### 1. The $200 Million Subordination

Merrill had submitted to the NYSE by March 21, a draft subordination agreement designed to subordinate to the claims of other creditors and customers $200 million of lending from ML & Co. to Merrill Lynch. This would enable the firm to include that loan amount in its regulatory capital calculations. According to Merrill Lynch witnesses, the decision to subordinate that already existing loan was taken some time before the crisis and represented a response to capital needs arising principally from heightened customer activity and certain other financial factors. The possibility of using a subordinated loan to bolster the firm's net capital position was raised as early as 1978 but had not been completed prior to March 1980. Certain Merrill Lynch officials told the NYSE and later testified that neither the rationale nor the timing of the subordination were specifically related to the Hunt situation.

Merrill submitted to the NYSE an executed subordination agreement on or about March 26. NYSE officials have told the staff that on or about that date, ML & Co. chairman Donald T. Regan ("Regan") told the NYSE that the proposed subordination was being effected in anticipation of potential firm exposure concerns regarding the Hunt accounts. In addition, Regan noted that on Wednesday, March 26 he had talked to Roger Birk about the Hunt accounts and that in a meeting with Birk, Fitzgerald, Neil and Conheeney about the silver situation it was decided to add $200 million in capital to Merrill Lynch.

According to Merrill Lynch witnesses, the NYSE agreed and authorized the firm to utilize the $200 million thus subordinated in its FOCUS report for March 28, thereby raising to approximately $360 million the net capital in excess of 4% minimum reflected in the report.

### 2. Seeking the Hunts' Guarantee of the IMIC Account

As described earlier in this report, Merrill Lynch management believed that the Hunts, specifically Bunker and Herbert Hunt, stood behind IMIC's obligations to the firm even though there was no written document to that effect. Merrill personnel had at one time considered obtaining a written cross-guarantee of all the Hunt accounts. An internal memorandum indicates that this effort was abandoned at least in part because the Hunts had responded adversely to earlier attempts to gain such guarantees.

In March 1980, however, the situation became more acute. By at least March 27, 1980, Merrill requested a guarantee of the IMIC account by Bunker and Herbert at a meeting at Merrill's offices with Hunt attorneys. The Hunts and their representatives did not agree to sign a written guarantee of the IMIC account at that time.

On April 1, 1980, Schreyer and other Merrill Lynch officers met with Bunker and Herbert Hunt and their attorneys in Dallas. Among the topics discussed was a guarantee of the IMIC account by the two brothers. Lengthy negotiations over this issue ensued and several draft agreements were exchanged. Finally on the night of April 1, Bunker and Herbert Hunt signed a document concerning their relationship to IMIC's obligation to Merrill. The agreement contained the following salient provisions:

1) Herbert and Bunker authorized Merrill "to hold" the assets in their individual accounts as "security for any loss or debit balance due or owing by IMIC";

2) Merrill would liquidate the IMIC account "in an orderly, prudent and businesslike manner" with the "cooperation of and [in] consultation with the Hunts";

3) If IMIC did not pay any deficit remaining after liquidation, the Hunts authorized Merrill "to treat our individual accounts in a manner (other than by sale) which permits [Merrill] to use any and all equities, securities or other collateral in such accounts as capital for regulatory purposes";

4) Herbert and Bunker agreed to deposit within four days of notice "cash in an amount equivalent to any regulatory deduction" still required after Merrill took the steps outlined in Item 3; and

5) If any deficit in the IMIC account remained outstanding for 60 days, or if Herbert and Bunker failed to deposit cash to offset a required deduction, Merrill could liquidate their individual positions to pay the obligation.

According to Merrill Lynch counsel, the firm viewed the April 1 agreement as constituting the Hunts' personal guarantee of the IMIC account and contemplated that excess collateral in Herbert and Bunker's accounts could, under the agreement, be considered as having been posted in satisfaction of IMIC's margin calls, notwithstanding that it ruled out sale of the individual Hunts' assets as an immediate means of satisfying regulatory capital requirements. The agreement as a whole, however, does appear to make it possible for the firm to sell the Hunts' individual assets if necessary to cover a capital charge arising in the IMIC account after an unsuccessful attempt to obtain cash from the individual Hunts. Indeed, Herbert Hunt, according to a May 27 agreement among IMIC, Placid Investments, Herbert and Merrill, acknowledged that the April 1 agreement constituted a personal guarantee of the IMIC account. 159/

On Thursday, April 3, according to Merrill Lynch witnesses, the firm obtained advice from the CFTC and the NYSE to the effect that the April 1 agreement would suffice to enable the firm to treat the Bunker and Herbert Hunt and the IMIC accounts as one for margin and regulatory capital purposes. Merrill did so by treating margin calls outstanding in the IMIC account as having been met by application of excess equity in the Herbert Hunt account.

### F. Liquidations

On the morning of March 27, after receiving from the Comex its final determination that the silver market would open as usual that day, Merrill began to liquidate Hunt positions. 160/ Pursuant to a joint liquidation

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159/ It should be noted that Merrill at no time during or after the crisis sought or obtained a guarantee of the IMIC account by any Hunt family members or related entities other than Herbert and Bunker Hunt. The staff has included equities in other Hunt-related accounts in its evaluation for analytical purposes only and without suggesting whether or not Merrill could have succeeded in applying those equities to the IMIC deficit.

160/ As discussed above at page 92, Bache requested on March 26 and again at a meeting at Merrill's offices on the morning of March 27, that the Comex board of governors not open its silver market on March 27. At the meeting in Merrill's offices that morning, attended by representatives of the Comex, Merrill, Bache, and ACLI, Merrill maintained a neutral position as to closing the silver market. Later in that morning, after Comex board had determined to keep the market open, Conheeney received a call from CFTC Commissioner Reed Dunn. Dunn sought Conheeney's advice from the Merrill Lynch commodities division director as to whether a "national emergency" existed in light of events occurring in the

Footnote continued on next page.

arrangement with Bache, Bache senior vice president, Frederick Horn, liquidated approximately 300 silver contracts on Merrill's behalf that day. Merrill Lynch, through its New York commodities sales office began liquidating Treasury bill currency future, platinum future and gold future positions in the IMIC account. At that point, according to Conheeney, it was Merrill's intention to liquidate the positions as rapidly as possible.

In a meeting on the evening of March 27, senior executives in the firm decided to begin liquidating physical silver positions the next day. The firm on March 28, liquidated the five million ounces of London silver it had received from IMIC on March 26. It also succeeded in switching out 161/ of approximately 312 Comex silver futures contracts and liquidated an additional 115 contracts in CBT silver. According to Merrill Lynch records, at the close of business on March 28, the IMIC account had a net position of 2,662 silver futures contracts and 5.24 million ounces of physical silver.

On Sunday evening, March 30, 1980, Schreyer, Conheeney and others met at the Essex House in New York City to discuss the silver situation. According to Arnold, participants in the meeting made the determination to hedge 25% of the remaining IMIC domestic futures position by establishing a short silver position in the London market.

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Footnote continued from previous page.

silver markets, the only condition under which Dunn would consider closing those markets. Conheeney responded that he did not believe a national emergency existed. Later that day, after hearing rumors of Bache's financial troubles as a result of the Hunt silver positions at the firm, Conheeney called Dunn. Conheeney reported the rumors to Dunn and added that if a firm the size of Bache collapsed it might have serious effects on the entire financial community. Dunn responded, according to Conheeney, that such an eventuality would not constitute a national emergency.

According to Regan, he spoke on March 27, 1980 to Fed Chairman Volcker and Bache president Sherrill about closing the silver market. Regan informed them that Merrill Lynch would not recommend that the market be closed, but would not object to such an action to protect Bache.

161/ See discussion of switch transactions at n. 83.

The firm would leave the remaining 75% of the futures position unhedged hoping to avoid losses by liquidating more slowly and at favorable prices. Conheeney testified that Merrill Lynch executives based their position on the fact that "at that stage of the game [they] were not sure if the Hunts were going to pay [them] what they owed [them]." In addition, Merrill Lynch executives believed that the proceeds the firm would have realized had it hedged or otherwise liquidated the entire silver position at that time would not have covered the deficits in the account.

The next day, Monday, March 31, Merrill established a short hedge against approximately 900 contracts in the IMIC position by selling in London 4.5 million ounces of silver for three months forward delivery. It was able to switch out of an additional 492 Comex contracts in the May and July maturities. Merrill also liquidated $9 million in shares of Penn Central and Dome Petroleum collateralizing the account. Sometime that day, however, Herbert Hunt requested that the firm suspend liquidations in the IMIC account pending a meeting the next day in Dallas.

As described above at pages 162 through 164, the Hunts agreed in that April 1 meeting with Schreyer and other Merrill Lynch executives to indemnify the firm for any regulatory capital charges it might be required to take on the IMIC account. According to Merrill Lynch witnesses, after obtaining that agreement, the firm believed that the combined equity in the individual accounts of Herbert and Bunker Hunt was sufficient to satisfy outstanding margin calls and any liquidating deficits in the IMIC account. The firm, accordingly, adopted a gradual policy of liquidating in the IMIC account. Occasionally, the Hunts would request that the firm cease its liquidation of their accounts, often indicating a major development was underway in response to their silver problems. Merrill usually complied with these requests, but continued the liquidation when no major development materialized. From March 31 to April 30, 1980, Merrill disposed of 902 silver futures contracts representing a sale of 4,510,000 ounces. Merrill disposed of approximately 2186 futures contracts and 1.6 million ounces of silver during the period from May 1 through May 27, 1980. On May 27, 1980, Merrill sold the remaining IMIC physical silver positions to Placid Investments, Ltd. which fully paid the deficits remaining in the account out of the proceeds of the Placid loan transaction.

### G. Public Disclosure Concerning the Crisis

Apart from Conheeney's testimony before the Senate Agriculture Committee and disclosure in various filings concerning the existence of this investigation, Merrill Lynch has made no public disclosure concerning its role in the silver crisis or the impact of the crisis on the firm. It did, however, circulate an all-office wire internally on March 27, 1980, and Merrill Lynch witnesses have testified that they assumed that the wire would become publicly available. The statement appeared over the signatures of Messrs. Regan, Birk and Schreyer. It noted the "unusual developments" that had occurred in the commodities and securities markets, and then assured employees that "Merrill Lynch is financially strong and healthy and will continue to be so in the future." The wire admitted that the day's events might have "some effect" on Merrill, but asserted that the firm was in a "strong capital position" with more than "$250 million in excess capital over and above the minimums required." Further, the wire stated that the firm's commodity positions were fully collateralized, and it stated that the situation in the markets was "an aftermath of the government's recent severe credit restricting policy" and pledged to take "all necessary and prudent steps" to protect the employees, customers and stockholders of Merrill Lynch.

# PART FOUR

# THE E.F. HUTTON GROUP INC.

## I. THE E.F. HUTTON COMPLEX

### A. The Holding Company

The E.F. Hutton Group Inc. ("Hutton Group"), incorporated in Delaware, is a holding company principally engaged, through approximately 22 subsidiaries, in retail and institutional securities brokerage, investment banking, commodities futures merchandising and life insurance. It 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, Pacific and London Stock Exchanges. At December 31, 1979, its 6.4 million outstanding common shares were in the hands of 11,800 holders of record.

For the fiscal year ending December 31, 1979, Hutton Group reported after-tax income of $37.3 million on revenues of $750.3 million. The company derived its revenues principally from commissions on securities transactions ($189.4 million), interest on customer margin accounts ($106.3 million) and on resale agreements ($105.4 million), investment banking ($72.0 million), commodity commissions ($67.9 million), principal transactions ($63.2 million) and insurance ($60.8 million). Its principal expenses were employee compensation and benefits ($271.6 million), interest ($185.3 million), communications ($39.8 million) and occupancy and equipment ($37.0 million). Hutton Group reported net worth of $173.9 million at December 31, 1979.

### B. The Broker-Dealer

Hutton Group's principal subsidiary is E.F. Hutton & Company Inc. ("Hutton"), a broker-dealer registered with the Commission pursuant to Section 15(b) of the Exchange Act. Hutton Group reports that at December 31, 1979, Hutton had approximately 400,000 clients serviced by 3,475 account executives in domestic and overseas branch offices. Hutton or its subsidiaries are members of major securities and commodities exchanges in the United States and in other countries.

As a registered broker-dealer and as a member of the NYSE, Hutton is subject to the Uniform Net Capital Rule. At December 31, 1979, Hutton's net capital of $121.5 million was 11.64% of aggregate debit items, $48.4 million above the 7% "early warning" level and $79.8 million above the 4% minimum requirement, $60.0 million of subordinated debit contributed to these amounts. Hutton Group conducted all of its Hunt-related commodity futures and financing business through Hutton.

## II. THE BUILDUP IN SILVER - JULY 31, 1979 THROUGH JANUARY 31, 1980

### A. The Hunt Accounts Come to Hutton

In August 1979, when Loeb Rhoades merged with Shearson Hayden Stone Inc., Alan Cohen ("Cohen") moved from Loeb Rhoades to Hutton to become Hutton's Atlantic Region commodity sales manager. 162/ Cohen brought with him to Hutton not only several years of experience in commodities, but a business relationship with the Hunt brothers of Dallas as well. Lamar Hunt was the first member of the Hunt family to open an account with Cohen. By the summer of 1979, Bunker Hunt had also established an account with Cohen at Loeb Rhoades. 163/ Neither of these accounts was very large. Lamar's account carried approximately 30 silver contracts and Bunker's account a comparable number of precious metal futures contracts.

Cohen testified that he had never met the Hunts. He described his function as merely arranging for Loeb Rhoades, and later Hutton, to clear trades the Hunts placed with Alvin Brodsky on the Comex floor. Cohen's only actual contact with the Hunt organization was to call Hunt Energy assistant treasurer Charles Mercer at the close of business to report transactions executed that day in the Hunts' accounts.

It appears that only two Hunt accounts existed at Hutton before Cohen joined the firm in August 1979. One was a commodity account in Herbert Hunt's name trading in cattle and the other was a securities account in Portland, Oregon owned jointly by Bunker and Herbert Hunt.

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162/ Prior to that date, Cohen had served in that same capacity for Loeb Rhoades. Cohen became a Hunt account executive in late 1978 or early 1979 when Alvin Brodsky began to direct Hunt business to Cohen. Brodsky and Cohen had known each other since about 1971. Brodsky's brother is a cousin by marriage of Cohen's wife's and Cohen had discussed employment with Brodsky when Cohen was first entering the commodities business.

163/ As described earlier in this report, the Hunts also had an account with Scott McFarland ("McFarland") in a west coast office of Loeb Rhoades. These accounts were brought to Loeb Rhoades by McFarland when he moved to that firm from Drexal Burnham Lambert, Incorporated. On or about September 1979, McFarland, and his Hunt accounts, moved to Bache Halsey.

Bunker transferred his account from Loeb Rhoades to Hutton in late August 1979. Lamar transferred his silver trading account to Hutton in early December. Meanwhile, in mid-November 1979, Herbert Hunt opened a commodities account with Cohen.

B. Futures Trading in the Hunts' Accounts

From the 28th through the 30th of August, Bunker Hunt purchased 350 contracts of March 1980 Comex silver. He increased his position to 500 contracts early in October with additional purchases of 150 contracts of December 1979 Comex silver. In November he bought another 250 December Comex contracts. In addition, 138 March Comex futures appeared in the account as a result of "ex-pit" transactions. Those contracts originally had been purchased the previous July. Meanwhile, Herbert Hunt opened an account with the firm and on November 14 purchased 100 contracts of March 1980 Comex silver. In sum, by the end of November Bunker and Herbert's position combined totaled 988 contracts.

In December Lamar Hunt began trading silver futures in his account and by month-end he had established a 225 contract long position in March 1980 Comex silver and a 100 contract long position in the September 1980 contract. Herbert maintained his 100 contract long position in March 1980 Comex silver throughout the month. Bunker, meanwhile stood for delivery on his 400 contract long position in the December 1979 maturity, which left a total Hunt futures position at month-end of 913 contracts long. Just prior to the market break on January 22, Herbert and Bunker had liquidated 550 contracts of their position in March 1980 silver and Bunker had rolled the 38 contracts remaining into the May 1980 maturity. Meanwhile, during January, Lamar rolled 145 contracts in the March 1980 position he had put on in December into the September 1980 maturity and added an additional 314 September contracts to his position. During February, he rolled the entire position forward into the March 1981 maturity. At February 29, 1980, Lamar held 639 contracts and Bunker held 38 for a total Hunt position at Hutton of 677 long silver futures contracts.

C. Financing Physical Silver

As already noted, when his position in December 1979 Comex silver at Hutton matured, Bunker Hunt determined to stand for delivery. Through Brodsky, Bunker asked that Hutton finance these deliveries as well as deliveries on December contracts in Bunker's account at Paine Webber. 164/

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164/ As described elsewhere in this report, Paine Webber declined to do this financing.

At a special meeting early in December 1979, Hutton's commodity credit committee authorized the firm to finance these deliveries by lending Bunker up to $100 million against 75% of the value of warehouse receipts in his accounts. From December 7 through December 13, Hutton lent Bunker $30.1 million under this line of credit secured by warehouse receipts received in delivery on Bunker's December 1979 futures position at Hutton. From January 14 through January 21, Hutton made additional loans such that at January 21, 1980, it had $102 million outstanding to Bunker Hunt secured by 4.1 million ounces of silver.

Hutton charged interest of 1.5 percent over the New York brokers call rate on this financing. Of the interest income received by Hutton, Hutton paid one-third to Brodsky as a "finder's fee". Unlike Bache Group, Hutton did not engage in silver-collateralized borrowing to fund the loans to Bunker; rather, it relied on its internally generated funds and its ordinary sources of bank financing secured by customer marginable securities and firm securities positions to obtain the money it lent to Bunker.

### C. Management Decisions Concerning The Hunt Accounts

As was the case with other firms Hutton's commodity credit committee established substantial commodity position limits for the Hunts, and authorized large loans to them, without specific information concerning the extent of the Hunts' financial condition, the availability of certain Hunt assets to apply to potential losses in their accounts with Hutton or the extent of the Hunts' overall positions in the silver market.

In September, shortly after it was opened, Bunker's account was approved for positions requiring up to $25 million in original margin. As noted, in early December, the commodity credit committee approved warehouse receipt financing to $100 million. On each of these occasions the committee had before it nothing more than a form "statement of financial condition", apparently signed by Bunker, that listed as "total all assets" $400 million and set forth Bunker's net worth as $400 million. The statement contained no entries showing the composition of Bunker's assets, nor did it contain any entries whatever on the liabilities side of the balance sheet. Bunker listed his salary and investment income each as "$1 million +" and claimed "risk capital available for commodity trading" of $50 million. The form also asked: "Do you have a commodity account with another broker? If so, please give general details." In response, Bunker replied with one word "Bache". Moreover, Bunker's credit file contained no bank or other outside credit references on Bunker Hunt himself, although Hutton had received a Dun & Bradstreet report on HIRCO.

According to credit committee member Arnold Phelan ("Phelan"), Hutton's senior vice president for commodities operations and administration, in considering Bunker's financing request in December 1979 the committee considered the liquidity of the silver collateral that Bunker proposed to post for the loan as well as whether the Hunts had substantial silver positions at other houses. Phelan testified that although the committee "thought the market could handle this position if we needed to get out" it never gave real consideration to the prospect of a forced liquidation. Phelan stated that:

> [w]e never doubted that [the Hunts] would be able to come up with the money because they had related to us that they had X millions of dollars, plus the fact that it's almost common knowledge that they were billionaires. We were talking about millions and they were billionaires. Why should I be insecure?

No one at the committee meeting suggested that Hutton inquire of the Hunts concerning the amount of their aggregate silver commitments. There was, moreover, no discussion as to whether Bunker, the borrower in this instance, had access to family assets in order to repay Hutton.

None of the Hutton witnesses deposed on the subject recall discussion concerning trading limits in the Herbert Hunt account. Nor did the Herbert Hunt credit files produced to the staff contain the credit summary sheet that is ordinarily the vehicle by which Hutton credit department personnel convey information to the commodity credit committee for its use in connection with credit decisions. Herbert Hunt's credit file did, however, contain a "customer financial statement" dated November 26, 1979, apparently signed by Herbert, that was filled out in precisely the same manner, and with identical information, as that submitted by Bunker Hunt several months earlier. Despite this lack of information, Hutton approved Herbert Hunt's trading limit for positions requiring initial margin of as much as $3 million, according to daily "commodity status reports" generated daily by the firm. 165/

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165/ It should be noted that after January 1980, Herbert had no futures position with the firm. On March 14, however, Hutton lent him $13 million against silver bullion collateral without having obtained any additional information concerning his financing.

