker-dealer subsidiaries."

Neither of the March 31 releases disclosed the existence or extent of Bache Metals' loan to the Hunts or that Bache Metals had borrowed an equivalent amount from banks to fund the Hunt loan. The releases did not disclose that Bache Metals' borrowing from banks was on a demand basis, that certain banks had sought additional silver collateral or repayment and had been advised that Bache Group was unable to supply it, or that certain banks proposed to sell their silver collateral into the market. Similarly, the March 31 releases failed to describe Bache Group's guarantee of Bache London obligations and the insufficiency of the assets of both Bache London and Bache Group to cover the potential losses in the Huddlestons' London forward position.

The March 31 release also omitted mention of the difficulties, described at pages 103 through 106 of this report, that Bache Halsey was encountering in financing its day-to-day securities business as a result of bankers' lack of confidence in the firm's financial integrity. In light of these circumstances and those described in the preceding paragraph, Bache Group's statement in the first March 31 release that Bache Metals and Bache London's losses "will not in any way" affect Bache Halsey's ability to conduct business appears to create a misleading impression: (1) that Bache Halsey's financial condition was totally independent of Bache Group's other subsidiaries; and (2) that concealed the fragility of the broker-dealers' heavily credit-dependent finances.

4. The April 1 Release

Meanwhile, the trading suspension in Bache Group stock remained in effect. After receiving $17 million from Placid Oil on March 31, however, Bache Group again requested that the suspension be lifted. The Commission staff advised Bache Group that dissemination of the facts concerning the company's financial condition and the recent events in the market were a prerequisite to a lifting of the suspension. On April 1, 1980, after showing it to the Commission staff, Bache Group issued a press release summarizing "recent events particularly those in the silver market, which may affect [Bache Group's] financial condition and that of [Bache Halsey].

The release opened with Bache Group "emphasiz[ing] that, without qualification, the capital position of [Bache Halsey] remains in complete compliance with the rules of all regulatory agencies . . ." There followed a one-paragraph description of the Hunts' failure to meet margin calls, in which Bache Halsey asserted that the Hunts failed to meet calls "for the first time, on March 25th." The release "elaborated upon" the March 28 release by describing its use of switches to effect liquidations, but it did not attribute cause to or acknowledge its error in reporting on March 28 that the liquidation had produced no loss to the broker-dealer.

The April 1 release also acknowledged, for the first time, that the Hunts had borrowed from Bache Metals against silver bullion and that Bache Metals had in turn borrowed from banks. The release continued, however, to omit disclosure of the magnitude of Bache Metals' loans to the Hunts and from the banks and the fact that the loans were, at the time of the release, undercollateralized by approximately $10 million. The release did, however, allude collectively to "$33 million in potential losses in Hunt family accounts" with Bache Metals and Bache London.

Concerning the bank loans, the April 1 release also stated that:

> The banks which hold silver bullion supplied by the Hunts as collateral for loans to [Bache Metals] have not demanded payment of their loans and have agreed, upon Bache's pledge of additional collateral, to work with Bache to accomplish the orderly liquidation of their silver collateral.

On March 31, upon being told of the losses discovered over the weekend, the silver banks that had excess collateral insisted that unless they were paid out they would sell their collateral into the market. In the early morning hours of Tuesday morning, April 1, the so-called "short banks" agreed to buy out the "long banks" and implement what one of the short bankers described as a "workout" of the loan. The accurate statement would have been that while four out of the ten banks had demanded payment, the remaining six banks had agreed to increase their loans to Bache Metals, pending liquidation of the collateral, to enable it to pay the four banks. Jacobs, moreover, apparently believed on April 1 that silver banks had demanded payment on the loans. In Jacob's conversation with Herbert Hunt in which Jacob sought additional funds Jacobs said that "the banks have called the loan." This apparent inconsistency is perhaps best explained as a matter of semantics, or as a manifestation of Jacobs' desire to impress on Hunt the urgency of Bache Group's situation.

The April 1 release omitted another important piece of information concerning Bache Group's finances. On Monday or early Tuesday, Stevenson had explored with Pearson the possibility of Bache Halsey's drawing funds against its $24 million line of subordinated credit. By noon on April 1, Pearson had advised Stevenson that, in view of the adverse information discovered over the weekend, Bache Halsey should not risk a request for a draw that might be refused. This information rendered inaccurate the statement in the March 28 release that Bache Halsey's subordinated lending banks "have confirmed that $24 million or . . . subordinated . . . loan arrangements remain available to be drawn by Bache on demand".

B. Disclosure in Bache Group's Filings with the Commission and Shareholder Communications

1. Disclosure Before the Crisis

Bache Group made no disclosure concerning the Hunt silver positions in any of its annual, quarterly or interim reports, or in shareholder communications, prior to the silver crisis. During the buildup in silver prices in the fall and early winter of 1979-80, the Hunts' silver positions at Bache Group ranged from 2,549 to 7,304 futures contracts in accounts with Bache Halsey and approximately $40 million in loans from Bache Metals. Bache Group did not report the Hunt activity as being significant to the "commodity commission" or commodity customer financing segments of its business in its annual report for the year ended July 31, 1979, filed in October. It did not footnote the accounts receivable from customers item on its balance sheet at July 31 or October 31, 1979, to reflect the proportion of accounts receivable represented by the single Hunt loan nor did it note the nature of the collateral for the loan. It did not footnote the bank loans payable item on its balance sheet to reflect the proportion of its bank borrowing devoted to funding the Hunt loan.

As described elsewhere in this report, the Hunt loans increased from approximately $42 million to approximately $233 million during February 1980, an amount representing 160% of Bache Group's net worth. This new credit increased Bache Group's customer receivables from $1.172 billion at January 31, 1980, to approximately $1.46 billion (pro forma) at February 29, 1980, of which 17% was represented by the Hunt loan. The firm's bank loans payable also increased, as a result of Bache Metals' new borrowing to fund the Hunt loan, from $366 million to approximately $559 million, respectively. At February 29 borrowing to fund the Hunt loan represented approximately 42% of Bache Group's bank loans payable.

On March 17, 1980, after the loan increases in February, Bache Group filed its quarterly report on Form 10-Q for the period ending January 31, 1980. Bache Group did not report the $197 million increase in Bache Metals' lending to the Hunts and in its bank borrowings as material subsequent events. It did not footnote balance sheet items on accounts receivable from customers or bank loans payable to reflect the increases in the loans and borrowings or the reduction in the ratio of collateralization.

2. Disclosure After the Crisis

a. The Cohn, Dach & Howard S-16

Bache Group's first disclosure concerning the Hunt silver situation in filings with the Commission occurred in amendments to a registration statement on Form S-16 that Bache Group had filed in connection with the resale of its securities by persons from whom it had acquired the Cohn, Dach & Howard insurance agency in a stock-for-stock exchange in January 1980 (the "Cohn, Dach & Howard S-16").

Bache Group filed Amendment No. 1 to the Form S-16 ("Amendment No. 1") on April 10, 1980. That amendment incorporated by reference disclosures in Bache Group's annual report on Form 10-K for the year ending July 31, 1979, its quarterly report on Form 10-Q for the periods ending October 31, 1979, and January 31, 1980, and its interim report on Form 8-K reporting Bache Group's results for the three months ending February 29, 1980. As to events during the silver crisis, Bache Group stated:

> "On March 27, 1980, the Securities and Exchange Commission ("SEC") ordered a suspension of trading in Bache's common stock because of material corporate events relating to the abrupt decline in the silver markets and resulting margin calls on commodity accounts maintained by certain members of the Hunt family which could have resulted in a material loss to Bache. As a result of the liquidation of the Hunts' positions and collateral and payments by the Hunts, such loss did not occur. On April 1, 1980, the SEC lifted the suspension of trading of Bache's Common Stock."

Bunker and Herbert Hunt's beneficial ownership, as of January 16, 1980, of more than 5% of Bache Group's common stock brought Bache Metals' loans to them within the category of "transactions with management" for purposes of

Item 4(f) of Regulation S-K. However, Amendment No. 1 to the Cohn, Dach & Howard Form S-16 did not contain information amending the annual report on Form 10-K incorporated therein by reference, to disclose the Hunts' stock ownership in Bache Group or the existence or extent of the loans. 110/

Amendment No. 1 disclosed the acquisitions of Bache Group stock by entities controlled by Messrs. Samuel and Hyman Belzberg, and the related filings with the Commission on Schedule 13D. It also disclosed the "shark repellant" amendments to its certification of incorporation adopted at its 1979 annual meeting of shareholders. It did not, however, disclose that the Hunts had purchased 6.6% of Bache Group's stock or that they had made their purchases at Jacobs' request as a defensive measure against the Belzbergs.

Amendment No. 1 also disclosed Bache Halsey's subordinated borrowing, the lines of credit it maintained with RBC and the Continental group of banks, and the draws on the latter line it made on March 21 and March 24, 1980. It did not, however, disclose that as a result of the silver crisis, it had been advised by subordinated lenders not to request additional draws on these lines.

On April 22, 1980, Bache Group filed Amendment No. 2 to the Cohn, Dach & Howard S-16 ("Amendment No. 2"). Amendment No. 2 was identical to Amendment No. 1 except that it disclosed that Bache Group had established a reserve against debit balances in non-Hunt related securities and commodity futures trading accounts.

b. The April 25 Form 8-K

On April 25, 1980, Bache Group filed an interim report on Form 8-K reporting pursuant to "Item 5. Other Material Events" which included the following:

> On March 27, 1980, the Securities and Exchange Commisson ("SEC") ordered a suspension of trading in [Bache] Group's Common Stock because of material corporate events relating to the abrupt decline in the silver markets and resulting in substantial margin calls on commodity accounts maintained by certain members of

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110/ The Commission alleged in its complaint in SEC v. Nelson Bunker Hunt and William Herbert Hunt, Civ. Action No. 82-1931 (D.D.C.) that Bunker and Herbert Hunt acted as a group in acquiring Bache Group stock. The Hunts consented to the entry of a final judgment of permanent injunction in that action without admitting or denying the Commission's allegations.

the Hunt family which could have resulted in a material operating loss to [Bache] Group. As a result of the liquidation of the Hunt's positions and collateral and payments by the Hunts, such loss did not occur. On April 1, 1980, the SEC lifted the suspension of [Bache] Group's common stock.

There was no other disclosure concerning the Hunt relationship or the silver crisis.

c. The April 30 Form 10-Q

On June 16, 1980, Bache Group filed a quarterly report on Form 10-Q for the period ended April 30, 1980 ("April 30 Form 10-Q"). The April 30 Form 10-Q incorporated by reference the disclosures concerning the silver crisis contained in the April 25 Form 8-K. There was no other disclosure concerning those events.

d. The 1980 Form 10-K

On October 29, 1980, Bache Group filed with the Commission its annual report on Form 10-K for the fiscal year ended July 31, 1980. Bache Group disclosed the existence and subject matter of investigations by the Commission, the CFTC and the NYSE into matters relating to the silver crisis and reiterated earlier disclosure concerning the suspension of trading.

The 1980 Form 10-K contained no further disclosure concerning the Hunt silver accounts, the silver crisis or related matters. In particular, there was no disclosure of the existence or extent of Bache Metals' loans to the Hunts which, coming as they did while Bunker and Herbert Hunt owned more than 5% of Bache Group's stock, constituted "transactions with management" required to be disclosed pursuant to Item 11 of Regulation S-K. Moreover, notwithstanding that Bache Metals' loans to the Hunts represented virtually the only customer financing undertaken by Bache Metals during the period, the 1980 Form 10-K did not disclose the Hunt loan activity as being significant to the customer commodity financing segment of its business.

3. Other Material Publicly Disseminated

In addition to the press releases and public filings just described, Bache Group commented publicly on the events of the silver crisis in a two page letter to clients dated April 21, 1980, and in a large newspaper advertisement appearing late in April 1980. Each document purported to "set the record straight" concerning the silver crisis at Bache Halsey and each contains assertions that raise questions concerning the candor with which Bache Halsey reported to its clients and to the public the nature and extent of Hunt-related difficulties at the firm. These two documents made the following representations in substantially identical terms:

> "1. At no time was our day-to-day service to any Bache client affected in any way.
>
> 2. At no time did Bache fail to meet all capital requirements of the New York Stock Exchange or the Securities and Exchange Commission.
>
> 3. At all times Bache met all its financial obligations, both to clients and to the various exchange clearing facilities.
>
> 4. At no time did these events require Bache to seek additional capital by borrowing or any other means. Not one penny.
>
> 5. At no time did Bache give preferential treatment to any client because he was a shareholder, nor did any shareholder ask for preferential treatment."

Neither of these documents contains any additional information that would inform Bache Halsey's customers or the public of the precariousness of Bache Group's overall financial situation as described elsewhere in this report. Indeed, the newspaper advertisement was headed "A Test of Strength" and stated that "in an important way, this series of unique events proved the strength of this 100-year-old company. The strength of Bache." Bache's forceful assertions that it remained in compliance with net capital requirements and was not required to seek additional capital are of particular concern, inasmuch-as the advertisement and the client letter did not disclose the steps taken by the firm that contributed to maintaining its capital compliance: reledgering the Huddleston accounts in Bache London, reallocating collateral from the Bache Metals' loans to Bache Halsey and seeking and obtaining margin reductions from Comex.

With regard to the timing of the liquidations, the April 21 letter to clients states that it was on March 25th, that "a group of very substantial related accounts" were unable to meet a margin call. The letter goes on to say that on March 26, Bache began to liquidate the customers' accounts. These statements create the impression that a prompt sellout followed the Hunts' failure to meet margin calls without disclosing that for a period of eight days Bache management accepted additional silver deposits in lieu of cash margin.

<u>PART THREE</u>

<u>MERRILL LYNCH & CO., INC.</u>

I. THE MERRILL LYNCH COMPLEX

A. The Holding Company

Merrill Lynch & Co., Inc. ("ML & Co."), incorporated in Delaware in 1973, is a holding company engaged through approximately 109 subsidiaries in retail and institutional securities brokerage, investment banking, investment management, commodities futures brokerage, mortgage insurance, real estate, equipment leasing, financial consulting, real estate management and employee relocation. ML & Co. is a publicly-held company whose common stock is registered with the Commission pursuant to Section 12(b) of the Exchange Act and listed on the New York, Midwest, Pacific and London Stock Exchanges. On December 28, 1979, its 36.3 million outstanding common shares were in the hands of 20,107 holders of record.

For the fiscal year ended December 28, 1979, ML & Co. reported pre-tax income of $196.3 million on revenues of $2.05 billion (1980 pre-tax income was $366 million). The company derived its revenues principally from interest on customer margin accounts and financings ($763.2 million), commissions on securities transactions ($421.9 million), spreads on transactions as principal ($290.5 million), investment banking ($155.3 million) and commodity transactions commissions ($103.5 million) Its principal expenses were employee compensation and benefits ($733.1 million), interest ($638.5 million) and occupancy expense and equipment rental ($100.7 million). ML & Co. Inc. reported a net worth of $784.2 million on December 28, 1979 and $969.5 million on December 26, 1980.

B. The Broker-Dealer

ML & Co.'s principal subsidiary is Merrill Lynch, Pierce, Fenner & Smith, Inc. ("Merrill Lynch" or "Merrill"), a broker-dealer registered with the Commission pursuant to Section 15(b) of the Exchange Act. On March 28, 1980, ML & Co.'s equity in Merrill Lynch represented approximately 71% of the equity of ML & Co. itself. ML & Co. reported that in fiscal 1979 Merrill Lynch's "share of total public listed equity volume" was 10.8% and that it was "the nation's largest futures broker." Merrill Lynch is a member of all major securities and commodities exchanges in the United States and it, its subsidiaries or affiliates hold memberships or associate memberships on several principal foreign securities and commodities exchanges.

As a registered broker-dealer and as a member of the NYSE, Merrill Lynch is subject to the Uniform Net Capital Rule. It computes its net capital requirements under the alternative method authorized by the Rule. On December 28, 1979, Merrill Lynch's net capital of $297.9 million was 9.3% of aggregate debit balances, $74.0 million above the 7% "early warning" level and $170.4 million above the 4% minimum requirement. 111/ On that date, none of this amount was comprised of subordinated debt. ML & Co. conducted all of its Hunt-related commodity futures and financing business through Merrill Lynch. 112/

II. INCEPTION, DEVELOPMENT AND SCOPE OF THE HUNT RELATIONSHIP

Bunker and Herbert Hunt opened commodity accounts with Merrill Lynch in 1974 after Wilbur Marsh ("Marsh"), an account executive in Merrill Lynch's Dallas office, solicited their business. In 1975, Lamar Hunt and Hunt Holdings Co. opened commodity accounts. By July 31, 1979, Bruce Hunt, Nancy Hunt, Lyda Hunt and Barbara Hunt Crow also had accounts at Merrill. Numerous Hunt related entities, including International Metals Investment Company, Ltd. ("IMIC"), 113/ Western Bullion Corp., Hunt Holdings, GWS International Trading Company, Penrod Drilling Company, and certain Placid Oil Co. subsidiaries also opened accounts by mid-1979. On July 31, 1979, various members of the Hunt family and related entities maintained 46 separate accounts with Merrill Lynch. Sixteen of the Hunts or their related entities owned twenty commodity trading accounts of which 18 had related U.S. Treasury bill accounts. Eight of the 46 accounts were securities accounts. Of these, one traded commercial paper, six traded conventional securities and one was used as a conduit for short term time deposits with other financial institutions.

111/ The minimum net capital has recently been lowered to 2% of aggregate debit items under the Net Capital Rule's alternative computation. See Securities Exchange Act of 1934 Release No. 18417 (Jan. 25, 1982).

112/ On April 1, 1981, Merrill Lynch established a new subsidiary, Merrill Lynch Commodities Inc. to carry its customers' commodities accounts.

113/ As discussed on page 27 above, IMIC was owned 50% by Hunt interests and 50% by two Saudi Arabian investors.

The commodities accounts traded in precious metals, foreign currency futures, U.S. Treasury obligation futures, livestock, sugar and various other agricultural products. The Treasury bill accounts and the commercial paper account held instruments purchased with cash deposited as original margin on commodities futures positions or served as a repository for excess cash. The stock accounts carried various large positions.

Five of the Hunt accounts engaged in the vast majority of the silver trading the Hunts and their related entities conducted at Merrill Lynch. These accounts were owned by IMIC, Herbert, Bunker and Lamar Hunt and Hunt Holdings. A separate account associated with each of these commodities account held Treasury bills posted as margin for commodities futures positions.

On July 31, 1979, on the eve of five and one-half months of sharp increases in the price and volatility of silver, Hunt-related accounts at Merrill Lynch were net long 2506 silver futures contracts representing 12,530,000 ounces of silver. 114/ At prices then prevailing, the silver represented by these contracts was valued at $112 million. Equity in the combined Hunt family accounts stood at $6.4 million and Placid had $43.3 million in equity in its securities accounts. 115/

114/ Certain of the Hunts' accounts held silver straddles, that is, the accounts were long silver futures contracts with one maturity date and short an equivalent number of silver futures contracts with a different maturity date. As a practical matter, the risk to the trader and the firm from such positions are ordinarily limited to the extent of the price differential between contracts with different maturity dates. This risk is generally smaller than the risk of a net long or net short position and the staff has, accordingly, chosen to assess the magnitude of the Hunts' position with Merrill Lynch and other firms net of any straddled positions in their accounts.

115/ From 1975 through 1978, seven Hunt commodity accounts alone generated almost $1.3 million in commissions. Of this, Hunt Holding's commodities accounts generated nearly $98,000 and Bunker Hunt's two commodities accounts generated nearly $190,000 in commission revenue for Merrill.

III. THE BUILDUP IN SILVER - JULY 1979 THROUGH JANUARY 1980

A. Introduction

As described elsewhere in this report, the price of silver and the volatility of the silver market increased significantly between August 1, 1979 and January 17, 1980. 116/ Merrill Lynch, like Bache Group, permitted the Hunts to increase the size of their silver positions with the firm during this time, thereby increasing Merrill Lynch's exposure in the Hunt accounts. During the last five months of 1979, the Hunts, Hunt-related entities and IMIC's aggregate net long silver position (future, forward and physical) with the firm showed a net increase of 224%, from 12.5 million ounces with an apparent value of $112 million on July 31, 1980 to 40.7 million ounces on December 31, 1980. 117/ This position aggregated 6281 net long futures contracts representing 31.4 million ounces, 1.95 million ounces of silver forward commitments, and 7.31 million ounces of silver bullion. The apparent value of this position was $1.4 billion and it was supported by equity which rose from $6.4 million to $535.4 million. At December 31, assuming no reduction in the position or additional cash or collateral deposits, a decline of approximately $13.00 per ounce in the price of the metal, from a price of $34.45 to $21.28, would have carried the combined Hunt/IMIC accounts into deficit. 118/

The increase in Merrill's Hunt-related exposure in the increasingly volatile silver markets during the fall and winter of 1979-1980 occurred as a result of management decisions to permit IMIC to open and maintain silver futures and forward positions that totaled 3,808 contracts

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116/ For a more detailed description quantifying the increase in silver prices and volatility during this period, see page 54 above.

117/ The peak in Hunt silver positions with Merrill was reached in September 1979. At September 28, IMIC's future position stood at 10,309 contracts representing approximately 51.5 million ounces. It thereafter reduced its futures position with Merrill substantially in the EFP transaction with Mocatta described above at n. 37, and by standing for delivery on maturing contracts. Merrill financed certain of these deliveries as described below.

118/ During January 1980, the Hunt position had diminished somewhat. On January 31, 1980, the Hunts' positions at Merrill represented 35 million ounces in silver futures, forward contracts and bullion.

on December 31, 1979, and to lend IMIC, Hunt Holdings and Herbert Hunt approximately $56 million to finance deliveries of silver bullion in their accounts.

As with Bache, Merrill Lynch's executive committee made these decisions based on the Hunts' reputation for substantial financial resources, their past history of promptly meeting their obligations, and the magnitude of their equity with Merrill. In addition, Merrill Lynch executives believed that Bunker and Herbert Hunt and their family interests stood behind IMIC. They did not seek a written guarantee or similar written assurance to that effect until March 27, 1980. They received such a document on April 1. While the firm had substantial information of a general nature developed over the course of its six-year relationship with the family, it had little specific, current information as to the Hunts' financial condition in 1979 and 1980 or the availability of Hunt family resources to satisfy IMIC or the individual Hunts' obligations to the firm.

The remainder of this section will discuss the transactions that produced the increase in Merrill's Hunt-related silver exposure and then identify the information that was available to Merrill Lynch decision-makers as they determined whether or not to permit the Hunts and IMIC to effect the transactions in their accounts that produced increased exposure for the firm.