The commodity credit committee considered Lamar Hunt's trading limits on or about January 24, 1980, approximately seven weeks after Lamar opened his account with the firm. Lamar signed and submitted on January 8 the same "customer financial statement" as had Bunker and Herbert and completed it with precisely the same numbers: assets $400 million, no liabilities indicated, net worth $400 million, available risk capital $50 million. The credit summary sheet submitted to the commodity credit committee, however, stated that "[e]fforts to obtain a financial statement through account executive Al Cohen have proven fruitless," and indicated that Lamar's net worth was "N/A". In mid-January, commodity credit department personnel also obtained a bank reference from Morgan Guaranty Trust Co., which stated that:

> On your behalf we contacted a Dallas, Texas bank source. They reported that Lamar Hunt opened an account with them in 1943. Balances in this account are substantial and handled in a satisfactory manner. The banker stated that all loan experience with Lamar Hunt has been conducted in a satisfactory manner. The banker was unwilling to reveal additional credit information concerning this inquiry.

On the basis of the foregoing information the commodity credit committee approved a 500 contract trading limit in silver for Lamar.

### E. Hunt Accounts at the Market Break

On January 21, the Hunts' accounts with Hutton held silver futures contracts and silver warehouse receipts representing an aggregate of 7.4 million ounces of silver. At market prices prevailing at the close on January 21 these positions were valued at $325 million. Hutton had outstanding to Bunker $102 million in loans collateralized by 4.1 million ounces of silver valued at the end of that day at $180 million. At the end of January, the firm was protected against a $12.50, or 36%, decline in the price of silver.

## III. THE MARKET BREAK - JANUARY 17 THROUGH THE CRISIS AT HUTTON

In contrast to the situation at Bache Halsey and Merrill Lynch, the Hunts continued until March 26, 1980, to wire cash to Hutton in satisfaction of calls in the silver accounts. Meanwhile, Hutton first reduced its exposure in the Hunt accounts in late January by cancelling the $100 million line of credit it extended to Bunker, and then, in mid-March, increased its exposure again by reinstating the loan, albeit at a 10% higher collateralization ratio.

A. Cancelling the Silver Loan

On January 21, 1980, within days of Bunker Hunt drawing the final $77 million advance under the December financing, the Comex imposed liquidation-only trading in silver. On January 22 the spot market experienced a $10 per ounce drop. At about that time Robert Fomon, chairman of Hutton Group, concluded that the profits from the Bunker Hunt financing did not justify the risks inherent in extending $100 million to one customer. Phelan testified that Hutton officials met to discuss Fomon's concern, and that, except for himself, all agreed with Fomon that the loan should be terminated. 166/

On January 23, 1980, after Phelan notified Mercer of Hutton's decision, Bunker paid Hutton approximately $102.9 million in principal and interest. Hutton in turn released to Swiss Bank Corporation the silver warehouse receipts it held as collateral for the loan.

Terminating the loan greatly reduced Hutton's exposure to Hunt activities in the silver markets. Although Lamar opened a speculative account in copper on February 12, 167/ until mid-March Hutton's silver related exposure was limited to Lamar's 639 and Bunker's 38 contract position.

B. Re-establishing the Silver Loan

On March 14, 1980, Hutton lent Bunker and Herbert $100 million. 168/ The terms were the same as the earlier loan to Bunker, except that the margin was set at 65%.

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166/ Phelan and others testified that the events at the Comex on January 21 and the price drop on January 22 had nothing to do with the decision to terminate the loan, although Phelan recalled that Fomon was concerned with silver volatility in general.

167/ On February 12 Lamar executed additional documentation to open an account with Hutton to carry copper futures. He again executed a "customer financial statement." This time, he stated assets of $400 million, indicated no liabilities, and described his net worth as $50 million. Without seeking further information, Hutton set Lamar's copper trading limit at $30 million in initial margin.

168/ Bunker received $87 million and Herbert $13 million. Bunker deposited 1,509 silver warehouse receipts on March 14, 1980, and Herbert deposited 240 silver warehouse receipts on March 14 and March 19, 1980, to collateralize this financing.

Both Phelan and Hutton chief financial officer Thomas G. Lynch ("Lynch") testified as to how this financing came into existence. Their explanations differ in many respects. Phelan testified that Brodsky asked him if Hutton would be interested in extending financing to the Hunts. Phelan said he doubted that the firm would be interested, but when Brodsky suggested that a loan-to-collateral percentage of 65% would be acceptable to the Hunts, Phelan said he would discuss the matter with others at the firm. Phelan testified that he then contacted Lynch about the financing, and that Lynch stated that he would talk to some of those present at the meeting at which the termination of the first financing was discussed. Phelan also discussed the matter with some of the participants at that meeting. The next day, according to Phelan, Lynch called him and told him that the $100 million financing to Bunker and Herbert Hunt was approved.

Lynch testified that the first time he was informed of the second Hunt financing was when Ball told him that Hutton was going to lend Bunker and Herbert Hunt $100 million. Lynch testified that he did not know how Ball had heard of the Hunts request, or whether Ball discussed the matter with anyone prior to approval of the loan. Lynch also testified that when he later informed the commodity credit committee of the decision, the general reaction was surprise.

Ball attended the meeting in which the termination of the first financing was discussed. Ball, however, does not recall the events surrounding approval of the second $100 million loan. He does recall discussing the proposed loan with Fomon and testified that it was Fomon who approved the second financing. He also testified that both Phelan's and Lynch's version of how the March financing was approved were plausible.

If Lynch's version of the approval of the second $100 million Hutton loan to the Hunts is correct, then it means that the commodity credit apparatus and procedures established by Hutton were not followed in the largest commodities loan ever extended by the firm to a single customer. Even Phelan's version indicates that the normal credit procedures were not strictly followed.

There is no evidence that the firm had received any additional financial information about either Bunker or Herbert Hunt by March 1980. Thus, the only knowledge Hutton possessed about the Hunts' financial condition when it approved this loan was the information that the Hunts had submitted when they first opened their accounts at Hutton over four months earlier, as well as this subsequent favorable experience with the Hunts. As described earlier by Phelan, Hutton essentially relied on the belief "that it's almost common knowledge that they were billionaires."

On March 14, 1980, Hutton wired $100 million to the Hunts' account with First in Dallas. Once again, the firm arranged for Brodsky to receive one-third of Hutton's interest spread on the loan. Hutton subsequently issued four margin calls to Bunker and Herbert Hunt in connection with this financing. On March 18, 1980, Hutton issued a call of about $11.5 million to Bunker Hunt. The next day it issued a call of almost $1.2 million to Herbert Hunt. The brothers met both of these calls. On March 26, 1980, Hutton issued a call to Bunker for about $580,000 and the next day issued an additional call to him for nearly $11.9 million. Bunker did not meet these calls. Instead, Hutton liquidated the collateral Bunker and Herbert maintained to support the loan.

## IV. THE CRISIS PERIOD AT HUTTON - MARCH 26 THROUGH 28, 1980

### A. The Hunts Decline to Meet Margin Calls

On the morning of March 26, 1980, the Hunts held 677 long silver futures contracts and 8.7 million ounces of bullion. Computing Hunt futures positions at futures prices, in accord with recognized industry practice, the combined Hunt accounts were $79.5 million in equity; at the spot prices that represented the actual value of the accounts in liquidation equity was only $49 million, enough to protect the firm from a decline in the spot price of silver to approximately $11.75 per ounce.

Due to market fluctuation, Hutton issued three margin calls to the Hunts that day. It issued one to Bunker for approximately $578,000, another to Lamar for about $3.2 million in connection with his silver account, and another for $195,000 in connection with Lamar's copper account. Jim Curley, Hutton's director of commodity operations at the time, called Mercer that afternoon to inform him of the calls. 169/ Mercer responded that because one of the brothers, apparently Bunker, was unavailable, he could not inform Curley until 10:00 the next morning as to whether the calls would be met. Normally Mercer responded to calls more quickly,

169/ This was the usual manner in which Hutton informed the Hunts of margin calls.

so Curley immediately informed Phelan of this development. Phelan was not concerned by this news, apparently figuring that there could be many innocuous reasons for the delay. 170/

Phelan arrived at work at 8:00 Thursday morning unaware of the meeting the Hunts had held at the Drake Hotel with ACLI, Bache Halsey and Merrill Lynch the night before, in which they had announced their inability to meet margin calls. He also was unaware of the meeting with Comex president Lee Berendt to discuss closing the Comex silver market. Accordingly, he went about his regular business, including attending a meeting across the street from Hutton's offices concerning business in Australia.

At about 9:45, while still at the meeting on Australian business, Phelan received a call from Curley. Curley reported that Mercer had called to say that the Hunts would be unable to meet their commitment to Hutton. Curley reported that Mercer said he would call back in ten minutes. Phelan immediately returned to Hutton's offices.

Charles Mercer did not call Curley back in ten minutes; Herbert Hunt did. Curley and Phelan spoke to him on a speaker-phone.

Herbert explained that the Hunts 171/ were illiquid and would thus be unable to meet their calls in the near future, although he assured them that they would honor all of their obligations to Hutton. Apparently neither Phelan, Curley, nor Herbert mentioned the word "liquidation", but Phelan made it clear that he would act "in accordance with the customer's agreement" and that he would do so immediately. Herbert said he understood that, and mentioned that he would attempt to see Phelan later that day.

B. Liquidating the Accounts

Phelan began selling out the Hunt accounts immediately after his conversation with Herbert Hunt. On the Comex, he worked with Al Brodsky and another floor trader, Marty Greenberg. On the CBT, Phelan used Nicky Bank of Hutton.

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170/ Phelan was not certain, but he may have informed John Daly of the Hunts' short delay in meeting the morning calls.

171/ Although Phelan related Herbert Hunt's statements as employing the first person singular, Hutton did not have any calls outstanding to Herbert on March 26, 1980. Further, the subsequent action taken by Hutton and the Hunts indicate that Hutton assumed that Herbert Hunt was speaking for Bunker and Lamar as well as for himself.

Phelan concentrated on liquidating the Hunts' physical silver positions throughout Thursday. He accomplished this while the domestic markets were open primarily by selling Comex April 80 silver contracts. Because much of the physical silver in the Hunt accounts was CBT silver, Curley later arranged for a switch to enable Hutton to offset the just purchased Comex contracts with the Hunts' CBT position. Curley arranged the switch with Swiss Bank, which provided this service for a fee of 15 cents per ounce. Hutton switched approximately 2.5 million ounces with Swiss Bank, thus incurring a commission cost of approximately $375,000.

Some time during Thursday morning, Phelan told other senior management at Hutton of the situation, including Ball. Fomon was in the hospital that day and it is unclear when he learned of the day's events.

Near the end of the trading day on the Comex, Phelan, Curley and an Associate General Counsel for Hutton, Loren Schechter, were in Phelan's office discussing the day's events. They received a message there that "somebody" was in Curley's office who wanted to see him. Curley went to see who it was, and returned shortly thereafter to inform the others that their visitors were Lamar and Herbert Hunt.

The two Hunt brothers, along with three or four of their aides, were ushered into Phelan's office. Phelan advised Daly, who in turn advised Ball of the Hunts' arrival. Ball invited the group to a conference room near his office. There, Herbert again explained that they could not meet their commitments immediately, but that they would honor their obligations. Again, the word "liquidation" was apparently never used. Ball, however, advised the Hunts that the firm would act under the customer agreements. Herbert's only response, apparently, was a request that Hutton do so in a professional manner.

Neither Phelan nor Ball could recall the Hunts revealing their silver positions at other firms. Herbert did mention that he had met the previous night with representatives from other broker-dealers, however, and apologized for Hutton's not having received an invitation to the meeting. 172/

Hutton issued three additional calls to the Hunts on March 27, 1980. These were an approximately $3.2 million call to Lamar on his silver account, a $127,500 call to Lamar for his copper account, and an approximately $11.9 million call to Bunker. At the close of trading on

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172/ Phelan testified that he had learned of that meeting earlier in the day.

domestic exchanges, the Hunt accounts still held large positions in silver physicals. Further, their silver futures positions had not been reduced at all. Account documentation reflects equity of $36.2 million in the combined accounts valuing Lamar and Bunker's long futures position at futures prices in accordance with recognized industry practice. At spot prices, however, the Hunt accounts on March 27 held an unsecured debit balance of $8.9 million.

Phelan and Curley determined that it was necessary to continue to liquidate. The next exchange to open would be the Hong Kong exchange, and they had no contact there. Accordingly, they called Sal Azzarra of Mocatta Metals at his office in New York.

Phelan and Azzarra had known each other professionally for several years. Hutton did not have an account at Mocatta, so Phelan first asked Azzarra how much credit Mocatta would give the firm over the phone. Azzarra said, according to Phelan, that Hutton could have as much credit as it needed. Then, in Phelan's words:

> I said, "Fine, how late are you open?" He said, "We're open, obviously, during the hours of Hong Kong". I said, "Sal, I don't know anybody there. How late will you be there?" He said "I can be here till 6:00." I said, "It's my understanding that Hong Kong opens at 8:30." He said, "That's correct." I said, "Can I ask you to stay till you open?" He said, "You could." I said, "I am." He said, "I'll stay."

Phelan and Azzarra talked approximately every fifteen minutes from the time of that conversation until about 6:30, when, along with Curley, they met for dinner. Phelan was planning to sell bullion in Hong Kong and later that night in London, yet he had warehouse receipts from the Comex and CBT, neither of which could be used as delivery on a Hong Kong or London transaction. Hutton did not have an internal cache of Hong Kong silver bullion with which to effectuate a switch; Mocatta did. At the dinner, Phelan asked Azzarra if Mocatta could extricate Hutton from this dilemma. Azzarra agreed to have Mocatta switch with Hutton to allow delivery on whatever silver they sold that night. Further, Mocatta would do so at no charge.

At about 8:15, Phelan, Curley, and Azzarra returned to their respective offices. They established both telephone and telex hook-ups between Mocatta and Hutton, and Azzarra established a telex connection with Hong Kong.

The Hong Kong silver market opened Thursday night at about 8:30 p.m. EST. Every ten or fifteen minutes, Azzarra would relay quotes from that market to Phelan, and Phelan would place an order. Phelan described the orders he placed as small--10,000 to 25,000 ounces. When Mocatta and Hutton first began selling in Hong Kong, Phelan claims Azzarra said that they were the only sellers in the market. Later the market there "softened", and Phelan held back some orders. Hutton liquidated approximately 160,000 ounces of silver during that night in Hong Kong.

After a short nap, Curley, Phelan, and Azzarra returned to their respective offices and prepared to continue liquidation of the Hunt accounts in London. Phelan had called Jim Sweeney, head of Hutton's London operation, earlier that night to arrange for Hutton's London offices to be ready to assist the firm's liquidation of the Hunt accounts if necessary. To avoid revealing that Hutton was a heavy silver seller, however, Phelan chose to continue selling through Mocatta.

Mocatta and Hutton worked the London silver markets in the same fashion that they worked the Hong Kong silver markets earlier, although the size of the lots traded in London were generally smaller than those traded in Hong Kong. By the time the London market closed, the entire physical silver position in the Hunt accounts at Hutton was liquidated.

The only Hunt silver positions at Hutton remaining unhedged on Friday morning when the domestic commodities markets opened were the 639 March 81 silver contracts owned by Lamar and the 38 May 80 silver contracts owned by Bunker. 173/

To liquidate Lamar Hunt's future positions, which were in a contract month almost a year away, Phelan had to do double switches. Phelan used the same two brokers he had used on the Comex the previous day, Brodsky and Greenberg. By the time Comex closed, the net position remaining in Lamar's account stood at nine silver contracts long. Bunker Hunt's 38 May 80 silver contracts had been liquidated on Friday. Transactions executed the following week completely liquidated the accounts.

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173/ Lamar Hunt also had 300 December 80 copper contracts in his account on Friday. These were liquidated that day.

At some time on March 28, Phelan learned that Bunker and Herbert Hunt maintained a joint securities account at a west coast Hutton office. Phelan informed Mercer 174/ that Hutton would not sell out that account unless it was necessary to prevent a loss in the Hunt commodities accounts. 175/ It was not necessary to do so. By April 2, 1980, Phelan had succeeded in completely liquidating the Hunt commodities accounts. There remained a deficit of $1.2 million, representing storage charges on the Hunts' bullion and losses on the liquidation of the Hunts' Treasury bill position. Placid Oil repaid this amount on the Hunts' behalf on April 8, 1980, out of the proceeds of interim banks loans. Since the silver crisis Hutton has issued no press releases nor made any disclosure in its public filings concerning its role in the crisis or the impact on the firm.

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174/ Phelan could not recall if this conversation took place on Friday night or Monday morning.

175/ Many of the trades executed on March 27 and March 28, 1980, did not clear until April 1 or April 2, 1980. Thus even if this conversation did take place on Monday morning, April 1, 1980, Phelan could not be sure that he had managed to liquidate the Hunt accounts without incurring a deficit.

## PART FIVE

## PAINE WEBBER INCORPORATED

## I. THE PAINE WEBBER COMPLEX

### A. The Holding Company

Paine Webber Incorporated ("PWI"), a holding company incorporated in Delaware, is engaged through various subsidiaries in retail and institutional securities brokerage, investment banking, investment management and commodities futures brokerage. PWI 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 Stock Exchange. At September 18, 1979, its 5,361,006 outstanding common shares were in the hands of 3,327 holders of record.

For the fiscal year ended September 20, 1979, PWI reported pre-tax income of $24.5 million on revenues of $507 million. The company derived its revenues principally from commissions on securities transactions ($178 million), interest ($220 million), transactions as principal ($43 million), investment banking ($37 million), and commodity commissions ($22 million). Its principal expenses were employee compensation benefits ($190 million), interest ($188 million), communications ($30 million) and office and equipment rental ($16.7 million). PWI reported a net worth of $101 million at September 28, 1979.

### B. The Broker-Dealer

PWI's principal wholly-owned subsidiary is Paine, Webber, Jackson & Curtis Incorporated ("Paine Webber"), a broker-dealer registered with the Commission pursuant to Section 15(b) of the Exchange Act. PWI reports that in fiscal year 1979, Paine Webber's share of round lot volume traded on the NYSE was 2.94% and that it was one of the nation's largest financial services firms. Paine Webber is a member of all major securities and commodities exchanges in the United States and it and its subsidiaries or affiliates hold memberships or associate memberships on several foreign securities and commodities exchanges.

As a registered broker-dealer and as a member of the NYSE, Paine Webber is subject to the Uniform Net Capital Rule. At March 31, 1980, Paine Webber's net capital was $14 million above the 7% "early warning" level and $66 million above prescribed minimums. The Hunts conducted all of their silver futures trading with PWI through Paine Webber.

During the three months prior to the silver crisis, a series of events occurred in Paine Webber that rendered the problems encountered by the firm in connection with the Hunts' activities more acute than otherwise would have been the case. After the close of business on December 31, 1979, Blyth Eastman Dillon & Co. Inc., ("BEDCO"), a registered broker-dealer, was merged into PWI. The merger resulted in an increase of approximately 100,000 customer accounts handled by Paine Webber's operations system. The merger, one of the largest in the securities industry, created an entity with combined revenues of over $900 million and capitalization in excess of $220 million. It resulted, however, in bookkeeping problems that rendered Paine Webber's books and records substantially unreliable in major respects. 176/

## II. INCEPTION AND DEVELOPMENT OF THE HUNT RELATIONSHIP

### A. Background

Hunt commodity accounts first came to Paine Webber in 1977 as a result of its acquisition of Mitchell Hutchins, another broker-dealer. At that time, Paine Webber account executive John Wagner ("Wagner") learned from Hunt silver

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176/ On December 17, 1980, the Commission issued an Order Instituting Proceedings and Findings and Opinion in the matter of Paine Webber and PWI. The Order, to which Paine Webber and PWI consented without admitting or denying any of the allegations, facts, findings or other conclusions contained in the order, was based upon findings that: (1) Paine Webber willfully violated the financial responsibility, securities count, bookkeeping, and supplemental reporting provisions of the Exchange Act; and (2) PWI filed with the Commission a quarterly report on Form 10-Q for the three month period ended March 31, 1980, which failed to comply with the reporting and disclosure provisions of the Exchange Act. The Order censured Paine Webber and required it, through December 31, 1981, to submit to the Commission staff reports concerning certain aspects of its operations and financial condition. The Order imposed limitations on the firm's ability to expand its business through December 31, 1981, and directed the firm to conduct all securities counts and to make and keep current its books and records in compliance with the Exchange Act. Securities Exchange Act Release No. 34-17384 (December 17, 1980). The NYSE censured Paine Webber and fined it $300,000 based on these and other allegations arising from its operational difficulties in early 1980.

broker Alvin Brodsky that there was a possibility that some Hunt silver business could be directed to Paine Webber. Wagner wrote and telephoned the Hunts inviting them to do business with the firm. 177/

On April 20, 1977, Bunker and Herbert Hunt each opened a new commodities account with the firm. They began trading silver in these accounts and by July 31, 1979, the combined accounts held a total of 1713 silver futures contracts representing 8.6 million ounces of silver.

As at Bache Halsey, the Hunts placed their silver orders in the Paine Webber accounts directly with Brodsky on the floor of Comex. Brodsky "gave up" Paine Webber on certain of the trades and he and Wagner split 60% of the commissions the Hunts paid to Paine Webber. Brodsky received more than half of this amount. Wagner's role in the process was to telephone Mercer or an associate at the Hunt Energy Corporation offices in Dallas to report the number of contracts traded and the prices.