B. Increasing Silver Exposure - The IMIC Account and Silver Financing for Hunt Holdings and Herbert Hunt

1. The IMIC Account

a. Establishing the Account

In July 1979, the Hunts and two Saudi Arabian associates formed IMIC, 119/ and Herbert Hunt approached Marsh concerning the establishment of an account for IMIC with Merrill Lynch. Marsh conveyed the request to the firm's corporate credit department, which requested a meeting with Herbert to discuss the proposed account. The meeting was held in Dallas in late July or early August 1979 between Marsh, senior Merrill Lynch officials, Herbert Hunt, his son Douglas, and one or two Hunt employees.

According to Merrill Lynch witnesses, Herbert Hunt told the Merrill personnel that IMIC intended to become a precious metals dealer, that it wished to establish a

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119/ Bunker and Herbert Hunt's relationship with IMIC is discussed in greater detail at page 27.

position in silver futures and that it planned to stand for delivery of physical silver. Hunt requested a futures trading limit of 10,000 contracts. The Hunts also mentioned that IMIC might seek financing of silver deliveries but stated, according to Marsh, that Merrill's willingness to extend such financing was not a prerequisite to the firm doing business with IMIC. Merrill personnel sought assurance that if it accepted the account, IMIC would trade silver only through Merrill Lynch. Herbert Hunt gave them that assurance.

Hunt did not disclose the identity of the Saudi coventurers in IMIC at this meeting, but he did describe IMIC's funding sources. An August 15, 1979 memorandum to Merrill's executive committee described IMIC's initial capitalization:

Cash from Herbert and Bunker Hunt	\$ 5 million
Cash from other principals	\$ 5 million
Contributions of debentures and other securities from both sources	\$ 20 million
Available "on demand", 50% from each group of principals	\$ 40 million
Bank line of credit	\$ 30 million
TOTAL	\$100 million

It is apparent from this analysis that IMIC's initial capitalization was \$30 million net of commitments for further contributions from the principals.

Before the meeting discussed above, on July 25, 1979, Marsh opened a commodity account for IMIC in the firm's Dallas office. By August 3, after that meeting, IMIC's account was long 1,800 silver futures contracts with further orders pending. By August 15, this position had expanded to more than 4,600 contracts, well beyond the 2,000 contract level at which Merrill's internal procedures required executive committee approval for further trading. 120/

120/ Marsh testified that IMIC acquired its initial position under the earlier trading limits of \$10 million in margin, or 2,000 contracts-per-person established for several other Hunt commodities accounts at Merrill. He testified that he also received the approval of Merrill's corporate credit department for an interim limit of 3,000 contracts pending executive committee approval of the Hunts' 10,000-contract request. It is clear, however, that Marsh executed IMIC's orders beyond even this 3,000-contract limit before the executive committee formally acted on the larger line request.

b. IMIC Futures Positions

Because of the expected magnitude of trading in the IMIC account, Merrill's corporate credit department presented to Merrill's executive committee for its approval IMIC's proposed trading plans as outlined to Marsh and in the Dallas meeting just described. The executive committee on August 20, 1979 approved futures trading limits for IMIC of either $30 million in initial margins or 15,000 contracts, whichever was less. If IMIC had utilized the full trading possibilities Merrill Lynch allowed it, it could have assumed a position of 75 million ounces. At margin rates then prevailing, the executive committee decision effectively permitted IMIC to commit the entire initial cash capitalization it had disclosed to the firm to a silver position at Merrill. 121/ The executive committee decision to permit IMIC to engage in futures trading of this magnitude enabled IMIC to substantially increase Merrill's Hunt-related silver exposure in the fall of 1979.

By the end of August 1979, the IMIC account held a 9,048 contract long position in silver futures. By the end of September, IMIC's long position totaled 10,309 contracts and its account held 7.1 million ounces of cash silver and forward contracts for delivery of an additional 400,000 ounces. In October 1979, IMIC reduced its long futures position with the firm to 3,808 contracts as a result of standing for delivery and effecting an "exchange for physicals" transaction with Mocatta Metals Corp. The IMIC long silver futures position remained at 3,808 contracts, or 19 million ounces, until March 27, 1980.

c. Merrill Lynch Lends to IMIC to Finance Silver Deliveries

In early September 1979, IMIC requested through Marsh that Merrill lend it 85% of the market value of 465 silver contracts on which it expected to stand for delivery that month. At prices then prevailing, the

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121/ Were the account to have had a position equal to its futures trading limits of 75 million ounces, each one dollar movement in the price of silver would have produced unrealized gain or loss of $75 million. This should be compared to IMIC's initial cash capitalization of $30 million and the total capitalization of $100 million IMIC represented to the firm that it had available. The IMIC account never reached this 75 million ounce level.

loan IMIC requested against the 2.3 million ounces to be delivered was $23 million. 122/ The terms of the requested financing were:

1. An interest rate of 1/2% over the New York brokers' call loan rate;

2. IMIC was required to maintain 15% of the value of the delivery at all times;

3. Calls for additional collateral or partial pay-down were to be met within 24 hours of the day they were issued;

4. The loan was extended for a 90 day term, although it was contemplated that the financing could be renewed each 90 days for an indefinite time.

Commodity division head John J. Conheeney ("Conheeney") and corporate credit department official Michael E. Lurie ("Lurie") recommended approval of the IMIC financing request to Merrill Lynch's executive committee in a memorandum dated September 7, 1979 transmitted through executive vice president for administration and finance Allan L. Sher ("Sher"). On September 10, the committee approved $25 million in financing for the IMIC account. 123/

Seven days later, on September 17, 1979, Lurie informed Sher, that the number of contracts IMIC planned to accept in delivery during September had increased from 465 contracts to 941 contracts. IMIC was now requesting additional financing of approximately $16 million.

122/ IMIC also requested consideration of a funding package which would be available to it for future purchases of precious metals. There is no indication that Merrill considered this aspect of IMIC's financing proposals.

123/ In the same meeting, the executive committee also eliminated the margin line limitation of $30 million on IMIC's futures trading, since Comex and CBT's increased initial margin requirements in silver caused IMIC's position to exceed the $30 million limit. To allow IMIC to trade at the volume it desired, Merrill's executive committee on September 10 changed the structure of its trading limit on IMIC. Instead of limiting the company to a specified amount of margin, it limited IMIC to a specified number of futures contracts. That number remained at 15,000, subject to certain conditions described at page 129.

On September 21, 1979, the executive committee unanimously approved $50 million in financing for the IMIC account for 60 days incorporating the first IMIC financing into the company's second financing request. 124/ In addition, the executive committee reduced IMIC's futures trading limit to 10,000 contracts unless IMIC committed "certain funds" to the firm or an affiliate to establish a money management account. 125/

On November 12, 1979, the executive committee extended IMIC's $50 million line of credit for an additional 60 days. In early January, IMIC reduced its financing from Merrill Lynch to $25 million, collateralized by 450 warehouse receipts with an apparent value of approximately $80 million. On January 14, 1980, the executive committee approved extending this remaining portion of IMIC's financing for another 60-day period. On each occasion, the corporate credit department memoranda to the executive committee recommending the loan renewal reiterated the growth in IMIC's net worth due to price increases in silver.

124/ This condition was apparently never met and the 10,000 contract trading limit remained in effect for the remainder of the IMIC-Merrill Lynch relationship.

125/ Two problems seem to exist with the IMIC account on October 31 as a result of errors in the firm's margin department. First, although the executive committee authorized only a $50 million loan to IMIC, Merrill in fact advanced a total of $60 million. Second, a shortfall existed in the non-silver margin deposits supporting IMIC's domestic futures positions. Physical silver held in the unregulated portion of the IMIC account was used for two purposes: to meet margin requirements on IMIC future positions and to collateralize loans IMIC received from Merrill to finance delivery of physical silver. Assuming that $75.6 million of IMIC's position in Comex cash silver is allocated to offset this shortfall, on October 31 IMIC maintained with Merrill only $40.8 million in unencumbered bullion to collateralize approximately $60 million in loans. IMIC had agreed to maintain physical silver equal to 118% of its loan amount; in fact, it maintained physical silver equal to only about 67% of the loan amount. Both problems were corrected during November.

2. Lending to Hunt Holdings

On October 2, 1979, Hunt Holdings stood for delivery of 128 CBT silver contracts at a cost of almost $10 million. Hunt Holdings sought 70% financing of that delivery at 1/2% over the New York brokers' call rate and, pending approval of its request by the executive committee, remitted slightly more than $3 million, or almost 30%, of the cost of the deliveries. Thus, between October 2, 1979, when delivery was taken by Hunt Holdings, until October 24, 1979, when the Executive Committee would approve the company's financing request, Merrill provided Hunt Holdings with over $7 million in financing prior to formal executive committee approval.

Merrill's corporate credit department and commodity division recommended to the executive committee financing for Hunt Holdings on the following terms:

1. The 70% financing be provided for 89 days from the date of delivery;

2. The financing be reviewed after 60 days to determine whether it should be extended for an additional 89 day period;

3. The interest rate be greater than 1/2% over the New York brokers' call rate "[i]n view of present bank interest rates and the tightness of credit. . . ."

The corporate credit department also recommended that the executive committee acknowledge and ratify the delivery and partial payment that Hunt Holdings had made.

On October 27, 1979, the executive committee approved a resolution authorizing financing to Hunt Holdings for 70% of the value of commodity futures contracts, "expected to approximate $10,500,000," for 89 days. The executive committee added that after 60 days the financing would be reviewed to determine whether it should be extended beyond 89 days. The executive committee also "confirmed, ratified and approved" prior actions taken by officers of the firm consistent with that action. This apparently ratified the pre-existing financing to the Hunts.

In December, during the 60-day review mandated by the committee, the corporate credit department learned that Hunt Holdings would reduce to about $4 million its silver-collateralized borrowing from the firm. On January 21, 1980, the executive committee approved approximately $4.5 million of the loan for an additional 89 days, secured by 79 of the original 128 warehouse receipts on deposit with the firm.

3. Lending to Herbert Hunt

Herbert Hunt was the third Hunt account to request loans against silver bullion. On January 3 and 4, 1980, he stood for delivery of 200 contracts of January 80 Comex silver with a value of approximately $38.2 million. Shortly thereafter, Herbert requested a loan for 85% of the value of the silver he received in delivery or approximately $32.5 million. He later reduced his request to 70% of the value of the silver, or approximately $26.7 million. On January 14, 1980, in the same meeting in which it authorized the extension of $25 million of the IMIC loan, the executive committee approved lending $27 million to Herbert Hunt for 89 days.

C. The Credit Decisions: Information Available to Merrill Concerning IMIC, the Hunts and the Silver Market

1. Introduction and Summary

As noted in the preceding section of this report, Merrill's executive committee reviewed and approved each of IMIC's futures trading and borrowing requests, as well as Hunt Holdings and Herbert Hunt's borrowing requests. In each instance the basis for the committee's review was information and analysis supplied jointly by the firm's commodity division and its corporate credit department. In contrast with Bache, where written records of the bases for executive committee Hunt-related credit decision-making are virtually non-existent, joint commodity division/corporate credit department memoranda at Merrill furnish relatively detailed background as to what information and recommendations were available to the executive committee when it made its credit decisions concerning the Hunts.

During the course of its six-year relationship with the Hunt family, Merrill Lynch credit analysts developed a file of approximately thirty pounds of material. This included, among other things, news clippings reporting on family business activities and resources during the entire period of the relationship, credit agency and bank credit reports obtained near the time the accounts were opened, public disclosure materials for HIRCO, memoranda of discussions between credit department personnel and the Dallas branch manager, and memoranda reflecting credit department analysis of the Hunt accounts. This material evidenced that the Hunts had enormous wealth and resources, although it revealed little concerning the extent or maturities of the Hunts' debts or other obligations.

A review of this material and the testimony of Merrill Lynch witnesses reveals that while the firm sought and received comparatively specific information concerning IMIC's initial capitalization and subsequent financial condition during the fall and early winter of 1979-1980, it obtained little, if any, comparable material during this period relating to the Hunts themselves or to Hunt Holdings, even though testimony of witnesses and the circumstances of the firm's credit decisions suggest that Merrill considered the financial reputation of the Hunts important in its decision-making concerning IMIC. The information the firm had on the Hunts, moreover, dated primarily from the 1974-1975 period during which the Hunts had opened their principal accounts with the firm. During the critical 1979 to 1980 period, apart from one event early in March 1980, the firm did not obtain additional financial information concerning the individual Hunts. Indeed, memoranda indicate that during 1974 and 1975 the corporate credit department was instructed not to conduct the credit inquiry on the Hunts it would normally accomplish for large accounts, although it is unclear whether that instruction was in effect in 1979 and 1980 at the time IMIC, Hunt Holdings and Herbert Hunt established the position discussed in this report.

Law and custom in the commodity markets seek to assure anonymity for traders and the positions they hold. Merrill Lynch did not ask that the Hunts provide information about their silver activity through other firms. In accord with custom in the industry, Merrill did not seek such information from other brokers. As a result, the firm remained unaware of the extent of the Hunts' overall involvement in the silver market. The lack of this information continued at the firm until March 26, 1980, even though commodity division and credit department personnel were conscious of, and had alerted the executive committee to, the potential illiquidity of the bullion collateralizing Merrill's loans to the Hunts, a position that was comparatively small in relation to IMIC's net long futures position with the firm and the Hunts overall silver holdings.

In reviewing joint commodity division/corporate credit department memoranda to the executive committee, corporate credit department files on the Hunts and the testimony of witnesses, it appears that Merrill's decisionmakers:

(1) Were aware of the Hunts' history of fully meeting all large obligations to the firm until March 1980;

(2) Had little specific financial information to corroborate extensive press reports and generally held beliefs as to the extent of the Hunts' financial resources or the availability of those resources to meet the obligations of individual account holders;

(3) Were aware of the Hunts' substantial holdings at Merrill Lynch. Indeed, Merrill Lynch president, William Schreyer, indicated that the loans to IMIC would not have been made unless the executive committee was "satisfied that we were in effect having a relationship with the Hunts generally, so we looked upon them as a total entity as opposed to individual accounts";

(4) Had comparatively detailed information, on an ongoing basis, concerning the initial capitalization and current financial condition of IMIC;

(5) Had assurances from IMIC that all of its futures trading activity was being conducted through Merrill;

(6) Had no information concerning the nature or extent of the Hunts' liabilities and obligations outside of Merrill Lynch;

(7) Were aware of the increasingly volatile condition of the silver market and the magnitude of Merrill's Hunt-related position in relation to it;

(8) Had no information, other than the general speculation within the industry, concerning the nature or extent of the Hunts' silver positions at other broker-dealers, FCMs or banks; and

(9) Believed that Hunt family resources stood behind IMIC notwithstanding the absence of a written guarantee to that effect.

The remainder of this section examines in more detail information available to management concerning IMIC, the Hunts and the silver market.

2. Information About IMIC

After learning from Marsh of the IMIC account and the amount of trading it proposed to do, the corporate credit department arranged meetings with the Hunts in Dallas and New York for the purpose, according to Merrill Lynch witnesses, of enabling the firm to learn more about IMIC and its plans. In these meetings and in other discussions prior to the executive committee's August 20, 1979, decision to approve a 15,000 contract trading limit for IMIC, the firm obtained the following information:

(a) In its initial capitalization, IMIC had a net worth of $30 million, a line of bank credit for an additional $30 million and funds "on call" from the Hunt stockholders in IMIC and their Saudi associates of $40 million;

(b) IMIC represented to the firm that all of IMIC's futures trading would be done through Merrill Lynch; 126/

(c) IMIC planned to establish a long position of approximately 10,000 silver futures contracts representing approximately 50 million ounces of silver.

There is no indication in the evidence developed by the Commission staff that at the time of the executive committee's first action on the IMIC trading line request it knew the details of IMIC's ownership structure. For instance, credit department memoranda contemporaneous with the Dallas meeting reflect that the firm did not know the identities or financial background of the Hunts' Saudi associates in the IMIC venture. 127/ The firm also was not aware that the Hunt's interest in IMIC was, in fact, held by a corporation in turn owned by trusts established for the benefit of Herbert and Bunker Hunt's children, rather than by Herbert and Bunker Hunt themselves.

In the ensuing five months, as the executive committee addressed IMIC's request for loans against silver bullion and for extensions of those loans, Merrill Lynch personnel obtained from IMIC representations as to the updated financial condition of the firm. On November 8, 1979, Lurie received a report from Guinn, IMIC's managing director, to the effect that IMIC's assets at that time were $782 million and its net worth approximately $398 million, an increase in net worth of over 1200% in three months. On January 4, 1980, Marsh informed the corporate credit department that as of December 31, 1979, IMIC's assets were $1.72 billion and its net worth $1.41 billion, an increase in net worth of about an additional 3400% in two months. Although IMIC, by year end, had become on

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126/ This representation was effectively fullfilled, although IMIC did execute a small transaction through another firm.

127/ Merrill learned the identities of IMIC's Saudi investors and its ownership structure within the Hunt family holdings when it received from the Hunts a copy of a September 1979 letter to the CFTC detailing that information.

paper, a $1.4 billion company, substantially all of its assets were concentrated in silver bullion or in cash or cash equivalents attributable to money received as positive variation on silver futures positions.

According to the testimony of Merrill Lynch witnesses and the contents of contemporaneous memoranda, the firm was aware both that the rapid growth in IMIC's reported net worth was attributable primarily to the extreme appreciation in the value of its silver holdings and that IMIC was withdrawing certain of the appreciation from its silver futures holdings and using these funds to make down-payments on loans it obtained to finance physical silver purchases. In a policy similar to Bache Halsey's treatment of the Huddleston account, Merrill, nevertheless, looked to the increases in reported net worth as support for its decision to lend to IMIC against warehouse receipts.

Although IMIC's futures trading was conducted through Merrill Lynch, the firm was aware that IMIC was borrowing from other lenders against certain of the silver warehouse receipts it acquired in deliveries on futures positions at the firm. As early as October 11, 1979, internal corporate credit department memoranda reflected transfer of 1,344 warehouse receipts to Swiss Bank Corporation in New York City apparently to collateralize loans. In addition, in mid-November 1979, the Al-Saudi Bank approached Merrill Lynch International ("MLI"), a subsidiary of ML & Co., requesting its participation in a $50 million silver-collateralized loan to IMIC. MLI declined to participate in the loan because of Merrill Lynch's pre-existing $50 million in lending to IMIC. 128/

Merrill Lynch witnesses testified that they remained "comfortable" with the IMIC account during this period. They uniformly testified that they believed that the loan was adequately collateralized and that Herbert and Bunker Hunt stood behind the IMIC account. Certain Merrill Lynch witnesses stated that Herbert Hunt had orally represented that to be the case in the August 1979 Dallas meeting between the Hunts and senior Merrill Lynch personnel. Merrill Lynch president William Schreyer testified that

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128/ The decision by MLI to decline participation in the loan proposal described in the text was made in consultation with the corporate credit department at Merrill Lynch. Lurie testifed that he told MLI that it was better to keep IMIC's financing within one Merrill Lynch organization rather than having "two entities within the Merrill Lynch umbrella lending to the same customer."

personnel at Merrill Lynch "let the Hunts know that we considered IMIC the Hunts, that was our understanding." There were, however, no written guarantees running from Hunt family members to IMIC. Moreover, corporate credit department memoranda requesting trading lines and lending indicated that the IMIC account was to be treated independently of those of individual Hunt family members and related entities. Further, as discussed later in this report, when the firm asked Herbert and Bunker Hunt to guarantee the IMIC account in writing, their attorneys initially resisted Merrill's efforts to have them do so.

3. Information About the Hunts Other Than IMIC

Memoranda dated July 21, 1976, and June 20, 1977, in commodity credit department files concerning the Hunts indicate that the corporate credit department had been asked not to perform its normal credit investigation into the Hunt family accounts and that the efforts the firm had made to "independently substantiate the financial structure of the Hunt family" had "caused certain unfavorable reactions on the part of the family." 129/ The credit files contained no financial statements or other authoritative indications, such as bank statements or schedules of indebtedness, of the net worth or liquid resources of the Hunts. While there is documentation reflecting Merrill Lynch inquiries concerning certain of the Hunts at First in Dallas and First Chicago early in 1976, memoranda of those conversations state only that bankers confirmed that Hunt-related account holders had a net worth in excess of $5 million. In other instances, credit department memoranda recite that banking contacts were unwilling to discuss net worth figures. Credit department records, however, do reflect a general belief on the part of credit department personnel that the Hunts were persons of "unquestionable" means. Further, Merrill Lynch witnesses and available records indicate that the Hunts had promptly met substantial obligations to the firm in the past.

During the build-up in silver prices in 1979 and early 1980, the firm received no new information concerning the individual Hunts' financial condition. This failure to obtain financial information occurred even though the directors of the firm's commodity division and its corporate credit department wrote in June 1979 that "any proposed limit for an individual Hunt account should

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129/ As previously noted, it is unclear whether the instruction described in the text remained in effect in 1979 and 1980 during the time IMIC, Hunt Holdings and Herbert Hunt established the positions described in this report.

be supported by financial documentation." 130/ Memoranda to the executive committee concerning IMIC futures trading requests and IMIC, Hunt Holdings and Herbert Hunt's borrowing request recite that the Hunts "were able to handle large positions and to answer calls for several million dollars on an immediate basis," but acknowledged that "the exact net worth and specific financial figures and liquidity of the individuals had never been calculated." In accordance with custom in the industry, the firm apparently did not contact other broker-dealers to ascertain whether they were also extending credit to the Hunts. 131/

4. Information Available to Management Concerning the Silver Market

The evidence relating to Merrill Lynch's credit decisions concerning the Hunt accounts indicates that the executive committee considered the volatility of the silver market, the magnitude of Hunt positions in relation to that market, and the possibility of regulatory intervention in making its decisions. This

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130/ John Conheeney and Michael Lurie noted in their June 27, 1979, memorandum to the Merrill executive committee concerning Herbert Hunt's account that financial documentation was important because, "[a]s with any significant account, we must be able to relate the position limit and the exposure in proportion to the account's financial structure and risk capital."

131/ One reason for Merrill Lynch's reluctance to inquire of other firms of their relationship with the Hunts was because of Merrill Lynch's respect for their customers' desire for confidentiality. Witnesses for Merrill Lynch, for example, noted that they would not respond to inquiries of this nature by other firms. According to Sher, at one meeting of the executive committee during late 1979 or early 1980, ML & Co. chairman Donald T. Regan ("Regan"), suggested that the firm "push the commodity exchanges, through the CFTC, to provide information on the overall position of customers so that firms could assess their customers' exposure." After March 1980 Sher, then a senior vice president of ML & Co., discussed Regan's suggestion with CFTC Commissioners Dunn and Martin. He described the CFTC response as "polite" but stated that he did not receive much encouragement from the CFTC on this matter. According to Merrill Lynch witnesses, then, except as to IMIC, the firm was without information as to the magnitude of the Hunts' silver positions with other firms until the evening of March 26, 1980.

concern is evident from the outset with regard to the IMIC account. In their joint August 15, 1979, memorandum to the executive committee, the commodity division and the corporate credit department included a description of IMIC's then current 4,641 contract silver position, compared it to the open interest on Comex and CBT, and concluded that "current silver markets . . . reflect sufficient liquidity and open interest figures to accommodate the requested trading limit" of 15,000 contracts. The memorandum also noted that the position in the IMIC account at that time "has not made an appreciable impact on the Firm's clearing position . . ."