### B. Establishing Trading Limits in the Hunt Accounts

The magnitude of the trading the Hunts conducted in their silver and other commodity accounts with Paine Webber required the approval of the firm's national commodity credit committee, the more senior of two such groups that the firm required to pass upon all but the smallest commodity trading limit requests. 178/ Early in 1978, however, the national commodity credit committee determined that the credit decision in the Hunts' case would have to rest with senior management. It arrived at this conclusion

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177/ Wagner remembered speaking with Bunker but did not recall if he spoke with Herbert.

178/ Paine Webber branch office managers could approve customer commodity positions requiring $20,000 or less in initial margin. Positions requiring from $20,000 to $150,000 in initial margin required the approval of the "New York" commodity credit committee. If a position required margin over $150,000, Paine Webber procedures required the approval of the "national" commodity credit committee.

because it had obtained no credit information on the accounts. 179/ A memorandum dated January 9, 1978, to members of the national commodity credit committee reflects that:

> The background and nature of the Hunt accounts were discussed. There is no credit information in their files. Indications are that it would be futile to attempt to obtain any statements, etc. The decision as to the extent of trading with these accounts will have to rest with senior management rather than with the credit committee. 180/

In accordance with its January 1978 determination that senior management should make credit decisions in the Hunt accounts, the national commodity credit committee consistently left ultimate decision making in the hands of Paine Webber president John F. Curley ("Curley") over the ensuing two years, although it entertained and discussed increased trading and limit requests in Hunt accounts and made recommendations to senior management. Thus, on February 12, 1979, Paine Webber treasurer, Herbert Z. Geiger ("Geiger"), wrote Curley that:

> The National commodity credit committee has recommended for your approval the assignment of $2 million margin limits for each of the six Hunt accounts, for a total of $12 million.

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179/ Section BPA.11.2 of the Paine Webber Business Policies Manual - Commodities is captioned "Restrictions for lack of Documentation" and reads in part as follows:

> . . . if the required documentation for opening a commodity account has not been received by the National Commodities Credit Officer within 15 business days after the account has been opened, the servicing branch office will be advised that the account is restricted to liquidations until such time as the documents are received by the National Commodities Credit Officer.

180/ A review of Paine Webber's files substantially confirms the statement quoted in the text. Each of the Hunt brothers executed the Paine Webber "Client Qualification Form - Commodities" when he opened his silver account with the firm. In Herbert Hunt's case, the form provided no response to the inquiry concerning annual income or tax bracket, showed a $10 million net worth, $2 million in "Liquid Net Worth" and $1 million in "Available Speculative Capital". Bunker Hunt's client qualification form was identical except that it showed net worth of $11 million and "Liquid Net Worth" of $3 million.

> Specific detailed financial information is not available on the Hunts. They are reputed to be very wealthy Texas millionaires with large holdings in oil and gas and commodities.
>
> These accounts have been heavy traders with us and Mitchell Hutchins. All commitments have been met promptly. Trading volume was materially in excess of current line requests. 181/

On February 15, 1979, Curley approved the foregoing recommendation.

Similarly, on April 6, 1979, Geiger wrote Curley stating that the national commodity credit committee had recommended a $1 million margin line for Bunker Hunt's son Houston. Geiger reminded Curley that "specific detailed financial information is generally not available on the Hunts" but that Houston Hunt had signed a client qualification form disclosing a net worth of $3 million, liquid assets of $100,000 and an annual income of $150,000. The firm also had a favorable bank report on Houston Hunt. On April 10, 1979, Curley approved a $1 million margin line for Houston Hunt.

### C. Hunt Accounts at July 31, 1979

At July 31, 1979, Hunt accounts with Paine Webber held 1713 silver futures contracts representing 8.6 million ounces of silver. Equity in the accounts totaled $10 million and was sufficient to protect the firm against a little more than a $1 per ounce decline in the price of silver.

## III. THE BUILDUP AND DECLINE IN SILVER - JULY 31, 1979 THROUGH MARCH 27, 1980

### A. Management Decisions Concerning Hunt Trading

During the fall of 1979, Hunt long silver futures at Paine Webber increased to 2046 contracts. The increase was due exlusively to activity in Bunker's account. In

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181/ The staff questioned Geiger about the apparent inconsistency between the committee's recommendation that Herbert Hunt be permitted to trade up to $2 million in margins and the disclosure in his 1977 client qualification form that he had only $1 million in available speculative capital. Geiger testified that the committee had no adverse financial information and assumed that the 1977 form contained "stale" information. He stated, however, that the committee had no more recent information in 1979 than that contained in the form.

October and November he established a 209 contract long position in December 1979 Comex silver and added 200 contracts to his March 1980 position. Near the end of November he rolled 133 December contracts forward into the March maturity and took delivery on the remaining 76 December contracts. In January both Bunker and Herbert reduced their positions substantially by closing out or taking delivery. At month-end, their combined position was 710 contracts in the May maturity, which they maintained until the crisis.

The futures trading limits Curley established in the Hunt accounts in February and April 1979 remained in effect until approximately November 1979, when the national commodity credit committee decided to recommend to Curley that he approve a $5 million line in the Hunt accounts. On January 16, 1980, Geiger sent Curley a memorandum containing the committee's recommendation; and on January 18, Curley replied that the request "probably makes sense", but wanted to know (1) the basis for the $5 million limit, and (2) at that limit the firm's maximum exposure under adverse conditions in the commodities in which the accounts would be trading. Curley received no reply to his inquiries and recalls no further discussion on the matter. 182/

Meanwhile, as Comex and CBT increased margin requirements in silver, Bunker and Herbert Hunt's silver accounts substantially exceeded approved trading limits. 183/ This generated "violation signals" in Paine Webber's Daily Commodity Credit Report as early as September 4, 1979, and frequently thereafter until the Hunt accounts were liquidated on March 27 and 28, 1980. Although John G. Capps ("Capps"), vice president in Paine Webber's national commmodities department, recalls telling Wagner in January 1980 to accept no further Hunt business, and Paine Webber records confirm that the accounts were restricted, Wagner does not recall such a conversation and Hunt accounts continued to carry positions beyond their authorized margin

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182/ Curley testified that while he did not consider his January 18 reply to constitute his authorization for a $5 million credit limit, it apparently was construed as such since he subsequently learned that the account was permitted to trade on that basis.

183/ Paine Webber's Daily Commodity Credit Report shows the earlier trading limit ($2 million per account) remaining in effect through March 26, 1980.

line throughout the period. 184/ On January 7 and again on February 12, 1980, the Hunt accounts were included in account status memoranda regularly sent to Paine Webber chairman James W. Davant ("Davant") and the members of Paine Webber's audit committee. Neither Davant nor Geiger nor other Paine Webber witnesses testifying on the subject recalled audit committee discussion concerning the status of the Hunt accounts. 185/

### B. Status of the Hunt Accounts Immediately Prior to the Silver Crisis

On March 26, 1980, the Hunt accounts contained 710 silver futures contracts, 3,000 Treasury bill futures contracts, 500 British pound futures contracts, 300 feeder cattle futures contracts, and a substantial amount of fully-paid-for Treasury bills. These positions had a combined equity, computing silver positions at futures prices, of $38.6 million. Computing the value of the Hunts' silver position at spot prices, however, equity in the combined accounts totaled only $6.2 million.

Although Capps had seen March 26 press reports on the Hunts' proposed silver-backed debt offering, and speculated that the Hunts might be having liquidity problems, no one at Paine Webber attempted to find out how the Hunts stood in regard to their silver positions because the Hunts were meeting their daily margin calls.

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184/ At March 10, 1980, for example, the Daily Commodity Credit Report shows Herbert Hunt's accounts with a margin line of $4 million. Margin requirements on that date were $23.6 million in the two accounts. In Bunker Hunt's two Chicago accounts, the margin line was $4 million and requirements were $12.9 million. The report reflected 100 days of violations in Bunker Hunt's account.

185/ The January 7 memorandum described in the text reflected that Bunker Hunt's Chicago accounts had margin limits of $4 million and current requirements of $12.6 million. The February 12 memorandum states that the Chicago accounts had requirements of $11.9 million and the Bunker Hunt Texas currency futures accounts had a margin limit of $5 million and a then-current requirement of $6.9 million. Both memoranda said that the Hunt accounts were being handled "on a businessman's risk basis" by Curley and others in Paine Webber's Chicago commodities operation.

## IV. THE CRISIS AT PAINE WEBBER - MARCH 27 THROUGH APRIL 14, 1980

### A. Liquidation of the Hunt Accounts

On March 26, 1980, the firm issued margin calls in connection with the accounts in the aggregate of approximately $5,100,000. These calls were not met on that day or the subsequent day. On Thursday, March 27, Wagner arrived in the office about 9 a.m. and found out that the Hunts had not sent in the money from the day before. Wagner recalls that approximately an hour later Paine Webber learned from the Hunts that they had cash flow problems and were unable to meet their margin calls. Wagner believes he tried to call Mercer while national commodity department director David Ganis ("Ganis") tried to call Bunker Hunt. Both were unsuccessful.

Capps, Ganis, Wagner and others held a brief meeting to decide how to sell out the Hunt positions, including the cattle, foreign currency, financial futures and Treasury bill accounts. According to Capps, the decision to liquidate the Hunt positions was automatic, and the only discussion concerned how to do it. Those assembled told Wagner to liquidate the silver account. Capps arranged for liquidation of the cattle account and advised the Dallas office that the Hunt accounts would be liquidated through the national commodity department in Chicago.

Wagner pointed out that futures contracts could not be liquidated on the CBT in a limit-down market, but that on the Comex they could be liquidated at the spot price by means of a switch transaction. The group discussed the prices needed for the account not to liquidate to a debit. Capps testified that he and the others attending the meeting, reviewing the status of the accounts as a group, believed that the liquidation would leave a credit balance of approximately $6 million.

Wagner had a direct line to Brodsky on the Comex floor, so as soon as the meeting ended Wagner called Brodsky and started selling silver. 186/ Wagner says that he told Brodsky that Paine Webber wanted a constant orderly liquidation. Brodsky would advise Paine Webber what the bids were and get authorization from Paine Webber to execute the trade.

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186/ Wagner was aware that it was generally known on the floor that Brodsky handled the Hunt silver trades, but cannot remember whether there was any discussion about not using him for the liquidations because of this.

Wagner believes he did not give Brodsky the whole sell order at once, but gave him 50 or 100 contracts at a time and as soon as those had been done he gave him more. Brodsky or his people reported each execution to Wagner, including the number of contracts and the price. Wagner informed Capps and Paine Webber senior vice president, Robert Raclin ("Raclin") of each sale and also advised Mercer in the Hunt Energy offices in Dallas. 187/

During the day on Thursday, Raclin and Mercer reached an agreement permitting the proceeds of liquidations in the Bunker Hunt account to be applied to deficits in the Herbert Hunt account. All of the liquidations took place on Comex and most of them were accomplished by the use of switch transactions. 188/ As Wagner received reports of sales, he attempted to monitor prices. At one point, Paine Webber stopped selling because the market was so bad. Wagner did not think that there were any formal meetings after the close that day, but he was sure that he had conversations with Capps. Wagner thinks some informal tallies were made that evening. At the close of business on March 27, 1980, 186 contracts remained in the accounts. The deficit at futures prices was $12.0 million. At spot prices, the deficit was $24.3 million.

On Friday, March 28, shortly after the market opened, Paine Webber began selling, using Brodsky to continue the liquidation of the Hunt accounts. The market was better on Friday than it had been on Thursday and Wagner belived they were getting better prices. Wagner reported to Capps as each sale was made on Friday and also continued to report to Mercer on the progress of the liquidations. Paine Webber completed the liquidation of the Hunt silver contracts on Friday, March 28, between 11 a.m. and noon, Chicago time, except for one small order which was done on Monday. At mid-day, on Friday, according to Wagner, Paine Webber learned that the liquidation would produce millions in debits in the Hunt accounts, and at the end of the day it appears the liquidation had left $8.4 million in deficits.

B. The Erroneous March 27 "All Clear" Report

Meanwhile, early in the day on March 27, NYSE Senior Vice President Robert Bishop called Davant and asked whether Paine Webber had exposure in the Hunt accounts. At the

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187/ Wagner was able to get through to Hunt Energy beginning about noon and believes that he spoke with Mercer several times that day.

188/ *See* discussion of switches in n. 84 *above*.

close of that conversation, Davant called Ganis, who at that time was meeting with Capps and Wagner in Chicago prior to liquidating the Hunt account, to obtain an answer to Bishop's question. During the course of this meeting, a hasty computation of the status of the Hunt accounts had been prepared using futures prices as of the close of March 26. That computation suggested that Hunt accounts would liquidate to an equity. According to Davant, Ganis called him back a short time later to tell him that it appeared that there would be no difficulties in the account. Davant also recalls that Ganis and Raclin called him twice later in the day as liquidations progressed to report that all appeared well in the Hunt accounts. 189/ Davant, based on the information he received from Chicago, reported back to Bishop that "things looked reasonably well."

Sometime during the afternoon of March 27, a Wall Street Journal reporter called Davant. According to Davant, in response to questions from the reporter he indicated that he had been advised that Paine Webber "did not have a problem". Davant testified that he does not remember the exact words that he used in his conversation with the reporter although he is certain that, because he knew that liquidation was not complete, he did not tell the reporter that it was. The Dow Jones Wire Service nevertheless carried a report quoting Davant as saying that Paine Webber "has liquidated the Hunts' silver contracts at no loss to the firm . . ."

According to Paine Webber witnesses, it was not until the completion of liquidations the next day that the firm learned of the $8.4 million in liquidating deficits in the Hunt accounts.

On March 28, PWI issued a news release and internal all-office wire, each of which announced that Paine Webber that day had liquidated two commodity accounts due to their failure to meet margin calls. The release and wire also both stated that the liquidation resulted in estimated deficits of $10 million in the accounts and that an earlier indication that there were no such deficits proved unfounded. They both continued that the firm did not have sufficient information to assess the collectibility of the deficits,

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189/ Capps testified that Raclin later said that he had told Davant that the account would liquidate to no loss, notwithstanding that the liquidation at that time was far from complete and the firm was realizing substantially less on the sale of the positions than it had anticipated earlier.

but that the firm's capital was satisfactory and in accordance with regulatory standards, even if the full amount of the deficits were to be charged against the firm's capital. 190/

C. Freezing the Hunt Accounts

On March 28, Geiger sent a memorandum to the members of the national credit committee which stated:

> Until the air has cleared, there is to be no more trading with any of the Hunt accounts except for liquidation of trades.

According to Capps, the Hunts have not done any commodities business with the firm since the silver crisis.

Meanwhile, two Placid Oil accounts at Paine Webber had equity of approximately $54 million. Paine Webber considered the possibility of looking to these accounts for reimbursement when it realized that the Hunt accounts would liquidate to a deficit. The firm was not in a position to liquidate the positions in these two securities accounts in order to satisfy deficits in Hunts' commodity accounts because there were no guarantees or cross-collateralization agreements between them and the Hunt commodities accounts. Paine Webber nevertheless froze these accounts pending receipt of amounts owing from the Hunts individually in order to ensure that no equity would be withdrawn from Hunt related accounts at the firm until the Hunts satisfied their commodity obligation.

D. Paine Webber Collects from the Hunts

As previously described, an $8.6 million Hunt deficit remained on Paine Webber's books until the firm received funds in that amount from the Hunts on April 14. In the interim, according to Davant, Ganis had numerous conversations with Mercer in attempts to have the Hunts pay the firm and on two occasions Davant himself spoke with Herbert Hunt requesting that the firm be paid.

On April 14, 1980, Paine Webber received $8.6 million in repayment from the Hunts out of the proceeds of "bridge" loans from various banks pending the completion of arrangements for the Placid loan.

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190/ The story appeared on the Dow Jones broad tape at 2:55 p.m.

## E. The NYSE Excuses Paine Webber from Taking Capital Charges in Connection with the Hunt Deficit

Paine Webber filed its FOCUS report as of March 31, 1980, after it received the Hunt payment as described above. According to Curley, prior to receiving the payment the firm had taken appropriate charges in its weekly internal capital computations. After being paid by the Hunts however, Paine Webber officials took the position with Exchange personnel John Senkewich and Robert Bishop that the subsequent repayment made it unnecessary to charge the Hunt deficits to the firm's capital position in its FOCUS report for March 31, 1980. According to Curley, the NYSE agreed with Paine Webber's position, and in computing its net capital for purposes of that report Paine Webber did not take as a charge any amount attributable to the deficits in the Hunt accounts as of March 31.

# PART SIX

# DEAN WITTER REYNOLDS ORGANIZATION INC.

## I. THE DEAN WITTER COMPLEX

### A. The Holding Company

Dean Witter Reynolds Organization Inc. ("DWRO") is a Delaware holding company with its principal offices in San Francisco, California. As of November 1979, DWRO had outstanding 7,968,471 shares of common stock and 193,300 shares of Series A Preferred Stock. Its common stock was registered with the Commission pursuant to Section 12(b) of the Exchange Act and was listed on the New York Stock Exchange. 191/

DWRO was formed in the merger, effective January 3, 1978, of Reynolds Securities International Inc. and Dean Witter Organization Inc. DWRO's principal subsidiaries are Dean Witter Reynolds Inc. ("Dean Witter"), a broker-dealer registered with the Commission; Surety Life Insurance Company, and Dean Witter Reynolds InterCapital Inc.

In 1979, DWRO derived 32.5% of its revenues from commissions on listed securities and 6.1% of its revenues from commissions on commodities transactions. In 1980, DWRO derived 28.4% of revenues from commissions on listed securities and 5.4% from commissions on commodities transactions.

### B. The Broker-Dealer

Dean Witter Reynolds Inc. ("Dean Witter"), a registered broker-dealer with principal offices in New York, New York, was incorporated in the state of Delaware on April 15, 1968. Dean Witter is the product of Dean Witter & Co. Inc. and Reynolds Securities Inc., the wholly-owned broker-dealer subsidiaries which were combined upon the merger of their respective holding companies into DWRO.

Dean Witter is a financial services company providing services to individual, corporate and institutional customers as: a broker in securities, commodities, and interest rate future markets; a dealer in corporate, municipal and U.S. governmental securities, an investment banker; a consultant

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191/ As of December 31, 1981 DWRO common stock was delisted from the New York Stock Exchange. Since that date, DWRO has operated as a wholly-owned subsidiary of Sears, Roebuck & Co.

in personal financial planning activities, and an agent for life insurance sales. As of August 31, 1980, Dean Witter estimated that it had in excess of 571,000 active individual and institutional customer accounts, served by approximately 3,800 registered representatives in 280 sales offices throughout the United States, Canada, Europe and Asia.

Dean Witter holds memberships on all major securities and commodity exchanges in the United States. A major portion of the firm's revenues is derived from commissions on brokerage transactions in common and preferred stocks, and corporate debt securities on exchanges and in over-the-counter markets. 192/ Dean Witter also acts as broker in the purchase and sale of commodity futures contracts, but does not make a practice of dealing in actual or "spot" commodities.

## II. DEVELOPMENT OF THE HUNT RELATIONSHIP

### A. Background

Herbert and Bunker Hunt each had individual accounts in which silver futures were bought and sold, collateralized by Treasury bills. These accounts were opened in late 1973 or early 1974 in response to a solicitation by Frederick Horn, then head of Dean Witter's Commodity Division. Orders were placed either with the Dean Witter order desk or with Alvin Brodsky, the Hunts' broker on the floor of the Comex. Brodsky's arrangement with Dean Witter entitled him to half of the commissions generated by those orders. The accounts, however, were house accounts handled out of the central commodities office in New York and no Dean Witter personnel received commissions. After the merger of Dean Witter and Reynolds, the surviving accounts in which silver futures were traded were the Dean Witter accounts. 193/

The Hunts had two other active accounts at Dean Witter. One was a joint account for Herbert and Bunker Hunt, with substantial equity securities holdings, opened in December 1975 through Reynolds' Oklahoma City, Oklahoma office. The other, opened by Bunker Hunt in November 1979, held and traded commodities other than silver and was handled out of

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192/ The firm acts as principal with customers in the over-the-counter markets, primarily where the firm is a market maker. Dean Witter makes a market in approximately 500 unlisted securities.

193/ These accounts were not necessarily active throughout the period from 1974 to 1978.

Dean Witter's Chicago office. By virtue of its customer agreement, Dean Witter considered all accounts at the firm in the name of any customer to be cross-collateralized.

B. Trading Limits in Hunt Accounts

When the Hunts began to do business with Dean Witter, their credit limits were based upon actual transactions and the firm's experience with their accounts rather than the establishment of dollar lines of credit or any net worth analysis. At that time, customer trading in commodities at Dean Witter was, in general, limited only by the money the customer had put in the account. There was no difference in treatment between speculative accounts and trade customers.