Approximately three weeks later, in their memorandum recommending that the firm lend approximately $50 million to IMIC, the corporate credit department and the commodity division acknowledged that "the Silver [sic] markets are presently experiencing violent and dramatic price movements and they are currently at all time highs." The memorandum pointed out that the silver warehouse receipt collateral for the IMIC loan was unhedged, but opined that "the Firm could further protect itself by establishing a short position in the futures market" in the event of default. Ten days later, Lurie observed in a memorandum to Sher dated September 17, 1979 that "the silver markets continue to experience extreme price volatility and have reached new highs on almost a daily basis." He noted that a "price correction" in the silver market "cannot be precisely measured and could be extreme". He alerted Sher to the possibility that "the volatility of the markets coupled with the size of the positions could preclude immediate liquidation or the establishment of hedges to protect the position." Finally, he noted that "there exists . . . the possibility of regulatory intervention due to the continuing volatility of the market place."

Meanwhile, the corporate credit department and the commodity division monitored the proportion of Merrill Lynch and the exchanges' open interest in silver represented by the Hunt accounts. As of September 18, 1979, they calculated that the futures positions in the combined IMIC and Hunt family accounts represented 79.7% of Merrill Lynch's long customer position in CBT silver and 67.1% of its long customer positions in Comex silver. These positions, in turn, represented 4.6% of the open interest on the CBT and 6.4% of the open interest on Comex.

During the same period, a series of alert notices had been issued by the commodity division and the corporate credit department concerning volatile conditions in the precious metal markets. On October 2, 1979, commodity division director John J. Conheeney and corporate credit department official Paul Carberry drafted a notice to Merrill's branch offices concerning conditions in the precious metals markets. The memorandum noted that "each day debits are incurred from good established accounts as well as from accounts that had realized or opened profits of substantial amounts." The memorandum pointed out that:

> the debits often have occurred because excess funds were withdrawn from Merrill Lynch or used to pyramid positions without sufficient money in reserve to cover the additional position commitment. Still other debits occurred when maintenance calls, on seemingly reasonable positions properly margined at one point, could not be met by the customer because of one or more additional accounts with other brokers which were also on call.

Conheeney and Carberry urged that customers be encouraged to maintain unrealized profits on futures positions with Merrill Lynch and that they be discouraged from pyramid trading strategies.

The firm's concern with conditions in the silver market as it related to the Hunt accounts was evident again two weeks after the Conheeney/Carberry memorandum when Lurie submitted to the executive committee the corporate credit department and commodity division's recommendation that the firm make loans to Hunt Holdings secured by silver warehouse receipts. Lurie noted as a factor weighing against the proposal that if both IMIC and Hunt Holdings defaulted on their loans at the same time, "the volatility of the markets, the potential lack of liquidity and the size of the combined positions could preclude immediate liquidation or establishment of hedges to protect the positions."

The firm's corporate credit department and the commodity division raised similar concerns again early in January when Herbert Hunt requested a loan against 200 silver warehouse receipts. Lurie transmitted this request to the executive committee without a recommendation, but he did note that if Herbert Hunt, IMIC and Hunt Holdings were all to default on their loans at the same time, Merrill might not be able to liquidate or hedge the positions. He also noted for the committee that Hunt related accounts at the firm comprised 67% of the firm's open long customer silver positions at the

Comex and 73% of the firm's open long customer silver positions on CBT, and that the positions represented 7% and 5.6% respectively, of the open interest on those exchanges. He also stressed that the silver markets were volatile and that a "price correction" could exceed the protection for the firm afforded by the terms of the financing.

IV. THE MARKET BREAK - JANUARY THROUGH MARCH 1980

A. Introduction

As described elsewhere in this report, following Comex' imposition of position limits on large traders and the establishment of a liquidation-only trading rule in silver on January 21, 1980, the market price of silver fell more than $10 per ounce before temporarily stabilizing near $34.60 per ounce, the price of spot silver on January 31. It resumed its steep decline in March, closing on March 27 at $10.80, $24.50 per ounce below the price on February 29. On March 13, 1980, Merrill learned that IMIC, for the first time, would be unable to meet a margin call in its account on the customary 24-hour basis.

Meanwhile, Merrill Lynch's exposure to the Hunts in silver continued and increased. 132/ Early in March, the executive committee approved $86 million in additional financing for Herbert Hunt and extended for an additional 60 days the outstanding $25 million loan to IMIC. In addition, the firm on March 12, 1980, paid approximately $13 million for delivery of 600,000 ounces of silver in the IMIC account. IMIC failed to reimburse the firm for that expenditure as required when it began experiencing

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132/ It should be noted that Merrill expanded its relationship with the Hunts during this period in other areas, as well. Penrod Drilling Company, Hunt Energy Corporation and Eighth Crescent Investment Co. (a Placid Oil Co. guaranteed subsidiary) each opened new accounts with net long positions in gold futures. Marsh initially established a 50 contract trading limit in each account, a trading level that contemporaneous corporate credit department memoranda indicate would not normally be considered in the absence of audited financial statements, which were not available to the firm. On March 3, 1980, well after the three gold accounts had established positions that internal guidelines required that the executive committee approve, the executive committee ratified a $5 million line in each account. These accounts remained in equity throughout this period.

difficulties meeting margin calls on its futures position. By March 14, the spot price of silver below which IMIC's account with the firm would have liquidated to an unsecured debit balance, had risen to $22.31 per ounce from its January 31 level of $18.56. 133/

B. The Herbert Hunt and IMIC Loans

In February 1980, Herbert Hunt asked that Merrill lend him for 89 days 70% of the value of 500 contracts of Comex silver on which he intended to stand for delivery in March. At February 28 prices, the proposed loan was for approximately $61 million. At its March 3 meeting, the executive committee approved the proposal. Shortly thereafter, Herbert asked the firm for an additional loan of $25 million to be secured by the remaining 5.5 million ounces of unencumbered silver remaining in his account. The corporate credit department approved this request on March 12 and it was ratified by the executive committee on March 17.

In considering the $61 million loan on March 3, the executive committee received a memorandum from Lurie concerning both the Herbert Hunt loan and the extension of the IMIC loan that raised a number of questions respecting the Hunts' financial posture.

Lurie's memorandum neither contained nor referenced any statements of Herbert Hunt's financial condition. In fact, Lurie described Herbert Hunt's financial worth as "difficult to precisely define." Lurie noted the positions Herbert maintained at Merrill included at least $73 million in treasury bills and 1352 silver warehouse receipts worth over $223 million on February 28, 1979. 134/ Lurie also noted that Herbert Hunt "and several related clients" had securities accounts at the firm with an

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133/ It should be recalled that recognized commodity futures industry practice is to value customers' accounts using futures prices quoted by exchanges even though, in limit-down trading markets, such prices cannot be realized in liquidation. Valued at futures prices the IMIC account on March 14 was $170 million in equity.

134/ Lurie added that 200 of these contracts were already financed by the firm. By the terms of that loan, Herbert Hunt was required to maintain 30% margin, giving Merrill $11.45 per ounce protection from the delivery price of $38.17. At the time of the meeting, silver was at $35.20.

aggregate debit balance of over $162 million. Lurie observed that, if Herbert's financing request was approved, the Firm would be extending over $280 million in credit to the Hunts, through both their securities and commodities accounts. Equity in the combined Hunt accounts at February 29, 1980 was $956 million.

Lurie calculated that the 30% required by the terms of this proposed Herbert Hunt financing would protect Merrill from a $10.50 fall in the delivery price of silver. He also noted that the open interest in silver on both the Comex and CBT had decreased dramatically since late 1979. Lurie observed that in the event of a default on the loan, the condition of the silver markets might not allow the firm to establish a short hedge or to liquidate the collateral in a timely or efficient manner in order to protect the firm. Lurie noted that the Hunts were a "dominant factor" in the silver markets and that a default by them could precipitate the collapse in the price structure of that metal.

Lurie cited several other negative considerations relative to Herbert's request for financing:

1. A severe "market correction" could exceed the firm's available margin protection;

2. The collateral supporting the financing was unhedged;

3. The CFTC and the exchanges were closely monitoring the Hunts' silver activities and the Wall Street Journal had reported allegations that the Hunts were cornering or squeezing the silver market; 135/ and

4. Although this financing would have a "minimal effect" on the firm's Rule 15c3-3 reserve requirements, it would have a greater effect on the

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135/ In connection with the reported allegations described in the text, Lurie expressed his view in this memorandum, as others, that "[Merrill] has acted in a manner consistent with the highest standards with regard to the [Hunt] accounts." He also noted, however, that "[Merrill] could . . . be subject to regulatory review and adverse publicity, if the allegations against the Hunts are proven."

firm's net capital posture. 136/ Herbert Hunt's financing, therefore, "should be with the understanding that the loan may be called if capital requirements from [the firm's] regular securities and commodities operations require additional capital."

Lurie also outlined several positive considerations supporting Herbert's request for over $61 million in financing: 137/

1. Hunt accounts had always met their obligations to the firm;

2. The financing to Herbert Hunt would produce interest income to the firm of about $1 million annually. 138/ He also noted that the firm had already earned over $1.8 million in interest from its prior loans to IMIC, Hunt Holdings and Herbert Hunt.

3. Hunt would not withdraw appreciation in the collateral;

4. Hunt would meet maintenance margin calls within 24 hours of issuance; and

5. Commodities commission revenues from the Hunts had been approximately $721,000 in 1979 and had been over $142,000 in January 1980.

Lurie did not explicitly recommend the IMIC financing. Instead, he suggested that:

136/ Lurie reported that the firm's excess Rule 15c3-3 reserve requirements on February 22, 1980 were about $120 million and he calculated that the proposed loan to Herbert Hunt would reduce that figure by less than $1.8 million. He also reported that, under the firm's conservative 8% internal guidelines, which required greater excess capital than SEC "early warning" provisions, the firm's excess net capital on February 22, 1980, was slightly over $33 million and that the proposed financing would reduce that, again pursuant to the firm's 8% guidelines, by about $4.8 million.

137/ Considerations similar to these also applied to IMIC's request to extend its $25 million financing.

138/ Although the financing was to be for 89 days, it was subject to renewal.

- The firm's senior management discuss the future relationship of the firm to the Hunt accounts, including whether to restructure the financing;

- The firm obtain permission from the Hunts to perform a "due diligence" review of their financial worth;

- [E]ach financing be subject to cross collateralization and default provisions. If one account were to default, [the firm] could call all loans or secure itself with funds in other accounts.

- The Hunts provide the firm with information regarding the Hunts' commodities activities at other broker-dealer firms.

In the March 3 executive committee meeting, Herbert's request for $61 million in financing and IMIC's request to extend its $25 million financing prompted significant discussion. One result of these requests, particularly Herbert's, was a decision by the executive committee to send a representative to Dallas in order to "determine that [the executive committee] was making a good businessman's decision" on the proposals. The executive committee instructed Schreyer, to obtain additional financial information about the Hunts, and specifically, Herbert Hunt. In the meantime however, the executive committee approved IMIC's $25 million request for renewal and Herbert's $61.6 million loan request. 139/

Schreyer selected ML & Co. treasurer, Robert Arnold ("Arnold"), to meet with the Hunts and obtain the financial information requested by the executive committee. Arnold described his mission as an attempt to obtain audited financial statements for Herbert Hunt and to gather such additional information as could be supplied by the Hunts.

Arnold and Schreyer called Herbert Hunt and scheduled a meeting between Arnold and Hunt Energy chief financial officer James Parker ("Parker") for Friday, March 7, 1980. To prepare for this meeting, Arnold met with various individuals from the corporate credit, investment banking and the firm's finance organizations. In addition to

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139/ Schreyer and ML & Co. treasurer Robert Arnold testified that the executive committee conditionally approved Herbert's request for $60 million in financing subject to the receipt by Arnold of this information. The minutes for that meeting do not indicate that any condition was placed on the executive committee's approval of Herbert Hunt's request.

bringing Arnold up to date on the status of the Hunts' relationship with Merrill, the participants in these meetings discussed the type of information about the Hunts that Arnold might seek to obtain. These suggestions included an exhaustive checklist of "Financial Data Requirements" for a comprehensive financial examination of the Hunts the extent of which went well beyond the instructions he had been given by the committee.

Arnold went to the Hunt offices in Dallas on the morning of March 7, 1980. He spent approximately four hours there, speaking mostly to Parker and Herbert Hunt, although Bunker Hunt joined the group for lunch.

Out of the meeting, Arnold learned, for the first time since before July 1979, additional information concerning Herbert's financial position other than as reflected in his substantial holdings at Merrill Lynch. He obtained Herbert's audited financial statement for 1978 and his unaudited interim financial statement for September 30, 1979. Herbert and Parker also gave Arnold other financial information and explained in general terms the structure and nature of the Hunt's business operations. Arnold testified that the discussion gave him "a better feel for how Herbert Hunt [and Bunker and Lamar Hunt] fit into the entire group of Hunt companies".

According to his testimony, Arnold focused on the Hunts' liquidity. He testified that Herbert and Parker assured him that the Hunt's banking relationships were adequate and that their existing loan facilities were sufficient to meet any liquidity problems which might confront them. Although, according to Arnold, he asked for information concerning any contingencies not reflected on the balance sheet, he remained unaware of the $434 million installment on the Engelhard transaction coming due on March 31.

Although Arnold testified that he felt Herbert was very straightforward about the Hunts' banking relationship and their liquidity, he apparently did have some concerns. He testified, for instance, that he questioned the Hunts' method for forecasting their future liquidity needs and that he was concerned about the Hunts' understanding of the development and maintenance of international banking relationships. While Arnold knew that Merrill was aware of certain Hunt banking relationships, he did not ask for, nor did he receive, a list of the specific banks or broker-dealers with which the Hunts did business. 140/ He did say he was told that the liquidity of various Hunt

140/ Arnold had learned of the existence of lines of credit extended by Swiss Bank Corporation and First in Dallas, although he did not learn to which Hunt individual or entity the line of credit had been extended.

family members could be enhanced by infusions of funds from Hunt trusts and the corporations those trust controlled. Arnold testified that Herbert explained this source of funds was limited by the estate and tax considerations guiding the trusts. He received no projections of funds available to individual Hunts from those trusts. Ultimately, according to his testimony, Arnold concluded that the Hunt's banking relationship problems, "if any", were manageable at that time and that the Hunts' liquidity situation did not threaten Merrill Lynch's loans to Herbert Hunt.

At lunch Bunker Hunt explained why he considered silver a good investment. Later, after Bunker had left, Herbert mentioned that although he expected to accept some additional silver deliveries on his domestic futures positions, he would not be accepting delivery on silver contracts in the same volume as he had done in the past.

During the week of March 9, 1980, Arnold discussed his Dallas meeting with various members of ML & Co. senior management, although apparently not at a formal meeting of the executive committee.

C. Hunt Accounts on the Eve of Crisis

During the first two weeks of March 1980, silver resumed its decline from January highs. 141/ By March 14, 1980, Merrill Lynch's exposure in the Hunt accounts had increased significantly since January 31.

On March 14, Hunt and IMIC accounts as a group held silver bullion and contracts for the future or forward receipt of silver aggregating 36 million ounces. Combined equity in these accounts at spot prices totaled $369 million. Of the assets in these accounts, $436 million, or 44%, was unrealized appreciation in future and forward silver positions and the market value of bullion positions. The firm's exposure was such that, assuming the value of the other assets in the accounts remained the same, that there was no reduction in the position and that the Hunts deposited no other assets, a decline in spot silver prices to $10.80 would have carried the accounts as a group into deficit. 142/

141/ From February 29 through March 14, spot silver prices declined in value 41% from $35.30 per ounce to $21.00 per ounce.

142/ Interestingly, $10.80 is precisely the decline that in fact occurred from March 14 through March 27. As noted later in this report, however, additional assets deposited by the Hunts with the firm maintained the accounts, taken as a group, in equity.

The exposure to Merrill Lynch from the IMIC account alone on March 14 was substantial. The account carried silver positions aggregating 25 million ounces. Although the account remained $170 million in equity computed at futures prices (in accord with recognized industry practice), if computed at spot prices the account on March 14 would have liquidated to an unsecured debit balance of $34 million. Even at futures prices, then substantially higher than spot because of exchange-imposed price-movement limitations, the firm's exposure in the IMIC account was such that a $9.00 decline in futures prices, to approximately $23.00, would produce unsecured debit balances in the IMIC account. IMIC, meanwhile, had told Merrill it was having difficulty obtaining funds to meet margin calls. Moreover, the firm had also paid approximately $12 million for delivery in IMIC's account of 600,000 ounces of London silver. IMIC failed to deposit this amount with the firm. Merrill Lynch thus effectively lent an additional $12 million to IMIC.

V. THE CRISIS PERIOD AT MERRILL LYNCH - MARCH 14 THROUGH APRIL 1, 1980

A. Introduction and Overview

On March 11, 1980, Merrill issued a margin call to IMIC for $45 million as a result of market decline in the company's domestic silver futures positions on March 10. Bob Guinn, IMIC's managing director, told Marsh on March 12 that IMIC would not meet the call within its accustomed 24 hour period because it was having trouble transferring funds from a foreign bank. 143/ On that day, the IMIC account generated an additional margin call of $44 million. Over the ensuing ten business days, according to Merrill Lynch witnesses, the firm continued to receive assurances from Guinn that cash would arrive in satisfaction of the calls. Merrill did not sell out the account as IMIC continued in its failure to meet the calls. On March 18, it began to treat excess bullion in IMIC's loan account as collateral for the calls. On March 21, IMIC offered as further collateral for its outstanding obligations options on bags of silver coins stored with various banks ("coin options") and, on March 27, leases covering silver bullion rented to industrial users ("leased silver").

143/ According to Arnold, he was told that IMIC's silver had been mistakenly commingled with Bunker and Herbert Hunt's silver and thus IMIC's silver could not be used to collateralize a loan that would have enabled IMIC to meet the calls. The Hunts claimed that the banks had created the problem and Arnold contacted Swiss Bank Corporation which confirmed the Hunts' representation.

In addition, $9.2 million of a call for $26.1 million generated in Bunker Hunt's account on March 13 remained unanswered during most of this period, although Bunker had substantial excess equity with the firm in a securities account he held as tenant in common with Herbert. Bunker finally met the call on March 26, 1980, using the proceeds of a loan from Merrill Lynch collateralized by securities of foreign mining companies and of Gulf Resources and Chemical Co.

Meanwhile, if valued at spot prices the IMIC account would have been recognized to have developed an unsecured debit balance. On March 14, 1980, spot silver closed at $21.00 per ounce, approximately $1.40 per ounce below the price at which debit balances in the IMIC accounts exceeded the assets it had deposited with the firm. The next business day, March 17, silver closed at $17.40, and unsecured debit balance in the IMIC account if computed at spot prices reached $155 million. 144/ However, because the firm computed the value of the accounts, consistent with industry practice acquiesced in by regulators, at futures prices, then $13.29 per ounce above spot prices, Merrill Lynch did not recognize the unsecured debit balances that would have been produced in a liquidation of the accounts.

The spot market moved up slightly from the 18th through the 21st and reduced the unsecured debit balance in the account computed at those prices. 145/ On March 21, Merrill received the initial documentation asserting that IMIC assigned to Merrill IMIC's interest in the coin options. 146/

144/ Other Hunt related accounts with the firm continued to carry substantial equity.

145/ Futures prices, however, continued moving limit down.

146/ It was not until March 28, after it had begun receiving confirmation from custodian banks of the effectiveness of the assignment, that Merrill gave value, for internal purposes and in determining the equity or deficit position of the accounts in its net capital computations, to 3.9 million of the seven million ounces of silver underlying the coin options. This produced additional equity of $46.8 million in the account at prices then prevailing. In view of the earlier date of the assignment, in assessing the firm's exposure the staff has credited Merrill with the entire seven million ounces of coin option collateral as of March 21. As noted below, however, for net capital purposes sufficient uncertainty remained as to Merrill's control of these assets through March 27, such that these values were not allowable for net capital purposes and Merrill did not so treat them. No adjustment has been made for the $8 million required to exercise the options.

On Monday, March 24, the market price of silver resumed its decline. At the close on March 25, with spot silver at $20.20, the debit balance in the IMIC accounts computed at that price was $65.4 million. The March 25 debit balance was, however, apparently secured by the seven million ounces of coin option collateral which had a value of $141 million at spot prices. On March 26, after a $4.40 decline in spot silver, the IMIC account valued at spot prices carried a debit balance of $183 million. Again, however, this amount was apparently collateralized by the seven million ounces of coin option collateral and an additional five million ounces of bullion that the firm obtained from IMIC that day. At the close on March 26, therefore, the IMIC account appeared to be approximately $7 million in equity.

That night, at the Drake Hotel in New York City, Herbert Hunt told Merrill, Bache and ACLI 147/ that the Hunts had no more cash or collateral to post in satisfaction of margin calls. The next day, March 27, silver fell another $5 per ounce to close at $10.80. At that price, the IMIC account would have liquidated at the spot price of silver to a substantial unsecured debit balance even after application of the value of the coin option and bullion IMIC had pledged on March 21 and 26 as well as three million ounces of leased silver that IMIC pledged on March 27. Other Hunt family accounts at Merrill, however, remained with more than sufficient equity to offset the debit balance in the IMIC account.

Once again, Merrill Lynch did not recognize the debit balance in the IMIC account because, consistent with recognized industry practice, it computed the value of the futures positions in IMIC's account on the basis of futures prices rather than the much lower spot price. At futures prices, then averaging more than $13 higher than spot prices, the IMIC account was approximately $76 million in equity on March 27, giving value at spot prices to the coin option, bullion and leased silver collateral. 148/

147/ ACLI International Inc. is a commodity merchant firm dealing as principal in a wide range of commodities. On March 26, 1980, ACLI had outstanding to the Hunts approximately $110 million in loans secured by silver bullion.

148/ As described more fully below, on March 27 the coin options and leased silver were not allowable as collateral for net capital purposes because of uncertainties concerning the degree of Merrill's control of those assets, and Merrill did not treat them as such. At futures prices that day, therefore, the firm had potential net capital exposure of approximately $32 million.

Individual Hunt family members and related entities, other than Bunker Hunt and IMIC, continued to remit cash or maintain adequate assets in related accounts to satisfy margin calls on relatively modest net long silver futures positions. Herbert Hunt and Hunt Holdings continued to maintain required collateralization ratios on their loans. These accounts as a group and individually remained in equity, both at futures and at spot prices, thoughout the crisis period. On March 27 Hunt family accounts were $136 million in equity, $14 million less than necessary to fully offset unsecured debit balances in the IMIC account computed at the spot prices. Placid Oil and other Hunt related entities' accounts held an additional $73 million in equity.