More formal procedures were established by Dean Witter in 1975. Thereafter, customers opening commodities accounts were asked to supply information as to their net worth and net liquid assets either orally or in writing. Using this information, the firm established its "call dollar lines", a limit on the amount of business the firm was willing to do with a particular customer, based upon the customer's net worth and net liquid assets. Smaller account limits were set by the credit analysis section. Larger accounts, in excess of $100,000-$200,000 were presented to a credit committee. 194/ There remained, however, no upper limit as to the line of credit that could be requested.

At some point, probably before the institution of formal policies, limits of $1 million were established for each Hunt silver account. 195/ Horn stated that no requests were made to increase the Hunts' credit limits between 1975 and 1978. Thus, with credit having been established in an earlier time, once the credit committee was formed, there was no occasion for the Hunt accounts to go before it.

Following the 1978 merger, no additional financial information was sought from the Hunts and there appears to be none on file other than new account papers. There were no requests for increases in credit limits in this period either. Therefore, consistent with Dean Witter's general policy following the merger, since there were no limit violations or other problems with the accounts, no review was made of the accounts as to credit limits.

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194/ A formal credit committee was not established until some time in 1977.

195/ The origin of these limits is unclear. Current employees were only able to say that the limits were established before the merger with Reynolds and maintained thereafter.

## III. HUNT ACCOUNTS DURING THE RISE AND DECLINE IN SILVER

### A. Futures Positions

As of July 1979, the silver accounts of Bunker Hunt and Herbert Hunt at Dean Witter carried open positions in Comex silver of 160 and 150 contracts, respectively. 196/ The accounts were relatively inactive and the size of the open positions remained constant throughout the period which followed. The Hunts neither sought nor were granted increases in futures trading limits with the firm.

In September 1979, Dean Witter imposed a "liquidation only" trading rule on customers with positions in silver. On September 21, 1979, the firm announced that as of September 18, no new business would be accepted in silver or silver coins. Only liquidation orders would be accepted and such orders should be so marked. Thereafter, Dean Witter continued to adjust margin requirements in accordance with commodity exchange requirements and internal considerations. The firm's liquidation only policy remained in effect until mid-March 1980. 197/

Dean Witter personnel testified that the reason for imposing a liquidation only rule was because of their perception that the market in silver was becoming chaotic. They stated they were concerned that the volatility demonstrated by the market up to that point would not enable

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196/ Earlier in 1979 the size of the positions in each account was somewhat larger. For the first half of the year, realized and unrealized profits in these accounts totalled $3.9 million and $2.6 million, respectively.

197/ On March 21, 1980, Dean Witter rescinded its liquidation only restriction on trading in precious metals. As to silver, that decision was said to be based upon the fact that the price had dropped to the low or mid 20's per ounce; and, it appeared to the firm, at that point in time, that some stability had re-developed in the market; or, at least that the upside moves were over. At the same time, the firm required that the original margin necessary to carry a customer's position, $60,000 per contract, had to be in the account prior to the time that any orders were entered, and that variation margins had to be maintained at 100%.

customers to get in and out of the market in an orderly manner and that they were uncertain over the direction that the market might take. 198/

There were some exceptions granted with respect to the liquidations only policy, but only the director of commodities operations, the national sales manager, and the commercial sales manager had that authority. These exceptions were granted only to individuals or corporate customers that met the firm's then current credit and margin policies, had a legitimate reason to be trading in the marketplace and were sophisticated and understood the risk of the market. The Hunt accounts were not among the exceptions to Dean Witter's liquidation only policy. In fact, no increases in credit or position limits were requested by or extended to the Hunt accounts for the period in which the policy was in force.

In the latter half of 1979, as the price of silver rose, the Hunts' equity in their silver accounts increased. In general, the accounts regularly withdrew most of the excess equity, or used it to purchase additional Treasury bills which were used as margin. In early 1980, as the price of silver began to fluctuate, funds frequently passed in and out of the silver accounts. All the Hunt commodity accounts at Dean Witter were handled through Hunt Energy. Firm personnel communicated with either Charles Mercer or Hunt Energy employee Debbie Leach with respect to margin calls or excess. In each case, whether excess margin was in the account or additional variation margin was required, the party seeking the funds would make a request by telephone and monies would be forwarded by wire transfer. 199/

The only purchase after July 1979 in either of the Hunts' Dean Witter silver accounts came on January 28, 1980. At that time, the 160 contracts of March 1980 Comex

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198/ Firm personnel indicated that in such a volatile market, not only was there a market risk to the customer and the firm, but there also was an increased risk that improper order handling could result in expensive mistakes.

199/ Dean Witter had a firm policy that variation margin calls could only be met with cash or its equivalent (i.e. federal funds). Dean Witter might permit variation margin calls to be met by subsequent market appreciation, but only at the customer's request. The Hunt accounts never requested such treatment.

silver in Bunker Hunt's account were rolled forward to May 1980. The profit realized as a result of the transaction was in excess of $21.3 million. 200/

B. Dean Witter Rejects a Hunt Borrowing Request

At some time in January or February 1980, Alvin Brodsky approached the director of Dean Witter's commodity division, Arthur Marcus, and asked, on behalf of the Hunt brothers, if the firm would provide some financing of silver warehouse receipts. The amount of financing sought was $100 million. The terms were to be 1 1/2% over prime on a floating basis. There was no discussion of what discount would be applied to the receipts and no documentation was offered at the time. Marcus advised that he would pass the request on to senior management. Marcus was later advised that management "decided not to do the business." Brodsky did not indicate whether he was seeking similar financing elsewhere.

C. Margin Calls in February and March 1980

Dean Witter personnel have stated it was their recollection that until late March 1980, the Hunt accounts were always prompt in their payment when variation margin was requested. Nevertheless, account statements indicate that beginning on February 20, 1980, Bunker Hunt's silver account began to accrue variation margin calls. The same pattern occurred beginning on February 21 in Herbert Hunt's silver account. It appears that these "aged calls," which remained outstanding until March 13, 1980, were a result of a margin clerk's failure to request the required margin on a timely basis. 201/ When the calls were made on or about March 12, the accrued balances of $3.8 million and $2.85 million, respectively, were promptly paid in full. By that time, however, the price of silver in the market had begun its limit-down retreat which was not to end until March 27.

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200/ The transaction also generated an original margin call of $5.6 million which was not satisfied until February 5, 1980.

201/ It is unclear whether a margin clerk failed to make a timely request for variation margin or whether the margin calls had gone unmet for the entire February 21 to March 13 period. Edward Kassakian, the director of commodity operations, indicated that he would not have been overly concerned even if the variation margin calls had been outstanding for the entire three week period because the accounts were still "in equity", that is, had Dean Witter liquidated the Treasury bills held as collateral, the account still would have had a positive balance.

After March 13, variation margin calls were again allowed to accrue in the respective accounts until paid down in full on March 19. Thereafter, variation margin was paid in the respective accounts on a daily basis until payments ceased altogether after March 24.

## IV. CRISIS PERIOD EVENTS

### A. The Hunts Miss Margin Calls

On or about March 25, 1980, Edward Kassakian, head of commodity operations, contacted Arthur Marcus, director of the commodity division, regarding the then current outstanding margin calls in the Hunt accounts. At the close on March 25, Hunt accounts remained $22.7 million in equity at futures prices, although at spot prices equity was only approximately $14 million. Dean Witter personnel called Hunt Energy and advised that there were outstanding margin calls in the Hunt accounts aggregating in excess of $3 million. As a result of market action on March 26th, additional margin was required. When no funds were forthcoming, Marcus called Hunt Energy to ascertain the status of the outstanding margin calls. After several attempts to speak with Mercer or one of the Hunts, Marcus was advised that Mercer would not be able to speak with him that day. Thereafter, Marcus discussed his concerns with senior management of Dean Witter over the non-collection of funds and the inaccessibility of the parties involved. At the close on March 26, equity in Hunt accounts at futures prices had fallen to $20.2 million, while at spot prices, which reflected the true value of the Hunts' silver position in liquidation, only $5.8 million in equity remained.

As of about March 26, Dean Witter internally began to take account of the spot price of silver in its margin calculations and adjusted its margin calls to the Hunts accordingly. 202/ The Hunts were long 310 contracts of May 1980 Comex silver at Dean Witter. The decision was made to ignore the May price because it was artificially high and to value the Hunts' contracts based upon the April spot market. The difference in the two prices at that date was over $6 per ounce which, on one and one half million ounces, would reduce the equity in the Hunt accounts by over $9 million. On March 26th, a margin call was issued to the Hunts for roughly $15.3 million based on the spot month price. Hunt records indicate that such a call was received on March 27.

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202/ The adjustments were $7.83 million for Herbert Hunt, $7.53 million for Bunker Hunt and $.41 million for Bunker Hunt's non-silver futures accounts in Dean Witter's Chicago office.

On the morning of March 27th, Marcus learned that Mercer would again be unable to speak with him and that no margin monies would be immediately forthcoming. By this time rumors from the Comex floor were spreading that the Hunts were having very sizeable problems and that they were unable to meet margin calls at other firms. Attempts were made to substantiate the rumor that the Hunts were not going to meet their obligations. A Hunt representative advised Dean Witter personnel that she had instructions from the Hunts not to transfer any further funds. She could not say when or whether funds would be forthcoming.

B. Liquidation

Marcus discussed the situation with members of the Dean Witter executive committee in a conference call on March 27. He advised the members of the committee that the Hunts were long 310 contracts of silver and that they had not indicated whether the outstanding margin calls would be met. Although Marcus was given authority to liquidate the Hunt accounts on March 27th, he recommended that because the market was under severe pressure, Dean Witter should not attempt to liquidate any portion of the silver positions during trading hours that day. The firm made the decision with respect to the silver accounts that it would wait and monitor the markets, hoping to hear from the Hunts later that afternoon or evening. 203/ Dean Witter personnel believed it likely that the firm would have to take liquidating action the following day.

During the afternoon of the 27th, Dean Witter's decision to totally liquidate the Hunt silver accounts firmed. Dean Witter observed that the market had stabilized somewhat going into the close and determined that there might be an opportunity to sell silver the following day at better prices than they had seen at the lows on the 27th. At the close on March 27, equity in Hunt accounts computed at futures prices declined to $18.1 million. At spot prices, however, an unsecured debit balance of approximately $3.2 million had developed in the account. Dean Witter considered that liquidation on the Comex would be most convenient, but considered the use of London and the CBT as options. In fact, the firm monitored the London market closely during the early morning hours of March 28th.

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203/ Because the markets in other commodities were more orderly, liquidations of Bunker Hunt's diversified commodities account, not containing silver, began on March 27th while the markets in those commodities were still open.

At approximately 8:25 a.m. (CST) on March 28, Mercer definitively informed Dean Witter that the Hunt brothers would post no additional margin and that Dean Witter should do whatever it determined was appropriate. Thereafter instructions were given for the liquidation of the Hunts' silver positions.

The liquidation was accomplished on the floor of the Comex on the morning of Friday, March 28, 1980. The Hunt positions held by Dean Witter were in May 1980 Comex silver. Since, in past days the market had rapidly moved limit down, the firm could not liquidate in offsetting transactions in May silver. Rather, it used transactions in the spot market. Dean Witter instructed its floor broker to sell 310 April Comex silver contracts "at market-not held." This was accomplished by approximately 9:40 a.m. (CST). Thereafter, a spread was done in order to unwind the positions and provide for total liquidation of the accounts.

The liquidation of Bunker and Herbert Hunt's silver positions and the Treasury bills associated with those accounts left a deficit of approximately $3.3 million. 204/ With credit from the liquidation of Bunker Hunt's diversified commodities account in Dean Witter's Chicago office, the debit balance of the two Hunt brothers at Dean Witter was slightly in excess of $3 million. Once this figure was ascertained, the deficit was satisfied through the liquidation of a sufficient quantity of Asamera Oil and Global Marine equity securities in the two brothers' joint stock account.

C. Net Capital Position and Public Disclosures

Despite widespread publicity concerning the possible impairment of certain members of the securities industry on March 27, 1980, Dean Witter was not concerned about the effects of the crisis with respect to its own capital position. The firm had very few customers in the silver market at that time, and most of them were fully hedged. With respect to the Hunt accounts, Marcus indicated that he was confident that he would be able to liquidate them well within the bounds of the collateral held by the firm.

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204/ Dean Witter indicated that although commodities were carried in more than one account, this was merely an administrative convenience. Once any account fails to proffer required margin, all commodities accounts in that individual's name will be totally liquidated pursuant to the provisions of the standard customer agreement.

An all office wire issued on March 27, 1980 by Andrew J. Melton, Jr., Chairman of Dean Witter's Board, confirmed that position. 205/ Dean Witter personnel have stated that the substance of the all office wire appeared in the press.

Following the liquidations, on April 2, 1980, a second All Office Wire advised that the "recent developments in the silver markets have had no impact on the operating profits or capital position" of Dean Witter.

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205/ The All Office Wire reads as follows:

> "Andrew J. Melton, Jr., Chairman of the Board of Dean Witter Reynolds, Inc., stated that while the company has customer accounts with silver futures contracts, the total number of contracts is small and that if customers failed to meet margin calls it would not seriously effect the company's financial position."

# PART SEVEN

## A.G. EDWARDS & SONS, INC.

## I. THE FIRM

A.G. Edwards and Sons, Inc. ("Edwards") is a publicly-held Delaware corporation with principal offices in St. Louis, Missouri. It is the successor to a partnership founded in 1887. Edwards is registered with the Commission as a broker-dealer pursuant to Section 15(b) of the Exchange Act. Its securities are registered pursuant to Section 12(b) of the Exchange Act and are listed on the NYSE. As of February 1980, Edwards had 4,774,500 shares of common stock outstanding.

Edwards is a broker-dealer operating exclusively in the securities and commodities industries. Its business includes listed securities, listed and unlisted options, principal and agency transactions in unlisted securities, underwritings, distribution of mutual funds and tax shelter programs, commodity futures contracts, life insurance agency and other financial services.

Edwards is a member of the NYSE, the American Stock Exchange, Inc., the Chicago Board of Options Exchange, Inc., other securities and commodities exchanges and the National Association of Securities Dealers.

As of February 1980, the firm employed 2,355 persons, including 1,175 registered representatives. Edwards serves approximately 125,000 active individual and institutional customers through 161 offices in 33 states located principally in the southeastern, southwestern and midwestern United States.

## II. INCEPTION AND DEVELOPMENT OF HUNT RELATIONSHIP

Herbert and Bunker Hunt each opened accounts at Edwards in December 1976. 206/ The accounts were introduced to Edwards by Alvin Brodsky, the Hunts' Comex floor broker, through a vice president of Edwards. 207/ Throughout their relationship with Edwards, the Hunts entered their orders directly with Brodsky on the floor of the Comex. Edwards

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206/ Each brother's new account form indicates his net worth at $100 million plus.

207/ The accounts were considered home office accounts. No one at Edwards received commissions on the accounts.

was to be the clearing and carrying broker for transactions in both sugar and silver futures.

In April 1979, a request was made on behalf of both the Hunts to increase their trading limits. The Hunt accounts were already approved by the commodity credit department for exchange minimum margins; and, by the spring of 1979, limits had been established for each account at a total of 300 contracts for both sugar and silver, with no more than 200 contracts in any one commodity. 208/ In April 1979, the Hunts, through Brodsky, requested that their credit limit be increased to a maximum line of 300 contracts of silver for each account, with sugar contracts to be deleted. An internal memorandum created in response to that request indicated that the Hunts had a favorable credit history with respect to margin calls and included detailed supporting information with respect to credit lines and net worth estimates. It also indicated that Brodsky was confident that both gentlemen "are aware of and can fully handle this type of risk."

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208/ Accounts are classified by Edwards either as speculative accounts or hedge accounts. Within each account category there are four subclasses ranging from small accounts, which essentially are dealt with at the discretion of the manager of the branch, to large accounts, for which credit limits are established by the executive committee. The credit class within which an account falls is a function of the customer's net worth and percent liquidity of assets available to the customer. "Small accounts" are those with initial margin requirements of less than $5,000 (house basis) and are opened solely at the discretion of the branch manager. The branch manager determines suitability. "Medium accounts" are those with margin requirement between $5,000 and $12,000. Branch offices are required to maintain financial credit information and to determine suitability. "Quasi-large accounts" are those with up to $20,000 margin requirements. Both the branch office and the Commodity Department are required to maintain financial and credit information, a customer profile and to update these items regularly. A definite maximum line must have been recommended and approved by the Commodity Department. "Large accounts" are those over $20,000, and are governed by the same credit requirements as quasi-large accounts. These basic credit guidelines are then adjusted by various factors. The factors include experience of the broker, experience of the customer, income of the customer, whether or not the customer has any dependents and the age of the customer.

The requests for increased trading limits on each account were considered together, an Edwards executive explained, because it had been the firm's experience that the brothers normally acted together. That is, when transactions were tendered to Brodsky, they were normally similar for both accounts. 209/ Thus, the request for increases in each account were handled together "in order to have the proper perspective of the commitment," and because the firm "didn't really believe that they [the Hunt brothers] would act separately to meet their commitments." Edwards' executive committee approved the request for increased trading limits in silver on April 24, 1979.

Despite the approval, the Hunts never made use of the increased limits. Although there were several purchases and sales of Comex silver in both accounts, and Bunker Hunt's account rolled forward 100 contract positions several times, his account held no more than 130 contracts at any one time. Herbert Hunt's account, slightly less active, never exceeded 100 Comex silver contracts. On January 14, 1980, Herbert Hunt liquidated his account at Edwards and it remained inactive, at least through April 1980.

The Hunts did not approach Edwards for loans against silver collateral.

## III. THE CRISIS AT EDWARDS

### A. Bunker Hunt Misses a Call on March 25, 1980

Computed at spot prices in the limit-down silver market, the Bunker Hunt account with Edwards fell into a liquidating deficit of approximately $2.8 million at least as early as March 14. Until March 24, however, the Hunts met all margin calls issued to them by Edwards. 210/ On March 24, 1980, Edwards issued a margin call in the amount

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209/ The Edwards official disclaimed any knowledge of whether the brothers were acting with combined resources.

210/ It should be noted that from at least February 4 through March 14, 1980, the Bunker Hunt account was undermargined. Edwards' personnel attribute this to their not having received notice of increases in Comex margin requirements that took effect on February 14. When they learned of the increased requirements in mid-March, they called for, and received, additional funds.

of $1.5 million on Bunker Hunt's account. On Wednesday, March 26, Larry Hendricks, an assistant vice president at Edwards, inquired whether the call had been met and was advised that Edward's bank had not yet received any funds. Hendricks contacted Debbie Leach, a Hunt Energy employee, and requested her to make the necessary funds available. 211/ He also requested an additional $500,000 to keep the account properly margined in light of the adverse market movement on that day. By the close of business that day, the Hunt account was only $1 million in equity at futures prices and at spot prices it held a deficit of $3.5 million.

B. Attempts to Collect

On Thursday morning, March 27, Hendricks telephoned Leach to confirm whether money had been wired to Edwards. She advised him that she had prepared the authorization, but had been instructed by Mr. Hunt not to transfer the money. She could supply no further information. Hendricks asked to speak to Mercer and was advised that he was not available at that time. Hendricks again telephoned to attempt to reach Mercer about one-half hour later. In this conversation, although Mercer was still unavailable, Hendricks learned that Mr. Hunt had instructed that no margin calls would be met at any firm.

On March 27th, the margin call to the Bunker Hunt account was increased to a total of $2.5 million. Robert Dissett, manager of Edwards' New York operations, informed Raymond A. Kalinowski, then director of all operations, of the outstanding margin calls to Bunker Hunt. Kalinowski ordered that a notice be prepared which would inform Hunt that Edwards would take liquidating action at the market opening on the following morning, March 28, if Edwards was not provided with margin, either in the form of cash or acceptable collateral. The "demand notice" was hand delivered to Mercer early in the afternoon of March 27.

Kalinowski instructed Dissett to visit the Comex offices on the afternoon of March 27 to determine whether there was a possibility that trading in silver futures contracts would be suspended. Dissett later informed Kalinowski that he was assured by the president of Comex

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211/ Hunt Energy assistant treasurer Charles Mercer, Leach's supervisor, had been Edwards' contact for the Hunts since the inception of the accounts.

that all margin calls due the Comex clearinghouse would be met and that silver futures trading would continue on Friday, March 28. 212/

At 5:00 p.m. on March 27, 1980, Hendricks first spoke with Mercer. Hendricks inquired about the general status of Bunker Hunt's account and specifically about Edwards' margin call. Mercer replied that he could not tell Hendricks anything at that time. Hendricks suggested that Edwards would not like to take market action and offered to finance Hunt's position if it could be collateralized. Mercer responded that he would be talking to Hunt shortly and would see how Hunt felt about the proposition. The parties agreed to speak again the following morning.

At the close on March 27, the Hunt account with Edwards had equity of $500,000 valued at futures prices in accordance with recognized industry practice. At spot prices, however, the account was $6.1 million in deficit.