It will be recalled, however, that the Hunt family had not guaranteed in writing the IMIC account nor authorized the firm to execute on family assets to satisfy IMIC's obligations. Merrill personnel sought such a written guarantee of the IMIC account hoping to use excess equity in Hunt family accounts to offset anticipated deficits in IMIC's positions. In Merrill's first attempt on the afternoon of March 27, Hunt attorneys resisted these efforts and the IMIC accounts continued through March 31 to carry unsecured debit balances if liquidated at spot prices. On Tuesday, April 1, 1980, however, Schreyer and other senior Merrill Lynch officials met with the Hunts in Dallas in an effort to obtain a written cross-guarantee of the IMIC account. Merrill secured an agreement, later acknowledged by Herbert Hunt in another agreement to be a personal guarantee, that it could "treat [the Bunker and Herbert Hunt's] individual accounts in a manner (<u>other than by sale</u>) which [permitted the firm] to use any and all equities, securities or other collateral . . . . as capital for regulatory purposes." [Emphasis added] Bunker and Herbert Hunt also agreed to remit cash to Merrill to cover any capital charges it was nevertheless required to take. According to Merrill Lynch witnesses, after obtaining this agreement and having it reviewed by the CFTC and the NYSE, the firm treated the IMIC account in the aggregate with other Hunt accounts and accordingly made no charges to its regulatory capital for deficits in the IMIC account.

As events unfolded in connection with the IMIC account, Merrill continued doing business with the Hunts on other fronts. On March 26, 1980, the firm lent a total of $26 million to Bunker and Herbert Hunt secured by a variety of stocks of South African mining companies with market value at the time of over $118 million. The Hunts apparently used this loan to satisfy margin calls in their Merrill Lynch accounts. The excess market value of these securities over the amount loaned increased the equity in Bunker and Herbert Hunt's accounts with the firm by nearly $93 million. Meanwhile, however, the CBT

Clearing Corporation assessed Merrill for a $20 million special margin deposit as security for its continuing fulfillment of its obligations to the clearinghouse.

The next morning, March 27th, Merrill began to liquidate bullion and futures positions in the IMIC and Hunt accounts. By the close of business on Friday, March 28, the firm had liquidated 9.9 million ounces or 41%, of IMIC's position with the firm. It became apparent on the weekend, however, that continued liquidation of positions in the IMIC account with silver prices at the levels then prevailing would, to use Conheeney's words, "lock in a loss". According to Conheeney, the firm was concerned about the possibility of liquidating to a loss because it was not sure the Hunts would pay what they owed. On March 31, Merrill suspended liquidations at the Hunts' request pending the outcome of its efforts to obtain the cross-guarantee that would enable it to attribute to the IMIC account excess equities in the Hunts' individual accounts.

After obtaining the Hunts' written consent for the firm to attribute their individual equities to the IMIC account under certain circumstances, Merrill began a program of gradual liquidation of the remaining positions. On May 27, 1980, Placid Investments purchased the physical silver in the IMIC account, and fully paid the debit balance remaining in the account.

B. Merrill's Attempt to Obtain Cash and Collateral

As evident in the foregoing discussion, only the IMIC account had potential losses of serious concern to Merrill. Accordingly, virtually all of the firm's efforts appear to have been directed to forestalling losses in that account. On March 11, 1980, Merrill issued a margin call to IMIC for $44.6 million as a result of market decline in the company's domestic silver futures positions on March 10. After learning from IMIC on March 13 that it was unable to meet Merrill's March 11 margin call, Marsh remained in contact with Guinn throughout the following week. Guinn continued to tell Marsh that cash would be forthcoming as soon as IMIC resolved the technical difficulty with bank collateral that had created the problem. Based on this representation, Merrill did not sell out the IMIC account. Meanwhile, calls in the account mounted as silver prices continued to decline. On March 14 another $44.1 million call issued for market action on the 13th. On March 18, additional calls went out for $32 million.

On March 18, with no funds having been forthcoming and the earliest outstanding calls aging to the point at which a charge to regulatory capital would have been required, commodity operations head Victor Silano ("Silano"), on advice of counsel, decided to treat the calls as adequately collateralized by allocating to them excess silver bullion in IMIC's "unregulated" commodities account (the account in which Merrill carried IMIC's physical silver positions and the loans they collateralized). On March 18, IMIC's excess bullion collateral was approximately four million ounces valued at approximately $72 million, an amount insufficient as of March 18 to collateralize all of IMIC's outstanding calls. 149/

While Silano was engaged in the effort just described, other Merrill personnel, including Arnold, Conheeney, and Lurie, met throughout the week of March 17 to discuss the IMIC situation. In a March 20 memorandum summarizing

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149/ It should be noted that Comex rules acknowledge that exchange members may receive warehouse receipts from customers to satisfy calls, but permit only 75% of the value of the material at spot to be counted. Merrill, however, appears to have utilized 100% of the value of the excess IMIC bullion in determining whether the calls were satisfied. It did so in reliance on advice received from the NYSE, Merrill Lynch's designated regulatory authority, in a conversation on March 19 to the effect that no haircut need be taken for net capital purposes on bullion received in satisfaction of maintenance margin calls.

It should also be noted that Merrill could not use this bullion to meet calls to it issued by the clearinghouses, which it had to meet with cash. Merrill thus found itself advancing cash to the clearinghouses, on IMIC's behalf, against IMIC's silver bullion collateral. In effect, this was a *de facto* loan to IMIC at no interest.

By March 18, Merrill had lent IMIC over $37 million, not including the *de facto* loan described above. This $37 million in loans to IMIC was $13 million more than the amount authorized by the executive committee. The additional $13 million came about because at about the time that IMIC missed the March 12 margin call it also failed to pay for delivery of 600,000 ounces of LME silver delivered in IMIC's account against maturing forward positions. Notwithstanding the executive committee's refusal to finance this additional delivery, the debit balance remained in IMIC's unregulated account and Merrill did not sell the silver received in the account when payment was not forthcoming.

Merrill's posture during this period, Arnold recorded that the firm expected to receive from IMIC $60 million in cash or 15 million ounces of silver collateral that day or the next, and an additional 10 million ounces on March 21.

Arnold testified that Merrill had been "constantly pressuring" the Hunts for information about the status of the bank facilities that IMIC had told Merrill it would use to meet the calls. With Herbert Hunt's permission, Arnold contacted Swiss Bank Corporation to substantiate that the Hunts were working on obtaining funds. According to Arnold, that bank confirmed the Hunts' story that "technical problems" were preventing an immediate advance of funds. In the first of two meetings on March 20, Herbert Hunt, according to Arnold, assured him that the Hunts "would meet their requirements and that they had collateral and were going to get banking facilities that would be adequate to meet their commitments."

Meanwhile, in a meeting on March 17, the executive committee had instructed Arnold to go to London to see what he could do to have Merrill Lynch International Bank ("MLIB") facilitate IMIC's attempts to put bank lines in place. In the second of his March 20 meetings with Herbert Hunt, also attended by Bunker, Lamar and Jim Parker, Arnold broached this subject. The next day, Friday, March 21, 1980, the Hunts agreed to have their employees meet with MLIB personnel in London.

On Sunday, March 23, Arnold flew to London in anticipation of meetings between IMIC and MLIB. The next afternoon, Arnold and various MLIB personnel met with Guinn. According to Arnold, Guinn told the Merrill representatives that IMIC had short-term liabilities that did not match its long-term silver bullion holdings and had been requested to post additional silver collateral for bank lines as the price of the metal declined. Accordingly, it had remaining only 10 million ounces of unencumbered silver. Arnold testified that he sought to obtain that silver as collateral for IMIC's unmet margin calls at Merrill, but was not immediately successful.

The next day, March 25, the Merrill personnel again met with IMIC representatives. This time Parker and IMIC co-director Mohammed Affara ("Affara") joined Guinn. Guinn told the Merrill officials that a $50 million line of credit from Dresdner Bank was finally in place but that IMIC now had remaining only seven million ounces of unencumbered silver bullion. During that evening and into the morning of the 26th, Arnold spoke with Parker, Guinn and Affara and tried to obtain additional collateral for Merrill Lynch from IMIC. The IMIC and Hunt Energy employees countered that the firm was fully collateralized in light of the leases and options IMIC had assigned to it on March 21, 1980, 150/ and that they saw no reason to provide the firm with excess collateral. Arnold argued that the price of silver had fallen substantially from Friday and that he wanted to make certain that the firm remained fully collateralized. Parker, Guinn and Affara replied that although IMIC had five million ounces of unpledged silver available in London, they had planned to use that silver to secure bank lines at London banks. They said that if they were successful in that endeavor, they would be able to provide Merrill Lynch with cash. Arnold persisted, however, and by March 26, he received from IMIC the five million ounces of collateral. Arnold also received from IMIC a copy of a wire from Affara and Guinn to Dresdner Bank ordering $45 million to be deposited in Merrill's account at the Morgan Guaranty bank.

Arnold returned to New York on March 26 carrying both the wire to Dresdner and a wire authorizing Sharps Pixley, bullion dealers, to transfer five million ounces of silver bullion to Merrill's account free and clear of encumbrances. The firm never received the $45 million from Dresdner Bank because, according to one witness, in view of the events in the silver market Dresdner decided on March 27 not to process the IMIC request. Merrill Lynch did, however, retain the five million ounces of bullion collateral Arnold had obtained notwithstanding IMIC's later assertion, on March 28, that Arnold had agreed that Merrill would rerelease that bullion if IMIC needed it elsewhere. 151/

On March 21, during the course of the negotiations just described, Guinn and Herbert Hunt gave Merrill Lynch counsel documentation asserting an assignment to the firm, on IMIC's behalf, of options to purchase at face value bags of silver coins containing approximately seven million ounces of silver. Merrill took no steps to

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150/ The leases were not actually assigned to Merrill Lynch until March 27, 1980.

151/ Arnold received a telegram from Guinn on March 28 in which Guinn, referring to an earlier telephone conversation between Arnold and Affara, explained IMIC's need for the five million ounces at Sharps Pixley. Without directly asking Merrill Lynch to release the silver bullion, the wire assumed that Merrill would release the bullion "as agreed in London". Arnold replied to Guinn's telegram, with the assistance of counsel, asserting that "Merrill Lynch never had and never has had any obligations to IMIC as suggested in [Guinn's telegram]." By the time Arnold sent his response to Guinn, Merrill Lynch had liquidated most, if not all, of the silver bullion at issue.

confirm the coin option assignment until March 27. In contacting the various banks holding the silver coins covered by the options, counsel learned that Mocatta Metals, from whom IMIC had obtained the options in an October 1979 EFP transaction, asserted the right to substitute bullion for certain of the coins upon exercise of certain of the options. While this situation had no material impact on the ultimate value of the coins to Merrill Lynch, it did pose an obstacle to Merrill's immediate liquidation of certain of the coins. Accordingly, on March 28, when the firm first assigned value to the coin option collateral in computing the status of the IMIC account for regulatory purposes, it utilized only 3.9 million ounces as collateral.

On March 27, meanwhile Guinn executed a document stating that it assigned to Merrill leases covering an additional three million ounces of silver then on loan to various industrial users. On March 28, Herbert executed documents which asserted a grant to Merrill of a security interest in this same material. Shortly thereafter, when Merrill sought to perfect its interest, Chase Manhattan bank as escrow agent informed Merrill that Mocatta Metals, which had earlier assigned the leases to IMIC, had to consent to IMIC's assignment to Merrill. Negotiations continued for weeks after the crisis, only reaching resolution after IMIC's deficits were paid in connection with the Placid loan. Merrill did not value the leased silver, which had a value on March 28, at spot prices, of approximately $36 million, in determining the status of the Hunt accounts for regulatory capital purposes.