C. Liquidations

At approximately 8:15 a.m. on the 28th, Mercer advised Hendricks that there would be no margin money and no collateral forthcoming. Mercer indicated that the Hunts would like the firm to "hold on" because they felt that the market was going to come back, but that the firm would have to use its own discretion as to what to do about the account. Hendricks alluded to a report in the New York Times of a meeting at Merrill Lynch at which the Hunts purportedly requested Merrill Lynch to forebear so that smaller margin calls could be satisfied. Hendricks also inquired as to when money might be available to the firm if Edwards decided to hold on to Bunker Hunt's position and finance the corresponding variation margin call with the clearinghouse. Mercer replied that he was not in a position to reveal the Hunts' relationship with other brokerage firms and that he could not speculate on any time frame. Mercer did indicate that the Hunts were currently working on "something" and would continue working on it that weekend as well. 213/

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212/ Kalinowski stated he was concerned that if trading was suspended and contracts were closed out at the last trading price, selling the Hunt account at the spot price would create a deficit that might be difficult to justify.

213/ Hendricks also asked if the firms that liquidated positions on the 27th by selling April contracts would close out the positions or leave them in a spread. Mercer replied that he believed that in some of the liquidations, the April positions were unwound.

Shortly after the first conversation, Hendricks telephoned Mercer again and advised him that the firm had decided to go ahead and unwind Bunker Hunt's position any way possible. He indicated that Edwards would first attempt to try and transfer the positions to another broker, or failing that, to go ahead and sell spot contracts and unwind the spread. Kalinowski then instructed Martin Krulik, an Edwards employee on the floor of the Comex, to contact Brodsky. Kalinowski was to advise him that the margin call had not been met, and suggest the two alternatives discussed with Mercer. Kalinowski later received a report that the transfer to another carrying broker was not possible and that the liquidation was proceeding.

In effecting the liquidations, Edwards sold short April 80 contracts at prices of $12 and a fraction to spread the accounts' existing long May position against the April spot price. Edwards then entered a spread order to purchase the April contracts and sell the May position. The 100 April 80s were purchased at $20; 100 Mays were sold at $20.05. The firm unwound its spread at a 5 cent differential.

The result of these transactions was a deficit of nearly $6 million; or, taking into account the approximately $1.9 million in Treasury bills held by the firm as collateral, a net deficit slightly in excess of $4 million.

Edward's net capital position during March 1980 was approximately $40 million, $32 million in excess of required minimiums. The firm charged the $4 million Hunt deficit against this account until it was recovered.

On March 28, 1980, Edwards issued two news releases. The first, at 9:00 a.m., announced that a customer holding silver futures contracts had failed to meet margin calls. It stated that although the number of contracts was not substantial, closing the positions would result in a substantial unsecured receivable. Failure to collect the receivable would not have a material adverse effect on Edwards' financial condition. The later release, at 10.50 a.m., clarified the amount of the receivable to be approximately $4 million and indicated that the firm had not yet determined the collectibility of the receivable. In that connection, as a result of the liquidating deficit, the firm took a charge against net capital of approximately $4 million.

Later in the day on the 28th, Hendricks telephoned Mercer to advise him of the executions with respect to liquidation of the Bunker Hunt account. Mercer indicated that the firm could use its discretion with respect to retaining or liquidating the T-bills. Regarding the remaining balance, however, Mercer stated: "That we'll have to take at a later date. I don't have any answers at this time."

### D. Recovery from the Hunts

On Monday, March 31, Kalinowski telephoned Mercer with regard to the deficit in the Bunker Hunt account. Mercer advised Kalinowski that the Hunts were in Boca Raton and that it would be late in the day before Mercer would have any advice for the firm. In a subsequent conversation, substantive discussions were postponed until the following morning.

On the morning of April 1st, Mercer advised Kalinowski that, based upon meetings that the Hunts were currently having, he expected that the Hunts would be able to forward money to the firm later in the day. That afternoon, $4.1 million was transferred by wire and the firm was instructed to liquidate the T-bills in its possession, thereby clearing the deficit in the Bunker Hunt account.

On April 1, 1980, Edwards issued a news release announcing that it had received full payment of its $4 million unsecured receivable. 214/

## IV. REMEDIAL MEASURES FOLLOWING THE CRISIS

As a result of its experience in March 1980, Edwards has adopted several new procedures with respect to commodities transactions. Edwards' new procedures formally recognize that accounts maintaining positions in the spot month can be subject to extreme equity loss. Accordingly, margins for various categories of commodities must now be established in an amount commensurate with the actual risk presented. Customers intending to remain in long or short positions after the termination of the trading contract are required to deposit the necessary funds to accept delivery, if long, or the appropriate documentation to complete the transaction, if short.

The margin department also has been instructed to give consideration to the spot market in fixing variation margin calls where there appears to be a distortion between spot and back month contract prices. In such situations,

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214/ NYSE took no disciplinary action regarding the discrepancy in Edwards' statements.

the margin department has discretion to call for an increased amount of variation margin based upon the amount of the distortion, the type of commodity, the firm's experience with the customer, and the customer's reliability in meeting margin calls. In this manner, the firm can put the customer on notice as to the amount of margin it needs to maintain the customer's position; the customer can either meet the calls, liquidate fully or partially, or transfer the position to another broker.

Credit guidelines were revised in January 1981. The dollar limits for each type of account subclass were raised to $25,000, $50,000, $99,000, and $100,000 and over, respectively. The large account class now requires approval of the executive committee. In establishing credit limits for large accounts, certified financial statements or other suitable credit information must be obtained from the customer which demonstrates that the customer has the requisite liquidity and net worth. For speculative accounts, although situations can vary greatly, the individual customer's situation is considered in light of the ability of that customer to meet margin calls, either through his own funds or current ability to borrow from banks or finance companies.

Edwards has also modified its procedures to enable it to more readily determine its exposure in customer commodity accounts. It developed a report that reveals customer positions on a net long or short basis by showing and reporting the true extent of its unhedged customer positions.

# PART EIGHT

## THE NEW YORK STOCK EXCHANGE

## I. BACKGROUND - ORGANIZATION AND RESPONSIBILITIES OF THE EXCHANGE UNITS RESPONSIBLE FOR SURVEILLANCE OF MEMBER FIRMS

The Surveillance Department of the New York Stock Exchange's Member Firm Regulation and Surveillance Division is responsible for the Exchange's surveillance of member firms. During the period prior to the silver crisis, this Department was composed of two sections: the Field Examination Section and the Coordination Section. 215/ The Field Examination Section was responsible for performing an annual comprehensive examination of every Exchange member and special examinations, on a cause basis. The Surveillance Coordination Section was responsible for overseeing the surveillance of the NYSE's member firms, and for coordinating all of the regulatory activities of the Exchange affecting those firms. Specifically, the coordinators reviewed all of the financial and operational reports filed periodically with the Exchange by the member firms. Each coordinator maintained personal contacts with representatives at each firm and typically spoke with these contacts at least once a month. Ideally, each coordinator was to have a full awareness of the business and health of the firms assigned to him.

According to Exchange officials, the coordinators made a concentrated effort to stay abreast of new developments in the brokerage industry. Each coordinator team was assigned a special product area, such as commodities, to study and monitor through the press, trade journals and contacts with specialists in the particular area. In addition, procedures existed to mobilize the entire Coordination Section for the purpose of assessing the impact of current trends or events on the financial and operational capabilities of the member firms. These efforts were known as "Surveys." When a particular trend or event was identified as potentially affecting the financial or operational well-being of some or all of the Exchange's members, the coordinators would contact the members for relevant information. By telephone calls to financial officers of member firms, the coordinators asked if there were firm inventory losses or undermargined customer accounts which would result in capital charges to the firm and the effect of such charges on the firm's excess net capital.

According to Exchange officials, the Surveillance Coordination Section worked closely with the Field Examination Section. Prior to a field examination, the surveillance coordinator prepared for the examiner a summary of all of

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215/ During the spring of 1982, the Member Firm Surveillance Department was reorganized and the Field Examination Section and the Coordination Section were merged.

the data about the firm known to the Exchange, and a "memorandum of understanding," which defined the scope of the examination. 216/ During the examination, the examiners were expected to be in periodic contact with the coordinators to report any significant findings during the course of the examination, and, if problems arose, the coordinators would offer guidance and assistance.

## II. THE NYSE'S SURVEILLANCE OF ITS MEMBER FIRMS DEALING IN SILVER - SEPTEMBER 1979 THROUGH MARCH 26, 1980

In early September 1979, individuals in the NYSE's Surveillance Department's Coordination Section became concerned about the sharp increase in prices of gold and silver and whether the increase would cause undue exposure to firms with proprietary or customer positions in the precious metals markets. Between September 17 and 21, 1979, the coordinators conducted a survey of the firms known to deal in commodity futures. They asked questions from a checklist 217/ concerning the make-up of customers and proprietary accounts, clearing arrangements, and margin requirements for public and trade accounts. The Exchange sought specific details regarding large accounts and general observations concerning the precious metals markets.

In accordance with Exchange procedures, the survey was conducted entirely by telephone, and, except in the case of Merrill Lynch, the Exchange did not verify the information reported to the Exchange by the firms. As far as the staff could determine, in only one case did the coordinators request information from a firm regarding the specific identity of those accounts with positions, and in no cases did the coordinators request information concerning possible financing arrangements with customers, concentrated positions, or positions of affiliated entities. The survey disclosed that very few firms had proprietary positions, and that for the most part, all outstanding margin calls were being met. In the summary memorandum concerning Bache Halsey's responses to this survey, it was noted that on the basis of the conversations with the firm "it appear[ed] that management ha[d] the necessary controls in effect to preclude any problems."

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216/ For example, the coordinator, knowing that the firm had recently expanded its business in a certain product area, had the authority and responsibility to direct the examiner to pay particular attention to that area.

217/ This checklist was used in subsequent surveys throughout the period prior to March 27, 1980.

During the period this survey was conducted, the coordinators became aware of two important facts. First, at the time of the survey, Exchange examiners were conducting an examination of Merrill Lynch. The coordinator conducting the survey of Merrill Lynch asked the examiners to review those customers' accounts which met the daily CFTC reporting requirements. Among such accounts were those with net positions exceeding 250 contracts. The coordinator's workpapers reflect that the examiners provided details to the coordinators as to these accounts by account number. One of these account numbers was 542-76257, belonging to Herbert Hunt. Another was 542-93694, belonging to IMIC. According to the workpapers, only the IMIC account was identified by name and reported to the coordinators. Apparently, the examiners did not look into the ownership of IMIC, 218/ did not determine whether there were any related accounts, and did not identify the holder of account number 542-76257. 219/

On September 26, the supervisory coordinator for Bache Halsey reported to the director of the Surveillance Coordination Section that the Hunts were transferring their commodity accounts, which consisted entirely of long positions in silver, to Bache from Shearson Loeb Rhodes, Inc. ("Shearson"). According to the supervisory coordinator's memorandum, the transfer was due to the fact that the Hunts thought Shearson's margin requirements were excessive. 220/ The supervisory coordinator concluded that "the transfer does not present any problem (i.e. added exposure)."

The inspection disclosed that while this survey was being conducted, the Exchange was in contact with the Comex and CFTC. According to an Exchange internal memorandum,

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218/ Not until March 27, 1980, did the surveillance coordinator find out that the IMIC account was a Hunt-related account.

219/ During the fall of 1979, the Exchange also examined Hutton. The examiner's workpapers included a notation to the effect that an account of Nelson B. Hunt lacked a signed loan agreement. It was not until March 26-27, 1980, that the Surveillance Coordination Section learned that the Hunts had an account at Hutton and that Hutton had loaned the Hunts funds.

220/ At the time, the Comex required a minimum of $5,000 per contract. Shearson required $20,000 in Hunt silver accounts, while Bache only required $7,500.

the Comex advised one of the senior staff of the Surveillance Coordination Section that the Hunt brothers "may be involved" in the trading of that period, but that their names had "not yet appeared anywhere." According to another memorandum, a CFTC representative advised the Director of the Surveillance Coordination Section that the long positions were of particular concern because the professionals, feeling the market was overinflated, might sell off their positions causing a "roller coaster" effect. According to this memorandum, the Director of the Surveillance Coordination Section offered the CFTC representative information concerning the results of the NYSE's survey. This offer was declined.

Between this initial survey and January 1980 the Exchange conducted two more surveys. In both cases, the Exchange coordinators used the same checklist and procedures as before, and again learned that, except for a few minor instances, no firm was experiencing any problems.

Another survey was conducted in early January, 1980 and on January 23, 1980, the director of the Surveillance Coordination Section reported to Commission staff that the Exchange members surveyed had been cautious in their silver activities and "have sufficiently insulated themselves against exposure." On or about that same date, the Exchange conducted another survey. The summary of Bache's responses stated: "The firm referred to its commodity accounts as being in super condition. This is attributed to their conservative and very close monitoring of accounts." As in the case of the previous surveys, the Exchange learned of no significant problems.

On January 25, 1980 the Exchange received a FOCUS Part II Report for Bache Halsey. 221/ The Report showed a 373% increase (from $16,279,000 to $60,834,000) over two months in commodities receivables. The sharp increase was not noticed by the coordinators reviewing the documents. 222/

On January 26, 1980, the Exchange began a regularly scheduled routine examination of Bache Halsey. The examination, conducted according to Exchange procedures,

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221/ The FOCUS Part II Report is a summary statement of certain financial and operational data filed quarterly by broker-dealers who carry customer accounts.

222/ Additional research by the Exchange, since the staff's inspection, disclosed that other firms, such as Hutton and Shearson, experienced marked increases (206% and 438% respectively) in this line item during approximately the same period. The Exchange was not aware of these facts at that time.

entailed among other things, a review of the accuracy of the firm's December 31, 1979 FOCUS report. Thus it included a detailed review of Bache's customer commodities operations as of that date, the same time that the silver market was near its historic high. On February 4, 1980, the coordinators sent the examiners a memorandum which noted that the firm was adequately capitalized and that the coordinator's daily monitoring of the firm had not disclosed any problems. The memorandum did not mention the firm's commodities operations.

During February and the first half of March, the Exchange did not conduct any silver surveys although there was a general awareness that the price of silver was declining from its highs of about $50 per ounce reached in January. During February, the Exchange examiners continued their examination of Bache Halsey. It took three examiners the entire month to review the firm's commodities operations. The examiners were located in the firm's commodities offices and were in daily contact with the commodities managers. The review, following Exchange procedures, included an examination of many customer accounts as of December 31, 1979, even though examiners involved in the commodities aspects of the examination knew of the downward trend in the silver prices that had occurred since December 31. Accounts which exhibited no problems as of December 31, 1979 were only cursorily reviewed. The Hunt accounts, which, according to Exchange documents, were long 6900 futures contracts and had equity of $171 million as of that date, presented no problems, and therefore were neither specifically identified nor reviewed in depth. 223/ At no time was there a suggestion that the accounts should be reviewed in light of the current market developments, or evaluated in terms of potential firm exposure. During February, the examiners were rarely in contact with the coordinators. In accordance with Exchange procedures, the examination did not include a review of the books or records of Bache Halsey Stuart Metals, Inc., an affiliated corporation not within the Exchange's regulatory jurisdiction. 224/

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223/ The figures in the text, derived from Exchange documents appear not to reflect all Hunt-related positions carried by Bache Halsey at December 31, 1979.

224/ By the end of February, Bache Metals had loans of approximately $233 million to the Hunts which were collateralized by silver with a market value, at that time, of approximately $400 million.

On or about March 1, 1980, the Exchange examiners at Bache Halsey began to write up the various portions of their examination report, in a room specially provided for their use by Bache. From that date on, the examiners working on the commodities aspects of the examination had little contact with the commodities department. The examiner in charge of the commodities review spent the entire month of March finalizing his report on Bache Halsey's premises.

On March 18, 1980, the Exchange conducted another silver survey of its member organizations, using the same procedures and checklist as in prior surveys. The memorandum, sent to the supervisory coordinators directing the survey, noted that the Comex limits on the number of future contracts that could be held were a "saving factor," and that the Exchange had no reports of problems. The summary of Merrill's response to that survey noted that the firm was experiencing an increase in margin calls, but that the calls were "for the most part, being met with a transfer of cash" and not significantly by liquidations. It went on to state that "there is no sizable customer account that doesn't maintain sufficient equity to meet their [sic] current margin calls." At the time, Merrill Lynch had outstanding margin calls to the IMIC account totaling $158 million which had not been met, as in the past, with cash within 24 hours, and IMIC had failed to pay for 650,000 ounces of bullion delivered in its account with the firm. Merrill considered the outstanding margin calls to be adequately "collateralized" by bullion in IMIC's account.

Bache Halsey similarly reported that there were no problems, although it had, by that time, learned from the Hunts that they had no cash with which to meet calls. The Commission staff found no evidence that the Exchange, in conducting this or previous surveys, obtained any details as to the identity of large accounts or the potential capital impact on firms if the downward trend of silver prices continued. The coordinators did not request the Exchange examiners, still on Bache Halsey's premises, to verify the data reported by Bache.

On March 19, 1980, Bache Halsey informed the Exchange that it was going to take down $5 million of subordinated standby capital so as to increase its net capital percentage to 7.68%. The next day, the firm advised the Exchange that it would take down an additional $5 million "to positively avoid any problems," and to increase its capital percentage to 8.10%. On March 25, 1980, the Exchange approved these infusions effective as of March 24th.

The Exchange conducted more surveys on March 24th and March 25th. The firms contacted continued to advise the Exchange that while margin calls were higher than usual, the situation was under control, since "for the most part" the calls were being met on a timely basis. According to an Exchange document, the firms were weathering the situation "without much difficulty." In conducting the March 25th survey, the coordinator for Bache Halsey did not speak to either of the individuals who were in charge of Bache's margin and commodities operations. Rather, he spoke to a first vice president in charge of financial reporting, who, according to Exchange documents, told him that there were no problems. 225/ Exchange documents reported that the coordinator did not feel it was necessary to contact the heads of the margin and commodities departments, because there was no indication of any problems. The coordinator did not contact the Exchange commodities examiners who were still on Bache Halsey's premises.

The Commission staff did not find any Exchange documents evidencing contacts on March 24 or 25 with Merrill Lynch in connection with its precious metals surveys. On March 25, 1980, however, Merrill Lynch filed documents with the Exchange for approval of a $200 million cash subordination from its parent company. In a memorandum to the files, the supervising coordinator for Merrill Lynch noted that according to the chief financial officer of Merrill Lynch, the subordinated net capital was desired to support the firm's increasing debits and to prepare for expected new growth. According to the coordinator, he verified that the firm had no current capital problems. The infusion would increase the firm's capital percentage from

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225/ At that point, there were in fact serious problems with the Hunt accounts. On March 17, according to an Exchange document, Bache Halsey issued the Hunts a $20 million margin call, and on the following days issued more calls. According to an Exchange document, it was during the week of March 17, that the firm learned that the Hunts were "cash poor" and would not meet the calls. On Friday of that week, however, the Hunts met the calls by depositing $100 million in silver. This was not acceptable to Bache and on Monday, March 24, Bache Halsey told the Hunts to deposit cash or face liquidation. Bache Halsey did not credit the Hunt accounts with the $100 million silver and instead treated it as additional collateral. When the Hunts failed to meet its calls with cash on March 24, Bache began to liquidate the silver, crediting the sales proceeds to the Hunt account. Certain of the information obtained by the Exchange is inconsistent with information developed in the staff's investigation.

9.2% to 15%. According to Merrill Lynch, the subordination had been planned by the firm for some time and was not in anticipation of any potential net capital problems. The Exchange approved a draft of the subordination agreement on March 26, 1980. 226/ As far as the staff can determine, the agreement became effective March 31, 1980.

## III. THE SILVER CRISIS - MARCH 26 THROUGH MARCH 31, 1980

On March 26, 1980, the Exchange surveillance coordinators were working on a monthly GNMA survey. The Hutton coordinator called his contact at the firm to request the GNMA data. During the conversation, the Hutton contact mentioned that he had had a phone call from the Commission staff, inquiring as to what Hutton's exposure would be if silver dropped to $15. 227/ After the coordinator told his supervisor of the call, the supervisor asked the other supervisory coordinators to begin another survey of the commodities firms, regarding their silver positions. As far as the staff can determine, whatever calls were made on the supervisory coordinator's prompting yielded no information of import.

That morning, the senior vice president of the Member Firm Regulation & Surveillance Division was scheduled to meet with the chief operations officer of Bache Halsey on a personal matter. The Bache individual called the senior vice president to cancel at the last minute. According to the NYSE officer, the Bache representative asked him cryptically if the general counsel of Bache Halsey had spoken to him. He had not, and the Bache representative offered the NYSE officer no details.

Late in the afternoon, the senior vice president received a telephone call from someone at the CBT Clearing Corporation. The CBT Clearing Corporation representative asked him if he knew why Bache Halsey management was panicking about silver prices, suggesting that Bache management had called the CBT and a high level government official 228/ with some overly pessimistic margin computations

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226/ See, however, discussion at p. 232, below.

227/ Silver had closed the day before at $20.20. The Hutton representative told the coordinator that he had told the Commission staff that if the price of silver dropped to $15, Hutton's exposure would be $2 million, and if the price of silver dropped to $0, Hutton's exposure would be $60 million ($30 million after taxes).

228/ The official was Paul Volcker, the Chairman of the Federal Reserve Board.

and had requested a closing of the commodities markets and/or a reduction of margin requirements. The Hunt accounts were mentioned specifically. According to him, it was his impression that the Clearing Corporation thought that Bache was overreacting. The senior vice president told the vice president of the Member Firm Surveillance Department of the phone call. The vice president called Bache Halsey and obtained some preliminary numbers. According to the NYSE vice president, Bache was placatory, and said there was no problem. The figures they gave were not alarming. 229/ The vice president then called the senior vice president with the figures and agreed that no further immediate action was necessary. As far as the staff could determine, moreover, the Exchange examiners on Bache's premises were not notified of the possible existence of a problem.

During this period, the vice president advised the Surveillance Coordination Section of the substance of the CBT Clearing Corporation's phone call. Several surveillance coordinators contacted their firms late that afternoon and asked specifically whether the firms had Hunt accounts and details as to such accounts.

The coordinator for Hutton called back his contact, and was informed that Hutton did have four Hunt accounts, and that there was a $10 million margin call outstanding for a Hunt account which Hutton expected would be paid the next day. A coordinator also spoke with an individual at Edwards' commodities department, and was informed that Edwards had a Hunt account, but had no problems with commodities customers generally or with the Hunt account specifically.

The coordinator for Merrill Lynch also called Merrill on the afternoon of March 26, and spoke with the manager of Merrill's commodity operations department. Exchange records reflect that it was in this conversation that the coordinator learned, for the first time, that Merrill Lynch had Hunt accounts and a bullion loan to the Hunts. His memorandum of the call reflects that he was told that there were no outstanding margin calls for the Hunt accounts, that the Hunt accounts had "tons of collateral," that margin calls were being met mainly through cash transfers and that the

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229/ According to the Vice President's notes of the telephone call, Bache reported that it had issued $35 million in margin calls against the Hunt accounts and that the accounts had equity of $150 million. According to other Exchange records, the next morning, outstanding Bache margin calls issued against the Hunts totaled, in fact, $146 million.

Hunt accounts had met their calls for the last several weeks. In connection with the staff's investigation, Merrill's commodity operations manager testified that although he could not recall the details of his conversation with the Exchange, he is certain that he would not have told the coordinator that the Hunts had been paying cash. In fact, as of the close of business on March 25, there were margin calls of approximately $100 million outstanding in the Hunt accounts, the Hunts had not met their margin calls of the previous weeks through cash transfers, 230/ and according to the staff's investigation, Merrill Lynch was actively soliciting the Hunts to deposit more collateral with the firm.

The next morning, March 27, the senior vice president, through the vice president, directed the Exchange examiners on Bache's premises to find out exactly what Bache's situation was. The supervisory coordinator for Bache joined the examiners in the firm's commodities department. By midmorning, he was able to report back to his supervisors at the Exchange that Bache's situation was deteriorating rapidly as the price of silver dropped during the day. Meanwhile, the surveillance coordinators had contacted all commodities firms and identified seven firms as having Hunt accounts.

Also on the morning of March 27, the senior vice president spoke to the chairman of ML & Co. who informed him that the night before, the Hunts had advised the firm that they would not meet their margin calls. According to the senior vice president's recollection and notes of the call, the ML & Co. chairman informed him that there was no cause for worry despite the large Hunt silver positions, because the firm had, in anticipation of potential exposure, infused $200 million in subordinated funds. Other reasons had been given by Merrill Lynch for the loan several days earlier, and the ML & Co. chairman was the only person at the firm that the senior vice president was aware of who tied the subordination to the silver situation. 231/

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230/ See discussion at pp. 147 through 155, above.

231/ The senior vice president later made inquiry of other Merrill Lynch officials who told him, as they had earlier told other NYSE personnel, that the subordination had been planned for some time for reasons independent of any anticipated problems in silver accounts. Information on this subject developed in the staff's investigation of ML & Co. is described at p. 162.

After this report, a decision was made to send examiners to the four firms, in addition to Bache, located in New York City and known to have Hunt accounts. 232/ These firms were Merrill Lynch, Hutton, Dean Witter, and Paine Webber. The examiners reviewed Hunt positions, the firms' net capital situations, and monitored the firms' actions in response to the crisis. The examiners reported the data to the Exchange as it became available. The Merrill Lynch coordinator joined the examiners on Merrill's premises and learned for the first time of the relationship between the Hunts and IMIC.

During the day, the Hutton coordinator contacted Hutton and was informed that Hutton had liquidated 700 of the Hunts' 1700 silver contracts at equity with no loss to the firm. A surveillance coordinator also spoke to Edwards, located in St. Louis, and was told that the Hunt accounts had equity of $1.4 million. The Coordination Section also contacted Howard, Weil, Labouisse, Friedrichs, Inc. Howard, Weil reported no silver holdings and satisfactory equity in its Hunt accounts. 233/

Throughout the morning, the Commission staff discussed with Exchange officials the increasingly active trading in Bache Group, the NYSE listed parent company of Bache. In the early afternoon, the director of the Commission's Division of Market Regulation advised the Exchange that the Commission had ordered a 10-day trading suspension in Bache Group effective at 2:15 p.m., the closing time of silver futures trading on the commodity exchanges. The Exchange halted trading in Bache Group at 2:13 p.m. 234/

At 5:00 p.m., the NYSE's Surveillance Committee met to discuss the events of the day. The vice president advised the group that, as of that morning, Bache had margin calls outstanding for $146 million for various

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232/ The other two firms with Hunt accounts were Edwards, located in St. Louis, and Howard, Weil, Labouisse, Friedrichs, Inc. located in New Orleans. Howard Weil had no Hunt silver accounts.

233/ On April 7, 1980, the Exchange sent an examiner to Howard, Weil. He verified that the firm had provided correct figures to the Exchange.

234/ That afternoon, the Exchange also halted trading in the stock of Dean Witter and Shearson, due to imbalances in trading orders.

cross-guaranteed Hunt accounts and had liquidated nine million ounces of silver during the day and prior night at prices ranging from $12 to $16 per ounce. Bache had excess net capital of $17 million at the 7% level. Soon thereafter, the chief executive officers of Bache, representatives of the Commission's staff and the supervisory coordinator for Bache and one of the examiners assigned to the Bache examination, joined the meeting. Those present were informed by the Bache representatives that the Hunts had commenced meeting margin calls with silver warehouse receipts rather than cash as early as March 18, and on March 25 they had informed Bache that they did not intend to honor additional margin calls. The Bache representatives stated that 15 million ounces of silver, rather than the nine million ounces reported by the vice president, had been sold. They further reported that at that point, Bache had a loss of $4-5 million relating to the Hunt accounts, that the firm's net capital could absorb an additional drop in the price of silver to $8.00 per ounce before being in net capital violation, that a number of banks were willing to lend subordinated capital to the firm, and that Hunt accounts still carried 30 million ounces of silver after liquidations.

After the Bache and Commission representatives left the meeting, the Committee called an outside expert, who opined that the silver market would decline slightly Friday and that it was unlikely that large commercial buyers would enter the market at that time. Consequently, the Committee determined that it could not make any positive public statement regarding Bache or recommend lifting of the suspension of Bache stock trading, as urged by the Bache representatives. Furthermore, the Committee agreed to request that Bache prepare a capital position as of the next night for review early the next week. The Committee and the Exchange officials were also concerned about the financial well being of Merrill Lynch because, throughout the day, the Exchange had been unable to obtain firm figures from Merrill Lynch as to its Hunt accounts.

Numerous NYSE personnel stated that they worked unusually late that Thursday night, assimilating information as it came in from the five firms visited that day, and evaluating the situation. However, Exchange officials did not prepare a formal contingency plan in the event of a severe drop in the price of silver the next day.

The predictions of a continuing declining silver market on Friday proved false. The silver markets opened slightly up, thereby alleviating an immediate crisis.

Exchange examiners spent the day at the firms that held Hunt accounts, monitoring the firms' liquidation and covering of Hunt accounts, reviewing margin calls and verifying net capital figures. The examiners performed spot checks of the figures being supplied to the Exchange by the firms.

Sometime during the day, the Exchange learned via the Dow Jones tape that Edwards had suffered a $3.75 million loss in the liquidation of the Hunt accounts. The day before, Edwards had told the Exchange that there was $1.4 million equity in the Hunt accounts. Edwards' treasurer explained to the Exchange that this discrepancy was due to the fact that the equity reported to the NYSE on Thursday was based on the silver futures price of $21.00 an ounce, whereas the liquidations, commenced after the Hunts refused to meet a margin call based upon the spot price, were accomplished at approximately $11 per ounce. A similar problem occurred with Paine Webber, which, according to NYSE personnel, informed the Exchange on March 27 that it would experience no losses, only to report on March 28 a loss of $8.6 million liquidating the Hunt accounts. While Paine Webber's misrepresentation was a separate cause of action in a subsequent enforcement proceeding largely relating to other matters, no action was taken regarding Edwards, other than to warn the firm orally to provide accurate information in the future.

The coordinator for Hutton learned on Friday, from an outside source, that Hutton had made a $100 million loan to the Hunts backed by bullion. When he asked his contact at Hutton why the NYSE had not been informed of the loan sooner, the contact responded that it "didn't matter" because the loan collateral had been liquidated. According to the coordinator, he was satisfied with this response at the time because there was no exposure. The Hutton representative told him that the firm still held a $42.6 million Treasury bill position in the Hunt accounts. The coordinator verified with Hutton that no losses had occurred either in liquidation of loan collateral or the Hunts' futures position. 235/

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235/ On April 2, 1980, Hutton reported to the Exchange, in "the interest of full disclosure," its loss of $800,000 in its liquidation of the Hunt positions. A Hutton representative explained that this was due to the fact that the earlier reported $42.6 million Treasury bill holdings in the Hunts' accounts were liquidated at a loss. He also disclosed to the coordinator that on Wednesday, March 26, the loan had required additional collateral due to the collapse of the silver price, and that on Thursday, March 27, a decision was made to liquidate the loan.

Thursday afternoon and throughout Friday, the Commission staff had discussions with representatives of Bache and the NYSE concerning the lifting of the trading suspension in Bache Group stock. The Commission staff was not satisfied, however, that Bache Halsey's Friday press release provided fully accurate and complete information concerning Bache's financial condition. Late Friday afternoon, the Commission staff furnished Bache and its accountants with a schedule of questions for response over the weekend. Throughout Saturday and Sunday, the Commission staff maintained regular contact with Bache and other firms concerning their financial condition. On Sunday night, Bache delivered to the Commission staff a formal written response to Friday's schedule of questions.

During the weekend, most of the officers of the Member Firm Regulation and Surveillance Division as well as the supervisory coordinators reported to the Exchange's offices and maintained contact with the firms involved as they worked to resolve the crisis. Among other things, they reviewed drafts of a response of Bache Halsey to the questions asked by the Commission. During the weekend, examiners remained only at Bache. They spent both days working with firm personnel reviewing daily receipts and the firm's capital position. Late Sunday afternoon, the Exchange learned, from the Commission staff, that Bache had discovered an additional Hunt account.

By Monday, March 31, the immediate financial crisis appeared to have passed. Following publication of a more detailed press release by Bache Halsey, trading in Bache Group stock resumed. The Exchange continued to monitor the situation with frequent contacts to the firms. Bache Halsey was placed on the NYSE's internal alert list and required to report orally, and on a daily basis, all material events relating to its financial condition. This special surveillance continued until April 17, 1980.

Almost immediately, the Exchange began to assess whether it should bring disciplinary actions against any of its members. A pending action against Paine Webber was amended to include a charge for failing to give the Exchange accurate information. A case was brought against Bache Halsey. Bache Halsey consented, without admitting or denying that it violated the Constitution or Rules of the Exchange, to findings of an Exchange Hearing Panel, that it had violated Exchange Rule 401 by failing to adhere to the principles of good business practice, engaged in acts detrimental to the Exchange, engaged in conduct inconsistent with just and equitable principles of trade and violated Exchange Rule 342 by failing to establish adequate procedures of supervision and control to provide for the dessimination of accurate and reliable data concerning its financial condition. The firm agreed to be censured and fined $400,000. No other actions are contemplated.

The Exchange also began an assessment of its performance. From the staff's review, it appears that the Exchange experienced some self-doubt. Whatever doubts existed, however, appear to the staff to have been vitiated by a perception that whatever shortcomings there were in the Exchange's performance, were due to factors beyond its control. Exchange documents reflect, and Exchange officials voice, frustration over the failure of Bache Halsey, Merrill Lynch, the Commission and the CFTC to communicate with the Exchange and frustration over the failure of its members to supply it with accurate and timely financial data.

In the staff's view, the Exchange's failure to identify an impending crisis and its consequent failure to take appropriate prophylactic action, was due to the fact that the Exchange based its surveillance of Exchange members dealing in silver on a belief that the members would provide candid, accurate, and complete information to the Exchange staff, promptly and spontaneously. As outlined above, this assumption proved false. Based upon the staff's review, the Division of Market Regulation believes that the Exchange should implement better controls for the conduct of surveys that, in cases of substantial consequence such as encountered during the silver crisis, would include, at a minimum, submission to the Exchange of hard copy data, infield verification of such data, and attestation of the accuracy of data submitted to the Exchange by a senior officer of a firm. As detailed in this report, the Exchange's failures were due also to a serious breakdown in the coordination and exchange of information between the Field Examination Section and the Surveillance Coordination Section. The Exchange's organizational bifurcation of surveillance responsibilities between these sections clearly did not work. Although the Exchange has recently merged these sections, the Exchange should adopt procedures and supervisory controls to assure the closest possible interrelationship between the individuals performing the surveillance and examining functions.

# PART NINE

## LEGAL AND POLICY IMPLICATIONS OF THE SILVER CRISIS

## I. INTRODUCTION

The events surrounding the silver crisis raise a number of significant legal and policy issues. This part of the report identifies several areas in which the staff believes that Commission should consider proposing rules or recommending legislation designed to reduce the possibility that the financial instability occasioned by the crisis could recur. The staff believes certain of the issues raised warrant immediate consideration by the Commission; others may require more comprehensive consideration in order to determine an appropriate response. 236/

### A. Excessive Exposure to Particular Customers or Markets

The silver crisis demonstrated that financial instability can occur at even a large broker-dealer 237/ when obligations associated with a customer position in a single commodity are substantial in relation to the firm's capital resources. If the financial stability of the broker-dealer community is to be assured, it is essential for the Commission to limit a broker-dealer's exposure 238/ to loss arising

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236/ The observations herein may not apply to all broker-dealers, or may do so to varying degrees.

237/ When used herein, the term "broker-dealer" includes firms registered with the Commodity Futures Trading Commission ("CFTC") as futures commission merchants ("FCM"). Although these recommendations grew out of the staff's investigation of broker-dealers who were registered FCM's, the recommendations are intended to address analogous issues at non-FCM broker-dealers.

238/ The term "exposure" as used in this part means the potential for loss associated with:

(1) The obligation to clearinghouses incurred by a broker-dealer as guarantor of its customers' obligations on commodity futures contracts, I P. Johnson, Commodities Regulation §2.43 at 279 (1982).

Footnote continued on next page.

from substantial involvement with a single customer 239/ or customer group, or the establishment of proprietary or customers' positions that are highly concentrated in a particular commodity.

Accordingly, the staff recommends that the Commission commence rulemaking or recommend legislation to establish a ceiling on the degree of exposure that a broker-dealer or, in certain situations, its parent, may incur in connection with the transactions or accounts of a particular customer or customer group. The staff suggests that such a limitation could be based on a formula relating to a firm's net capital and excess net capital. 240/ In addition, the staff recommends revision of the Uniform Net Capital Rule (also referred to as the "net capital rule") to restore or enhance disincentives to excessive concentration in proprietary or customer commodity positions.

### B. Weaknesses in the Commodity Aspects of the Uniform Net Capital Rule

The silver crisis revealed weaknesses in the Uniform Net Capital Rule as it relates to customer commodity accounts. As described elsewhere throughout this report, use of futures prices in valuing futures positions in limit-up or limit-down markets distorts the true value of those positions. During the silver crisis, this practice

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Footnote continued from previous page.

(2) Margin extended to customers in securities accounts;

(3) Loans to customers against cash commodities; and

(4) All other extensions of credit, advances, receivables from the customer, debit/deficit balances, guarantees of customer accounts by firms, or negative amounts in accounts, of whatever form.

239/ As used in this report, the meaning of "customer" of a broker-dealer includes all persons or entities, including other broker-dealers. This is intended to be broader than the definition of "customer" under certain sections of the Securities Exchange Act of 1934, 15 U.S.C. §78a *et seq.* (1976 & Supp. IV 1980) ("Exchange Act").

240/ As used herein, "excess net capital" refers to an amount of net capital calculated by taking total regulatory net capital and subtracting regulatory minimums.

had the effect of delaying recognition of the actual rate at which the value of Hunt silver accounts was declining and masking the extent of customers', and thus broker-dealers', exposure to loss. The staff recommends that the Commission, in coordination with CFTC, commence rulemaking to require valuation of back month commodity futures positions at spot month or cash commodity prices in adverse limit-move market conditions.

The silver crisis also illustrated the extent to which the protections of the net capital rule may be impaired by the unilateral action of commodity exchanges in altering margin requirements on customer positions. The net capital rule incorporates by reference certain rules of commodity exchanges, including those setting margin requirements. Actions by commodity exchanges thus can determine, among other things, the timing and amount of charges to capital. There is the possibility, as happened in silver on March 26, 1980, that a change in margin requirements by a commodities exchange will enable a firm to postpone charging unmet margin calls to capital without receiving any cash from its customer, without favorable market movement and without the liquidating value of the account having been increased. The staff recommends that an alternative to the current scheme of regulation be developed that will assure that the levels of financial protection afforded by the net capital rule are not subject to reduction by the action of commodities exchanges.

C. Adequacy of Financial Information

Another troublesome feature of the silver crisis was the extent to which broker-dealers extended substantial credit to the Hunts without information concerning the amounts and maturities of the Hunts' liabilities, the extent and availability of their assets or the magnitude of their overall silver positions. Present "know your customer" rules, whether in their design or because of the discretionary nature of their provisions, cannot assure that credit decisionmakers will have all financial information necessary to an informed judgment.

While it may be possible and beneficial for the Commission to promulgate regulations that would require firms to obtain current and complete financial information from customers, there are several drawbacks to this approach. Moreover, the staff believes the need for such regulation will be substantially reduced or eliminated if the Commission adopts an effective limitation on a broker-dealer's exposure to loss. The staff, accordingly, recommends that the Commission develop limitations on exposure to loss rather than additional regulations to insure adequacy of financial information.

D. Public Disclosure

Each of the securities firms carrying Hunt accounts was either itself a publicly-held corporation or the principal subsidiary of a publicly-held holding company. As such, these firms were required to comply with the registration and periodic reporting requirements of the federal securities laws. These disclosure requirements to be effective must inform investors and regulators of the existence of business conditions within public corporations that may cause material losses to an issuer upon an event of default by a single customer or customer group. The suddenness with which the silver crisis came to public attention and the length of time during which significant exposure to the Hunts existed without disclosure in certain firms prior to the crisis, suggests that issuers need to be reminded of their obligations to timely disclose this type of material information.

E. Self-Regulatory Organization Oversight

This report described the failure of the New York Stock Exchange to identify in advance the circumstances at member firms that contributed to the silver crisis. Accordingly, the staff suggests that the Commission offer recommendations to the Exchange on gathering and identifying information and on operating its surveillance and examining functions.

F. Segregation of Commodity and Securities Activities

Most broker-dealers conduct commodities and securities business in the same entity. The Commission could require broker-dealers to segregate their commodities activities into a separate subsidiary to achieve industry stability and the Commission may wish to consider this approach. An exhaustive analysis of the issues implicit in corporate structure alternatives for broker-dealers is beyond the scope of this report and the staff makes no recommendation on the subject.

The remainder of this part will discuss in more detail each of the foregoing matters.

## II. EXPOSURE TO LOSS

### A. Introduction

The silver crisis jeopardized at least one major broker-dealer because that firm permitted a single group of related customers to establish an unhedged long position in silver futures and to borrow against silver collateral in disproportionately large amounts relative to the resources of the firm and the capacity of the market to readily absorb the position in the event of liquidation. 241/

Instability identified with concentrated commodities positions is neither a novel occurrence nor unknown to the Commission. Similar circumstances have brought about the bankruptcy of other broker-dealers, most notably New York

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241/ The potentially far-reaching impact upon the integrity of the U.S. financial system in the event of the failure of a major firm has been recognized by virtually all authoritative observers. Apart from such intangibles as loss of investor confidence, possible collateral effects of the collapse of one or more large broker-dealers include (1) collapse of commodity clearing associations, (2) exhaustion of the SIPC fund, and (3) material losses to banks.