The five million ounces of silver bullion Merrill received from IMIC on March 26 and the lease and option assignments just described were the last deposit of cash or other assets Merrill received from IMIC until the Hunts purchased the IMIC account in connection with the Placid loan.

C. Crisis Period Loans to Bunker and Herbert Hunt

Bunker and Herbert Hunt sought to obtain financing to meet margin calls on their silver positions from various broker-dealers during February and March 1980. 152/ In one of the March 20 meetings with Arnold, Herbert Hunt

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152/ The Hunts' efforts in February and March to borrow money to meet calls is described generally at pages 38 through 39 of this report. Their borrowing from Bache and Hutton is recounted at pages 67 through 76 and 177 through 179, respectively.

asked that Merrill make loans to him and Bunker collateralized by American depository receipts for securities of various South African gold and platinum mining companies. Arnold told Hunt that Merrill Lynch management would consider the request. Merrill gold stock analysts reviewed the proffered collateral and valued it at something over $100 million. Merrill Lynch agreed to lend up to 35% of the value of the collateral although, as noted below, the loan actually made totalled $26 million.

On March 25, 1980, the Hunts deposited the portfolio of gold stocks into a new joint securities account established for that purpose. On March 26, Merrill Lynch advanced the Hunts $26 million out of that account. Although account documentation reflects payment by check, Bunker Hunt's commodities account with the firm reflects a transfer of $13 million from a securities account in satisfaction of margin calls then outstanding. It appears, therefore, that Bunker used the proceeds of the March 26 gold stock loan to satisfy margin calls at Merrill.

Two Merrill Lynch witnesses, Arnold and Schreyer, have suggested that the firm's motivation in making the additional loan was to obtain for the firm additional collateral the excess value of which would provide added equity for the Hunt accounts as a group. Although the terms of the loan suggest this result, at that time Merrill had no written guarantee of the IMIC account. Until April 1, 1980 when Bunker and Herbert Hunt signed the written guarantee discussed above, it was not clear to what extent, if at all, the firm could look to Bunker and Herbert Hunt's assets to satisfy deficits in the IMIC account.

D. The Potential Financial Implications of the Crisis

1. Generally

As previously described, the IMIC account was the principal Hunt account that was of concern to Merrill during the crisis period. The account remained in equity on all but one day of the crisis period if its silver futures positions are valued at futures prices in accord with industry practice. If valued at spot prices, however, the account would have experienced substantial losses if liquidated on any but one of the days during the period. The staff has reviewed Merrill's Hunt accounts as of late March 1980 to assess their potential financial impact on the firm from the standpoint of both (1) Merrill's continuing compliance with the net capital rule and (2) the financial condition of ML & Co. as a whole. The staff review necessarily involves certain assumptions, inasmuch as the stabilization of silver prices after March 27, the Hunts' agreement to the written guarantee, and banks' willingness to refinance the Hunts' obligations through the Placid loan enabled Merrill to avoid a forced liquidation of the entire IMIC and Hunt family position.

2. The Net Capital Analysis

The net capital rule requires that broker-dealers maintain minimum levels of liquid assets in excess of liabilities. These assets must be in a form that can be realized upon immediately; unsecured customer obligations are not liquid assets for the purposes of the net capital rule nor is the value of any collateral beyond that which can be obtained in an immediate liquidation. For the same reason, accounts must be valued "at the market" to determine if, in an immediate liquidation, an unsecured customer obligation would result. On March 27, when the spot prices of silver closed at $10.80, the IMIC account in an immediate liquidation, exclusive of assets in other Hunt accounts, would have had a debit balance of $150 million which included the value of coin option and leased silver collateral. 153/

It is important to emphasize that the unsecured debit balance just described is that computed using the spot price of silver which in limit-down markets such as that existing during the crisis was the only realizable value of the futures position. In marking customer commodity accounts to "market" as required by the net capital rule, however, industry practice has been to use the settlement price for each future contract as quoted by exchanges, even though in a limit-down market such a practice produces an unrealistically high "market" value for the account. Exchanges and the two regulatory agencies concerned have been aware of this practice and have acquiesced in its continuation. Merrill and the other five firms described in this report valued Hunt accounts at futures prices in accordance with such industry practice. Valued at futures prices, in accord with the practice just described, the IMIC account held a debit balance of $32 million rather than the more substantial debit balance that would have resulted in a liquidation at spot prices.

While Merrill had the coin option and leased silver collateral for the IMIC account, that collateral was not allowable for net capital purposes and Merrill did not

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153/ See discussion above at page 121, concerning ML & Co.'s pre-tax earnings for fiscal year 1980.

treat it as such on March 27. Merrill had received documentation of an assignment of ten million ounces of silver in the form of options on bags of silver coins and agreements covering leases of silver to users. On March 27, Merrill began to contact certain of the banks holding the coins which were the subject of the options to confirm the validity of the assignment. It did not have written confirmation of validity from these institutions, however, and uncertainty remained as to Merrill's control of these assets such that none of their value would have been allowable for net capital purposes on March 27. By the close of business on March 28, however, Merrill had received telex or other confirmation of the coin silver collateral, which it valued at the spot price in computing its net capital as of that time. It did not, however, value for capital purposes the coin silver covered by the remaining options, in which Mocatta Metals Corp. asserted substitution rights, or the silver then leased to industrial users. In addition, although Hunt family accounts at Merrill held equity of $136 million at March 27, there was no written guarantee of the IMIC account then in effect. Accordingly, this amount was not allowable as an offset against the IMIC deficit for net capital purposes.

Valuing the IMIC accounts at futures prices, in accordance with accepted practices in the industry, Merrill therefore, had a maximum net capital exposure on March 27 and 28 of approximately $32 million and $8.8 million respectively. Merrill's regulatory net capital in excess of minimums then prescribed at the beginning of the crisis period was $175 million, and after a $200 million subordination of certain debt effective March 26, 1980 was $360 million. In reliance on the provision of the net capital rule as then in effect that did not require a charge for a liquidating deficit until the close of business on the second business day after the deficit was generated, 154/ however, Merrill did not charge the $8.8

154/ The waiting period provision was intended to afford brokers an opportunity to call a customer the morning after a deficit appeared and give the customer a full day to remit funds before requiring a charge to capital. Where a customer has already stated its inability to pay, it may be appropriate for a firm to consider an immediate charge to capital. On March 26, Herbert Hunt had told Merrill and others that no further cash or collateral would be forthcoming to cover margin calls or deficits. Further, on March 27, Hunt attorneys had resisted Merrill's efforts to have Herbert and Bunker guarantee the IMIC account in writing. Thus it was unclear during this period whether IMIC could cover its deficit immediately although four days later Merrill did, in fact, obtain the agreement described at pages 162-164.

million deficit as of March 28 against the net capital it reported against its approximately $360 million in excess net capital in its March 28 FOCUS report.

It should also be noted that according to Merrill Lynch personnel, ML & Co. had available at least approximately $1 billion in resources in the parent corporation and in other subsidiaries that it could have infused into Merrill Lynch if necessary. The firm did take certain steps that had an impact on its net capital.

3. The ML & Co. Analysis

The potential financial impact on ML & Co. as a whole of the Hunts' positions with Merrill is more difficult to assess. If the Hunts had been unable to refinance their silver related obligations, Merrill may have offset against the IMIC account other Hunt assets it held in the firm. Whether it would ultimately retain these amounts would, of course, have depended on whether Merrill Lynch obtained the Hunts' consent to utilize their individual holdings with the firm to offset IMIC's obligations or the outcome of whatever litigation the Hunts may have initiated to defeat such an offset in the absence of their consent. In fact, of course, Merrill later obtained the Hunts' guarantee.

If liquidation had been necessary on March 27, one analysis of Merrill's position, assuming (1) that Merrill could have realized in liquidation the full spot price of all 10 million ounces of silver underlying the coin options and leases as well as all of the physical and futures positions in the account and (2) that Merrill could have liquidated all of its other Hunt-related accounts (including among others, individual family members, Hunt Holdings, HIRCO, Placid and subsidiaries and Penrod) and applied the proceeds against the IMIC deficit shows that the Hunts' accounts including IMIC, would have yielded an equity of approximately $73 million. 155/

155/ As noted in the text, the deficits discussed are those computed using the spot price of silver. As we have observed elsewhere throughout this report, in a limit-down market such as existed in silver during most of March 1980, spot prices represent more closely than futures prices the liquidating value of a commodity futures position. Industry practice, acquiesced

Footnote continued on next page.

As described more fully elsewhere in this report, however, as of March 27 Merrill had no written guarantee of the IMIC account by any of the Hunts or related entities. An estimate of the status of the IMIC account in a liquidation at spot prices on March 27 taking into consideration this uncertainty assumes (1) that Merrill ultimately could have realized on the physical and futures silver positions already in IMIC's account and on the ten million ounces of the coin option and leased silver collateral IMIC had assigned, (2) that the equities in the individual Hunts and related entities accounts were not available to the firm except, perhaps, in later negotiation or litigation, and (3) that Merrill Lynch management would have taken no earlier remedial measures had the accounts been valued at spot prices. Based on these assumptions, another scenario is that a liquidation of the IMIC account on March 27 would have produced an unsecured debit balance of approximately $150 million. The following table illustrates the condition of the IMIC account during the crisis period had it been liquidated at spot prices and compares it to the value of the account as reflected in Merrill's automated bookkeeping system, which valued the silver in the account at futures prices in accord with recognized industry practice. The table also illustrates the value of individual Hunt and related entities' accounts.

Footnote continued from previous page.

in by exchanges and regulatory agencies, is to value accounts at significantly higher futures prices under such circumstances. Merrill Lynch, consistent with this practice, valued the IMIC account in its automated bookkeeping system using futures prices and computed that it remained in equity through at least March 26. In special calculations presenting a range of potential exposure prepared for management handling the crisis, however, Merrill Lynch operations personnel marked the accounts to market using both spot and futures prices. Thus, the firm was aware of the potential for substantially greater losses than those reflected in computerized account documentation.

TABLE VIII

HUNT-RELATED ACCOUNTS WITH MERRILL LYNCH
STATUS DURING THE SILVER CRISIS

Equity (Deficit) ($ Millions)

Date	IMIC Spot	IMIC Futures	Hunt Family & Directly Owned Entities	Placid and Subsidiaries	HIRCO	Penrod
Mar. 14	(34)	169.7	290.2	112.4	(1.8)	2.0
Mar. 25 156/	76	182.2	151.9	95.2	(3.6)	2.2
Mar. 26 157/	6.5	174.6	167.0	87.8	6.0	2.2
Mar. 27 158/	(150)	75.8	136.0	74.5	3.5	1.8
Mar. 28	(93)	64.4	204.4	88.7	(.7)	3.0
Mar. 31	(54)	110.2	209.1	89.6	4.4	2.5

E. Measures Relating to Merrill's Net Capital Position

During the crisis period Merrill took certain steps that had an impact on its net capital. These were (1) obtaining effectiveness of a $200 million subordination of an intracorporate obligation from Merrill to ML & Co. and (2) seeking to have Bunker and Herbert Hunt individually guarantee the IMIC account. The remaining two portions of this section of the report will discuss these measures.

156/ On and after March 25, equity (deficit) here described includes the value, at spot prices, of seven million ounces of the silver represented by the coin options assigned by IMIC.

157/ On and after March 26, equity (deficit) here described includes the value, at spot prices, of the five million ounces of bullion received that day.

158/ On and after March 27, equity (deficit) here described includes the value, at spot prices, of the three million ounces of leased silver assigned by IMIC that day.