> * * * financial markets in the United States and around the world have become integrated to the point where it is very difficult, as a practical matter, to segregate one market or one institution from others. For example, some of the institutions with the greatest exposure in the silver situation had farflung activities in many other markets. Had one of those institutions become insolvent, the problem would have quickly spread to other markets, many of which are far removed from silver * * *

Margin Requirements for Transactions in Financial Instruments: Hearings on S.2704 Before the Senate Comm. on Banking, Housing, and Urban Affairs, 96th Cong., 2d Sess. 5 (1980) (statement of Paul Volcker, Chairman, Federal Reserve Board). See also other statements therein.

Stock Exchange ("NYSE") member Ira Haupt & Co. ("Haupt") 242/ and J.R. Williston & Beane Inc. ("Beane") in the well-known "salad oil swindle" of 1963. 243/ With the recurrence in the silver crisis of many of the same conditions that underlay the Haupt and Beane bankruptcies, it is essential that the Commission act to prevent future instability caused by concentrated commodities positions and other forms of overexposure to loss.

The staff proposes two remedial measures. 244/ First, the Commission should restore to the net capital rule, and possibly enhance, disincentives to excessive concentration in a broker-dealer's customer commodities accounts. Second, a limitation should be placed on the total exposure that a broker-dealers may incur from the accounts of, or transactions with, a single customer or customer group. 245/

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242/ See e.g., Securities Exchange Act Release No. 7611 (June 2, 1965), 9891 (Dec. 5, 1972); N. Miller, The Great Salad Oil Swindle, 1965, cited in Seligson v. New York Produce Exchange, 378 F.Supp. 1076 (S.D.N.Y. 1974). "A concentration in the long interest * * * is fraught with potential danger to the market, inasmuch as it reduces liquidity, lessens price stability, heightens the risk of a disorderly liquidation of contracts * * * and in general threatens the maintenance of an orderly market. At the same time, a concentrated long position leaves the person who accumulates it exceedingly vulnerable to declines in the market". Seligson, 378 F.Supp. at 1081-82.

243/ See e.g., Mittendorf v. J.R. Williston & Bean Inc., 372 F.Supp. 821 (S.D.N.Y. 1974). In Mittendorf, the Court (quoting the Wall Street Journal) noted that "losses [from the commodities debacle] reverberated throughout the financial world." Id. at 824, n.2.

244/ A third measure, discussed below at 266-272, would be to require that customers provide firms with complete information on their financial condition, including securities and commodities positions. The staff does not believe that this alternative offers assurance of financial stability for broker-dealers.

245/ To be effective, any such limitation must include all forms of a broker-dealer's exposure to loss. See, n. 238 at 241, supra.

## B. Regulatory Disincentives to Excessive Commodity Concentration

### 1. Background: Regulation Prior to July 1979

After the collapse of Haupt and Beane, 246/ the NYSE in 1964 amended its capital requirements in NYSE Rule 325 to increase the minimum capital for member firms carrying commodities positions. The amendments required the firms to take deductions from net worth depending on commodities positions in proprietary and customer accounts and on the financial condition of the account. 247/ These charges to capital provided significant disincentives to over-exposure to loss from trading and holding cash commodities

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246/ Although there were differences, Bache's posture in the silver situation was somewhat analogous to the posture of Haupt in the salad oil crisis of 1963. Both carried very large unhedged long futures positions. Both lent against what appeared to be valid warehouse receipts and accepted warehouse receipts in lieu of cash margin as the market collapsed. Both firms' customers had met substantial earlier margin calls and had reputations for extensive financial resources. Bache ultimately received payment for the Hunts' obligations and the warehouse receipts it held as collateral were valid; Haupt held fictitious collateral, and, unlike Bache, Haupt's customer was not able to meet its obligations and Haupt did not receive payment, which led to its bankruptcy.

247/ These amendments, which were effective on May 1, 1964, are outlined in New York Stock Exchange, M.F. Educational Circular No. 188 (March 20, 1964). Prior to 1975, the Commission's net capital rule exempted from its requirements broker-dealers who were members of a national securities exchange and thus subject to an exchange capital rule. *See Report of the Subcomm. on Securities of the Senate Committee on Banking, Housing and Urban Affairs*, 93rd Cong., 1st Sess., *Securities Industry Study* 165 (1973). Effective September 1, 1975, the Commission's Uniform Net Capital Rule became applicable to all broker-dealers and supplanted the exchange capital rules. *See* Securities Exchange Act Release No. 11497 (June 26, 1975).

and futures contracts and to overconcentration in commodities. 248/

The Commission also established net capital disincentives to excessive exposure in concentrated commodities positions after the failure of Haupt and Beane. It significantly enhanced these disincentives when it promulgated the Uniform Net Capital Rule to displace exchange net capital regulation. 249/ Accordingly, prior to June 1979, the Uniform Net Capital Rule contained the following disincentives:

1. A charge to capital of 30% of the market value of spot commodities long or short in customer's and non-customer's accounts liquidating to a deficit;

2. A charge for the amount by which the daily limit fluctuations of all future commodity contracts carried for a customer's and non-customer's account or accounts would exceed 15% of the firm's debt-equity total;

3. A charge for the amount by which equity in a cash account is less than 20% of the market value of the position;

4. A charge for the entire amount of loans against unhedged collateral where collateral is other than licensed receipts obtained within the previous 90 days in a delivery on futures contracts; and

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248/ For example, under the NYSE capital rule, firms were required to deduct, with some adjustments, (1) 30% of the market value of unhedged proprietary and customer spot commodities positions; (2) 1.5% of the market values of the greater of either of total long or total short future contracts in each commodity carried for all customers; and (3) total of the amount by which the daily limit fluctuation of all future commodity contracts carried for a customer's account or accounts controlled by a customer exceeds 10% of the net worth of the member organization.

249/ See Securities Exchange Act Release Nos. 7611 (June 2, 1965), 9891 (Dec. 5, 1972) and 11497 (June 26, 1975).

5. A charge for .5% of one percent of the market value of net long or short customer positions. 250/

Had they continued in effect, these provisions may have had a restraining effect on the willingness of the broker-dealers to permit the Hunts to maintain extremely large futures positions or to finance deliveries of silver for the Hunts. 251/

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250/ See, e.g., Rule 15c3-1b as it existed in 1977; 17 C.F.R. §240.15c3-1b (1976). See also instructions to FOCUS Report - Part II, Fed. Sec. L. Rep. (CCH) ¶ 33,928 at 22,813-17 - 22,813-18 (although the commodity concentration "haircuts" have been removed from the rule, the instructions remain). Recently the Commission reinstituted haircuts when physical commodities are used to margin, guarantee or secure a commodities future account. See Securities Exchange Act Release Nos. 17564 (February 20, 1981), 17927 (July 9, 1981) discussed further below.

251/ Stated simply, capital charges remove cash from use or investment elsewhere in order to ensure the availability of liquid assets for customers. By effectively freezing portions of capital, the charges provide an obvious disincentive to unsecured lending or massive long positions. Despite the example below, it is, of course, impossible to say whether the past disincentives could have prevented the crisis. The staff believes, however, that had the capital charges continued in existence they would have discouraged broker-dealers from permitting the buildup of Hunt silver positions thus reducing the impact of the Hunts' default in the declining silver market.

At Bache Halsey, assuming aggregation of Hunt accounts, the provisions described in the text would have occasioned substantial charges to capital in Hunt futures accounts. At December 31, 1979, for example, Hunt accounts held an aggregate of 7304 domestic futures contracts. Limit moves in silver on Comex were $1.00 per ounce ($1.20 on the CBT) for a maximum daily fluctuation of approximately $36.5 million on the Hunt position. This exceeded by aproximately $12.9 million 15% of Bache's debt-equity total as reported at October 31. Bache would have been required to take a capital charge of approximately that amount on December 31, 1979 had the provisions described above been in effect.

The CFTC, in promulgating minimum financial requirements for futures commission merchants, the CFTC's counterpart to the SEC's Uniform Net Capital Rule, determined for various reasons to eliminate these "haircuts" on open futures contracts held by the customers. 252/ In June 1979 the Commission amended Appendix B of the Uniform Net Capital Rule to conform the Commission's rules to those of the CFTC. 253/ This amendment had the effect of essentially eliminating the disincentives for customer positions at broker-dealers.

2. Remedial Measures Since the Crisis

Following the silver crisis both the Commission and the CFTC have restored, in part, haircuts to spot commodity positions and accelerated the timing of capital charges in accounts with aged margin calls or unsecured debit balances. 254/ Specifically, these provisions:

(1) reduce the time margin calls on customer commodity futures accounts may be outstanding before they must be deducted from net worth from four business days to three business days;

(2) accelerate the time period in which broker-dealers must collect the deficit or debit balance from the close of the second business day following the adverse market movement giving rise to the deficit to the close of the next business day on which the market movement caused the debit/deficit account; and

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252/ Commodity Futures Trading Commission, "Final Rules: Minimum Financial Requirements," 43 Fed. Reg. 39956 (Sept. 8, 1978). Overall, the rules significantly improved the financial regulation of FCMs. See also Commodity Futures Trading Commission, "Proposed Rulemaking: Minimum Financial Requirements," 42 Fed. Reg. 27166 (May 26, 1977).

253/ Securities Exchange Act Rel. No. 15898, (June 15, 1979).

254/ In addition, the CFTC has discussed its concern that "large concentrations of positions in customer * * * accounts held in a particular commodity * * * can greatly increase an FCM's financial exposure in the event of large price movements." Commodity Futures Trading Commission, "Proposed Rules: Minimum Financial and Related Reporting Requirements," 45 Fed. Reg. 79498, 79498-79499 (Dec. 1, 1980). See also Commodity Futures Trading Commission, "Final Rules: Minimum Financial and Related Reporting Requirements," 45 Fed. Reg. 79416 (Dec. 1, 1980).

(3) require that any non-cash collateral securing a commodities related receivable be subject to a "haircut" as if the broker-dealer owned the collateral, for purposes of determining the extent to which the receivable is secured for purposes of the net capital rule.

In addition, if the proceeds of a loan to a customer are utilized to guarantee, secure or margin a commodity futures account, the non-cash collateral for the loan must be valued at the lesser of the value allowed the asset by the margin rules of the applicable commodity exchange or the value of the asset after being reduced by any relevant haircut.

While these recent amendments by the Commission and the CFTC are significant regulatory improvements, they do not restore to the net capital rule haircuts for excessive commodity futures positions in individual customer accounts and for the firm's aggregate customer long or short positions.

### 3. Reintroduction of Commodity Futures Concentration Haircuts

Based on experience in the silver crisis, 255/ the staff believes that the pre-1979 net capital disincentives served a useful purpose in discouraging excessive commodity concentration and should be restored. 256/ Consideration should be given, of course, to modifications to reflect conditions in the securities industry that increase the

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255/ The staff believes that excessive commodities concentrations at broker-dealers is a condition which, given sufficiently large adverse market conditions leading to customer default, could bankrupt a broker-dealer. The bankruptcy of a major broker-dealer firm, in view of its potential to bankrupt other firms from collateral effects, might exhaust the SIPC fund. One purpose of the Uniform Net Capital Rule is to protect the SIPC fund.

> It is * * * the objective of the uniform net capital rule not only to enhance the protection of customer funds and securities held by broker-dealers but to protect the SIPC fund by requiring all broker-dealers to operate under a sound capital base. Securities Exchange Act Release No. 9891 (Dec. 5, 1972).

256/ The staff does not offer a specific formulation for these "haircuts." Consideration should be given to the pre-1979 approach, as well as the relative volatility approach articulated by the CFTC in a 1977 release. See Commodity Futures Trading Commission, "Proposed Rulemaking: Minimum Financial Requirements," 42 Fed. Reg. 27166 (May 26, 1977).

dangers associated with the failure of a major firm, as well as recent reductions in the capital requirements for broker-dealers. 257/ In addition, it should be noted that recent CFTC pronouncements evidence significant concern with commodities concentration, and Commission action to reestablish a form of disincentives to concentration appears consistent both with its own historical concerns 258/ and with the CFTC's current posture.

C. Direct Limitation on Exposure to Loss

There are no direct limitations on the extent to which a broker-dealer can incur exposure through lending to a single customer, through its guarantee of customer commitments on commodity futures accounts, through lending in securities margin accounts, 259/ or through other transactions involving risk for the firm. In contrast, since 1864, federal statute 260/ has limited the total obligations to any national banking association of any person, co-partnership, association, or corporation to 10% of its unimpaired paid-in capital stock plus 10% of its unimpaired surplus fund. The intent of this lending limitation is, among other things, to safeguard the bank's depositors by spreading loans extended by a bank among a relatively large number of persons engaged in different lines of business, 261/ to prevent undue reliance upon the financial standing of a single borrower, 262/ to guard national banks from the hazards

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257/ *See* Securities Exchange Act No. 18417 (Jan. 25, 1982).

258/ For example, in Securities Exchange Act Release No. 9891 (Dec. 5, 1972), the Commission stated that the:

> "uniform net capital rule addresses itself to * * * the injudicious employment of capital, particularly in the area of undue concentration of resources * * *"

259/ The limits to lending against securities are based only on the percentages of the value of securities being purchased or used as collateral. Given sufficient qualified collateral, there is no limit on the total amount that can be loaned.

260/ 12 U.S.C. §84 (1976 & Supp. IV 1980).

261/ 12 C.F.R. §7.1310 (1982).

262/ *Corsicana National Bank* v. *Johnson*, 251 U.S. 68 (1919).

of speculative loans, and, generally, to insure sound banking practices. 263/

The same considerations that underlie bank lending limitations support the concept of a limitation on exposure to loss by broker-dealers. Although broker-dealers rely to a greater extent than do banks on the security of liquid assets immediately available in customers' accounts, 264/ and thus may not appear to require the protection afforded by the concept of customer diversification inherent in

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263/ United States v. Philadelphia National Bank, 374 U.S. 321, 329-330 (1963).

264/ Banks extend credit for many different purposes on an unsecured basis or secured by a wide variety of collateral that is often difficult to value. Accordingly, the safety of a particular loan is judged by the financial condition of the borrower as well as by the nature and extent of collateral. The stability of the bank as an institution is assured by diversifying the loan portfolio among a large number of customers.

Broker-dealers, on the other hand, extend credit principally to finance or guarantee customers' securities or commodities positions and have traditionally placed greater emphasis on the liquidity and market value of the assets in customers' accounts. Broker-dealers generally avoid unsecured debit balances by requiring customers to fully match their obligations to the broker-dealers with deposits of cash or readily marketable securities or commodities. Even a very large account, assuming its holdings are diversified, can be sold out rapidly in the event of default. The importance of liquid collateral in broker-dealers' extension of credit is recognized in the Uniform Net Capital Rule, which heavily penalizes unsecured credit by requiring an immediate charge to capital for the entire amount of any unsecured customer debit balances and requires substantial deductions from regulatory capital for illiquid assets.

As demonstrated in the silver crisis, however, a broker-dealer cannot rely for protection on the assets in an immediately available account, if the assets are so concentrated in a particular commodity that an attempt to sell them would severely depress the price of the collateral.

bank-type lending limitation, the silver crisis has highlighted the weakness inherent in the present reliance on net capital rule concentration penalties to deter excessive exposure.

In the crisis, the Hunts spread their highly concentrated silver position among a number of firms. An individual firm carrying part of the Hunt position thus had no basis upon which to evaluate the degree of concentration in the portion of the overall position the Hunts maintained with it. 265/ In addition, it is difficult to establish realistic objective standards of concentration in each of the different commodities, maturities and markets in which a firm's customers maintain positions. For both of these reasons, exposure limitation based on market concentration in accounts of an individual customer or customer group is uncertain in application and difficult to monitor, administer and enforce. 266/

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265/ It is particularly difficult for a firm to obtain information about a customer's overall position in the commodities markets. Knowledge of traders' positions is considered sensitive market information. I P. Johnson, Commodities Regulation §3.125 at 575-576 (1982). While the CFTC can collect this type of information, the Commodity Exchange Act currently bars the CFTC from disclosing traders' positions, except to Congress, a court or, under carefully defined circumstances, a contract market. See Sections 8(a), (b) and (e) and 8a(6) of the Commodities Exchange Act, 7 U.S.C. §§12(a), (b) and (e) and 12a(6) (Supp. IV 1980).

In order to enhance its monitoring capability the Commission has amended its Financial and Operational Combined Uniform Single Report (FOCUS Report) to require disclosure by broker-dealers of concentrated securities and commodities positions on a firm wide basis. See Items 5371, 5372, 5375 and 5376 of Form X-17A-5, Securities Exchange Act Release No. 17534 (April 1, 1981). The disclosure by firms does not include information on individual customer positions.

266/ There are no mandatory public reporting requirements for significant commodity positions. Securities traders are required to publicly disclose certain significant securities positions by mandatory reporting requirements. See e.g. Section 13(d), (f) and (g) of the Exchange Act, 15 U.S.C. §78m(d), (f), (g) (1976 & Supp. IV 1980), and rules thereunder. The staff believes that the historical ban on disclosure by the CFTC of trader positions reported to it and the lack of mandatory public disclosure requirements for trader positions need a fresh analysis.

A limitation on the amount of exposure to a particular customer would avoid many of the foregoing difficulties because its efficacy would not depend on the firm's ability to obtain information about the customer's overall position in a market or on a subjective evaluation of market liquidity. There are additional advantages as well. First, since the proposed limitation on exposure to loss could be formulated to reach only unusual situations, it would have little appreciable impact on the day-to-day compliance burden on broker-dealers. Second, by fostering an approach consistent with that employed in the banking industry, the Commission may facilitate uniformity in regulation of essentially similar economic functions. 267/

Whereas a bank's exposure limitations relate only to lending, to be effective a broker-dealer's exposure limitation must encompass other forms of exposure as well as lending. Included in this category are the obligations to clearinghouses incurred by a broker-dealer as guarantor of its customer obligations on commodity futures contracts, receivables from customers, debit balances in accounts, advances to customers and other transactions or relationships in which loss to a broker-dealer could occur.

A precise recommendation as to the measure of an exposure limitation is beyond the scope of the present report. Based on its experience in the investigation, however, the staff believes that a limitation formula should relate permissible exposure to the amount of a firm's total net capital and excess net capital. While a limitation based solely on a percentage of net capital will ensure that a broker-dealer's exposure to loss to a single customer or customer group is appropriate in relationship to the capital position of the firm as a whole, it will not ensure that a firm experiencing default by such customer or customer group will have sufficient regulatory capital to absorb the loss without experiencing

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267/ The staff is aware of the interpretive issues involved in the application of the lending limitation to banks. If the Commission were to adopt such a limit, it would be appropriate to consider issues continually faced in the administration of limitations, such as aggregation of customers and entities for purposes of the limit. As the staff has articulated such a limit, the Commission would be required to define "customer group."

deficiencies. A possible formulation, then, is defined as a percentage of firm's net capital, not to exceed an amount larger than its excess net capital. 268/

Most importantly, the silver crisis has demonstrated the degree to which the increasing centralization of securities and commodities business in a few very large concerns renders the stability of the financial system as a whole more susceptible to disruption by the failure of an individual firm. A direct limit on exposure to loss would, in our opinion, go a long way to insure that these firms would no longer carry the potential for a major dislocation in the financial system.

For the reasons stated above, the staff recommends that the Commission commence rulemaking or propose legislation to limit the degree of exposure that a broker-dealer can incur in connection with the transactions or accounts of a particular customer or customer group. 269/ The staff also recommends that the Commission, in advance of rulemaking, direct a staff study of the issues and recommend an exposure to loss limitation based on a percentage of an easily ascertainable objective measure.

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268/ After the crisis, Bache Group established internally a single-customer commodity credit limit of 15%, and a securities credit limit of 20%, of Bache Group's equity capital.

269/ The Commission has authority to establish such a requirement pursuant to Section 15(c)(3) of the Exchange Act, 15 U.S.C. §78o(c)(3) (1976), which authorizes it to

> * * * prescribe as necessary or appropriate in the public interest or for the protection of investors to provide safeguards with respect to the financial responsibility and related practices of brokers and dealers * * *

To the extent that transactions by the non-broker-dealer parent or affiliates of a broker-dealer carry the potential to impair the financial responsibility of the broker-dealer, Section 15(c)(3) empowers the Commission to promulgate rules establishing appropriate safeguards.

To the extent that the purpose of a limitation on exposure to loss is to protect the stability of these entities as financial institutions, rather than merely to further broker-dealer stability, the Commission may wish to recommend legislation that would provide for greater authority to direct the overall activities of a broker-dealer's holding company in instances in which a broker-dealer is the principal asset of the holding company in order to ensure financial stability.

## III. THE NET CAPITAL RULE

### A. Introduction

The net capital rule is the cornerstone of the Commission's financial responsibility requirements for broker-dealers. As the Commission stated in promulgating the rule, 270/ and as has been reiterated in Commission 271/ and judicial decisions, 272/ the basic concept of the rule is liquidity. The rule's objective is to insure that a broker-dealer has at all times sufficient liquid assets to cover its current indebtedness. A broker-dealer's "net capital", accordingly, is essentially its net worth less deductions for illiquid assets. 273/ Nonmarketable securities, for example, are entirely excluded from net capital, and marketable securities are includable in net capital subject to deductions (known as "haircuts") to take into account fluctuations in market value. Concentrations of securities are subject to additional "haircuts" to take into consideration the illiquidity of such positions. Regulations related to the net capital rule provide for "early warning" of potential capital deficiencies. Rule 17a-11 and related rules of the SROs require every broker-dealer subject to the net capital rule to give notice to the Commission 274/ and the

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270/ Securities Exchange Act Release No. 8024 (Jan. 18, 1967). As indicated above the Uniform Net Capital Rule was not promulgated until 1975. See discussion supra n. 249 at 248.

271/ See, e.g., Guy D. Marionette, 11 S.E.C. 967, 970-71 (1942); John W. Yeaman, Inc., Securities Exchange Act Release No. 7527, February 10, 1965; Lowell H. Listrom Company, Inc., Securities Exchange Act Release No. 16750 (April 16, 1980).

272/ Don D. Anderson v. Securities and Exchange Commission, 423 F.2d 813 (10th Cir. 1970); Securities and Exchange Commission v. C.H. Abraham & Co. Inc. et al., 186 F.Supp. 19 (S.D.N.Y. 1960).

273/ See Rule 15c3-1(c)(2), 17 C.F.R. §240.15c3-1(c)(2) (1981).

274/ The rule provides for notice to the Commission's principal office and regional office for the region in which the broker-dealer has its principal place of business. In addition, it requires notice to the Commodity Futures Trading Commission if the broker-dealer is registered with the CFTC. See Rule 17a-11(f), 17 C.F.R. §240.17a-11(f) (1981).

SROs of conditions that may indicate potential problems. 275/ Both the protections of the net capital rule and the proper functioning of the early warning provisions depend on accurate valuation of customer and proprietary commodities positions.

B. Use of Futures Prices to Value Customer Accounts

Throughout the long history of the net capital rule, the value assigned to securities and commodity positions has been "market value". Thus, Rule 15c3-1(c)(2)(i)(B)(1) provides:

> In determining net worth, * * * all * * * securities and commodities positions shall be marked to their market value * * * 276/

Appendix B to the Uniform Net Capital Rule, which applies specifically to commodity transactions, 277/ does not otherwise address the value to be assigned to open trade futures positions in customer accounts. 278/ Notwithstanding the language just quoted, industry practice has been to value open trade futures positions in other than the spot month at the settlement price quoted

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275/ In lieu of telegraphic notices, reports may be required to be filed. See e.g., Rule 17a-11(b)(1), 17 C.F.R. §240.17a-11(b)(1) (1981).

276/ 17 C.F.R. §240.15c3-1(c)(2)(i)(B)(1) (1981). A very large position in a stock that is otherwise easily marketable may be difficult to dispose of without a significant reduction in current market price and a discount will be applied in its valuation. See e.g., Wolfson and Guttman, The Net Capital Rule for Brokers and Dealers, 24 Stanford L.R. 603, 623 (1972). Illiquid assets must be completely excluded. Carter Harrison Corbrey, 29 S.E.C. 283, 287 (1949)

277/ Rule 15c3-1b, 17 C.F.R. §240.15c3-1b (1981).

278/ At the time of the events described in the report of investigation, the rules of contract markets (e.g. Comex and CBT) furnished little guidance in this area. As discussed herein, Comex Original Margin Rule Q, adopted May 28, 1982, in part addresses the valuation issue discussed in the text.

by the exchanges for each maturity of each contract in the position. This practice has been followed even in markets in which price movement limitations have created dramatic spreads between quoted futures prices and the true market value of the position. This valuation has been used in computing equity or deficit in accounts, as well as margin requirements. As noted elsewhere throughout this report, this practice contributed to the silver crisis by allowing broker-dealers to assign inflated values to the Hunts' silver futures accounts, thereby reducing or delaying margin calls and masking liquidating deficits in the accounts.

Commodity exchanges often impose daily fluctuation limitations on the trading price of commodity futures contracts. 279/ Generally in the spot month, as well as in the cash or physicals market, prices fluctuate freely. In a rapidly declining market, prices can rise or fall far faster than futures prices restrained by price fluctuation limitations. While in ordinary markets spreads between spot prices and futures prices may be relatively stable, in highly volatile markets containing substantial uni-directional market price movement, such as silver in early 1980, those spreads can become very wide. When price limited trading conditions exist, as they did in Comex silver on many of the trading days from January 1 through March 31, 1980, 280/ it is, as a practical matter, impossible to liquidate a long back month futures position at the quoted futures price; the cash or spot month price, less a transaction premium, is the only value that may be obtained on liquidation of the position.

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279/ Price fluctuation limitations may be variable. For example, Comex Silver Rule 5 provides a basic per day limit of fifty cents per ounce, which can be expanded to seventy-five cents per ounce or one dollar per ounce, depending on trading conditions. Commodity Exchange, Inc., By-Laws, Rules & Regulations, Chapter 9 at 9 (1982). The CFTC is concerned with this issue. *See* Commodities Futures Trading Commission, "Advance Notice of Proposed Rulemaking: Contract Market Sales and Practices Governing the Imposition and Maintenance of Price Limits," 45 Fed. Reg. 55469 (Aug. 20, 1980).

280/ In the silver markets in March 1980 the differences between Comex futures and spot prices was, at least at one date, over $13 per ounce. Thus, the value distortion in an account with one 5,000 ounce contract would be $65,000, in a 50 contract account, the distortion would be $3,250,000 and in a 1,000 contract account, the distortion would be $65,000,000. This distortion would not be reflected on standard account documentation. The artificial values are, under current industry practice, used in computing whether an account is in deficit.

The net capital rule requires commodity positions to be valued at "market value". As indicated, back month futures prices may not be realizable upon liquidation of the position in adverse price limited trading conditions. The staff believes the use of futures prices in these conditions is inappropriate and contravenes the principle of the net capital rule that commodities positions be valued at market value.

In a declining price limited market, valuing net long open trade futures positions at futures settlement prices in price limited trading conditions inflates the liquidating value of a customer position and masks the true worth of the account. 281/ It results in deficits not being recognized when incurred and delays margin calls 282/ that would otherwise be generated in an account.

As a hypothetical example of this delaying effect, assume that an account holds long back month silver futures positions and that the account can withstand a $3 per ounce drop in the price of silver before generating a margin call and a $10 per ounce drop in price before a liquidating deficit will arise. 283/ Assume also that the

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281/ Valuing short futures positions at futures prices in a price-limited rising market has the same effect.

282/ The Uniform Net Capital Rule looks to the margin requirements of the applicable board of trade or clearing association to determine the time and amount of variation margin calls in customer accounts. As indicated above, industry practice is to use futures prices to value these positions. Until May 28, 1982, Comex rules were silent as to the valuation of open positions for purposes of determining margin calls.

283/ In considering this simplified hypothetical, it should be borne in mind that broker-dealers are free to require larger margin deposits from all or selected customers. Many broker-dealers often do require larger deposits. See Commodity Futures Trading Commission, 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) Part II at 8 (1981). The example in the text is for illustrative purposes only. Actual positions, margin requirements, price fluctuation limitations, equities in customer accounts and other factors would all figure in the magnitude of the delaying effect in any particular instance.

market for silver drops and thus the cash market or spot month price of the commodity drops $5 per ounce per day for three days. Assume also that the exchange limited movement in back month futures prices is $1 per day. Under these conditions, on the second day the actual value of the account will be negative--a liquidating deficit. Under current industry practice, however, the first margin call would not be generated until the third day (the day after a deficit in the account arose) and the call would not be issued to the customer until the fourth day. It will take six more days after the date of the first margin call is communicated to the customer for the full amount of the loss occurring in a two day period eight days earlier, to be recognized in account documents. Obviously, such a system can result in the accumulation of staggering potential losses before the first margin call is generated. On the other hand, if cash market or spot month prices are used, a margin call would be generated, communicated to the client, aged, and charged to capital, thereby assuring an accurate evaluation of the firm's capital position. This method would also have the salutary effect of alerting both the client and the firm to actual market conditions.

As described elsewhere in this report, this delay resulted in Bache Halsey generating its first "rule" margin call in Hunt accounts on March 19, several days after the Hunt accounts had fallen into a liquidating deficit large enough to create a net capital deficiency in the firm. 284/

The Commission has plenary authority under Section 15(c)(3) to define "market value" for open trade commodity futures positions for broker-dealers carrying such positions. The staff recommends that the Commission undertake rulemaking, in consultation with CFTC, to amend the net capital rule to define "market value" for commodity futures positions to be cash market or spot month prices in "limit-up" or "limit-down" trading conditions, and to

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284/ It is noteworthy that Edwards and Paine Webber, which on March 27 erroneously informed the NYSE and the press, respectively, that they would experience no loss in Hunt accounts, attributed their error to the use of futures prices rather than spot prices in valuing the Hunt accounts.

require firms for net capital purposes to use such values to compute margin requirements and account equities or deficits. 285/

The measure herein proposed is not without precedent in the industry. On May 28, 1982, the Comex adopted Original Margin Rule Q, 286/ which requires firms to collect additional margin from a customer on certain days in which a price limited market moves against his position. The amount to be collected must be sufficient to margin the position to the "spot month" settlement price 287/ plus or minus certain differentials. 288/ To the extent additional margin is required under the rule, the rules provide for various forms of collateral including some irrevocable letters of credit to be accepted by members and member firms as margin.

In effect, Original Margin Rule Q requires the use of spot prices to value open trade futures positions for purposes of collecting margin in price-limited trading markets. The rule is an important step towards correct valuation of open trade futures positions in these markets.

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285/ Obviously, careful consideration of the exact formulation of the rule would be necessary. The Commission may wish not to value long open trade futures positions to spot in a rising market or short open trade futures position to spot in a falling market as these positions are increasing in value and can be liquidated at futures prices. It may also be appropriate to consider adjustments for market price structure.

286/ Commodity Exchange Inc., By-Laws, Rules & Regulations, Chapter 6 at 12-13 (1982).

287/ Spot month is defined in Original Margin Rule Q as the nearest maturity for which futures contracts are traded for a particular commodity.

288/ The differentials are designed to take into consideration price structures, known as "contango" and "backwardation", in which, in the absence of certain price limited trading conditions, the settlement price of the back months exceeds the settlement price of the spot month, or the settlement price of the spot month exceeds the settlement price of the back months, respectively.

The rule should help to protect broker-dealers from losses by reducing, in part, the valuation problems and delaying effects of the use of futures prices referred to above.

The Comex rule also will have an impact on net capital calculations. As discussed more fully below, the net capital rule incorporates certain commodity exchange rules by reference. It is not, however, dispositive of the staff's concerns. First, the Comex rule applies only to commodities traded on that exchange. Second, the rule does not address valuation for purposes of computing account equity or deficit. Finally, the rule itself is subject to change without regulatory oversight. 289/

It is important that the valuation of customer commodity accounts in these aberrant market environments 290/ be made consistent with the underlying purposes of the net capital rule and its emphasis on realistic assessment of the immediately realizable value of assets. The Commission, with the CFTC, should address this issue. 291/

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289/ Section 5a(12) of the Commodity Exchange Act, 7 U.S.C. §7a(12) (Supp. IV 1980), specifically provides that rules "relating to the setting of the levels of margin" need not be submitted to the CFTC for its approval.

290/ The staff would not recommend the use of spot month prices to value all open trade futures positions, only those positions experiencing adverse limit-up or down trading conditions.

291/ The competitive disadvantages to broker-dealers/FCMs of unilateral action by the Commission are obvious. Although the Comex has instituted Original Margin Rule Q, the use of cash market or spot month prices to value commodity accounts would be a fundamental change for other commodity exchanges. As a practical matter, brokers subject to such a regulation would call customers for valuation margin both sooner and in larger amounts than firms not subject to such a regulation. Thus, the resolution of this issue by the CFTC and the Commission should be economically and competitively neutral.

## C. Incorporation of Margin Requirements of Commodities Exchanges

During the time of the crisis, and at present, for purposes of computing deductions to net capital for under-margined commodity accounts Appendix B of the net capital rule incorporated by reference the maintenance margin requirements of the applicable boards of trade, or if there are no such requirments, then the clearing organization margin requirements applicable to such positions. 292/

Stated simply, when a board of trade increases margin requirements, the Uniform Net Capital Rule automatically requires greater margin, thus increasing customer protection. Similarly when margins are lowered, the Uniform Net Capital Rule requires less margin, thus decreasing customer protection. Therefore, because of this incorporation, unilateral action by boards of trade or clearing associations will directly affect the level of financial protection afforded by the net capital rule. The staff believes that the Commission should consider whether it believes it to be appropriate for the level of protection afforded by the net capital rule to be within the discretionary authority of these entities. 293/

It should be understood that, despite the fact that commodities transactions of a broker-dealer may not be its predominant business, the effect of margin increases and decreases can be dramatic. An example is the 33% reduction in Comex margins on March 26th. Faced with capital changes resulting from aged margin calls in the Hunt accounts, Bache turned to Comex to suspend trading and fix settlement

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292/ *See*, Rule 15c3-1b(3)(xii), (xiii) and (xiv), 17 C.F.R. §§240.15c3-1b(3), (xii), (xiii) and (xiv) (1981).

293/ The Commission also incorporates by reference the maintenance margin requirements of the examining authority for broker-dealers in determining the amount of charges to net capital for outstanding margin calls related to securities positions. *See* Rule 15c3-1(c)(2)(xii), 17 C.F.R. §240.5c3-1(c)(2)(xii) (1981). However, rules relating to maintenance margin by examining authorities, such as those of NYSE, are subject to, and shall not take effect, until approved by the Commission. *See* Section 19(b)(1) under the Exchange Act, 15 U.S.C. §78s(b)(1) (1976). Obviously, the Commission has no such similar authority over boards of trade or commodities clearing organizations.

prices or reduce margin requirements. 294/ The Board acted favorably on the second Bache request and voted to reduce margin requirements from $60,000 to $40,000 per contract. 295/ This reduction permitted Bache to apply $80 million of what had been the Hunts' original margin deposit to satisfy variation calls with the clearing association. The earliest of the Hunts' aged variation margin calls were eliminated and no capital charges were required. This result occurred despite the fact that the Hunts deposited no additional cash or bullion, there had been no favorable improvement in silver prices and the liquidating value of the accounts had not increased. 296/

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294/ During the market conditions in cottonseed oil futures which adversely affected Ira Haupt & Co., Haupt advised the relevant exchange and clearing association that it would be unable to meet its margin requirements should the market continue to drop. Thereafter, the exchange did not reopen, trading was suspended, and settlement prices fixed. Seligson v. New York Produce Exchange, 378 F.Supp. 1076, 1082 (S.D.N.Y. 1974).

295/ This example is chosen because of the dramatic impact on broker-dealers of the Comex reduction in margins. It should be noted that the margins in effect at the time were extremely high in relation to historical silver margins. The staff's point is not intended to address the issue of the appropriate level of silver margin, or whether this action by Comex was appropriate. Rather, it has been chosen to illustrate, and this discussion addresses, the effects of incorporation by reference of board of trade margin requirements on the level of protection afforded by the Commission's Uniform Net Capital Rule.

296/ The Commission and the CFTC have recently taken important steps to reduce the amount of time a margin call may be outstanding before a charge or adjustment to net capital must be taken. See Securities Exchange Act Release Nos. 17564 (February 20, 1981), 17927 (July 9, 1981); Commodity Futures Trading Commission," Proposed rule amendments: Minimum Financial and Related Reporting Requirements," 45 Fed. Reg. 42633 (June 25, 1980); Commodity Futures Trading Commission, "Final Rules: Minimum Financial and Related Reporting Requirements," 45 Fed. Reg. 79416 (December 1, 1980). These changes are helpful in assuring broker-dealer financial stability, but do not address or resolve the problem raised here.

The situation on March 26 is only an example. The level of margin requirements for commodity futures positions is within discretionary authority of commodity exchanges and the level can be lowered or raised by exchanges' unilateral action. Section 5a(12) of the Commodity Exchange Act explicitly excepts the "setting of levels of margin" from those rules which must be submitted to the CFTC for approval. Each change in the level of commodity futures margin requirements affects the quality, timing and level of financial protection afforded by the net capital rule. Had the market in silver continued to drop and had the Comex continued to lower margin, Bache and others would have been able to continue to defer recognizing the massive losses mounting in accounts in computing regulatory capital. The staff is not suggesting that the Comex would or would not have taken such action. The example, however, serves to illustrate that when the Uniform Net Capital Rule incorporates board of trade or clearing association rules, the level of protection afforded by the rule is subject to change without effective control or oversight by the Commission.

By illustrating this weakness, the staff is not necessarily advocating that the margin setting authority be removed from commodity exchanges or clearing associations. 297/ The staff believes, however, that after further deliberation some alternative to the current scheme of regulation should be developed which will be compatible with commodities activities of broker-dealers yet assure that the levels of financial protections afforded by the net capital rule are not subject to reduction by the unilateral action of commodities exchanges.

## IV. ADEQUACY OF CREDIT INFORMATION

### A. Introduction

Another notable feature of the silver crisis was the extent to which broker-dealers lent to the Hunts without detailed information on the then-current extent of the Hunts' overall silver position, their cash resources or their maturing debt or contractual obligations.

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297/ In the past the Commission has stated its opinion that it may be appropriate for a federal entity to have, at a minimum, oversight over margin on futures. See Statement of Philip A. Loomis, Jr. before the Subcommittee on Conservation, Credit, and Rural Development of the House Committee on Agriculture (October 1, 1981); Statement of Harold M. Williams, before the Senate Committee on Banking, Housing and Urban Affairs (May 29, 1980).

The staff believes that a regulation requiring firms to obtain and review comprehensive customer financial information and to keep that information current would help assure that credit decisionmakers have adequate information upon which to evaluate customers' accounts. The staff believes, however, that establishing the limitations on exposure to loss recommended in the foregoing section of this report should eliminate, in substantial part, the need for more extensive financial information requirements and would entail substantially less burdensome compliance procedures.

B. Existing "Know Your Customer" Rules

Present standards pertaining to customer information required to be obtained by broker-dealers are embodied in rules of self-regulatory organizations. The most significant and best known of these is Rule 405 of the New York Stock Exchange. 298/ These "know your customer" rules

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298/ New York Stock Exchange, Rules of Board, Diligence as to Accounts, Rule 405, N.Y.S.E. Guide (CCH) ¶ 2405. New York Stock Exchange Rule 405 is popularly known as the "know your customer" rule. It provides in relevant part:

> Every member organization is required through a general partner, a principal executive officer or a person or persons designed under the provisions of Rule 342(b)(1) to
>
> > (1) Use due diligence to learn the essential facts relative to every customer, every order, every cash or margin account accepted to carried by such organization and every person holding power of attorney over any account accepted or carried by such organization.
> >
> > (2) Supervise diligently all accounts handled by registered representatives of the organization.
> >
> > (3) Specifically approve the opening of an account prior to or promptly after the completion of any transaction for the account of or with a customer, provided, however, that in the case of branch offices, the opening of an account for a customer may be approved by the manager of such branch office but the action of such branch officer manager shall within a reasonable time be approved by a general partner, a principal executive officer, or a person

Footnote continued on next page.

obligate broker-dealers to know the background of their customers and to supervise their accounts on a continuing basis to be assured of their customers' ability to meet their financial obligations. 299/ In addition to obtaining all essential facts relating to every customer and every account prior to opening the account, the NYSE requires brokers to review customer accounts monthly to discover excessive concentrations of securities, paying particular attention to low-priced speculative situations, excessive trading in particular accounts, late payments by customers and prepayments to customers. 300/ NYSE Rule 405 and other rules apply to commodities accounts carried by broker-dealers. 301/

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Footnote continued from previous page.

> or persons designated under the provision of Rule 342(b)(1). The member, general partner, officer or designed persons approving the opening of the account shall, prior to giving his approval, be personally informed as to the essential facts relative to the customer and to the nature of the proposed account and shall indicate his approval in writing on a document which is a part of the permanent records of his office or organization.

299/ Nelson v. Hench, 428 F. Supp. 411, 419 (D. Minn. 1977).

300/ New York Stock Exchange, Manual on Supervision and Management of Registered Representatives and Customer Accounts (1962) (hereinafter "Supervision Manual"). The Supervision Manual has recently been revised. New York Stock Exchange, Patterns of Supervision - A Guide to the Supervision and Management of Registered Representatives and Customer Accounts (1982) (hereinafter "Revised Manual").

301/ Some rules speak specifically to commodities accounts see, e.g., New York Stock Exchange, Rules of Board, Transactions - Employees of Exchange, Member Organizations or Certain Non-Member Organizations, Rule 407, N.Y.S.E. Guide (CCH) ¶ 2407. Rules which do not speak specifically to commodities trading have nonetheless been enforced by SROs with respect to both securities and commodities trading. See, e.g., District Business Conduct Committee v. L.L. Cereghino, NASD No. C.A. 861 (District No. 2, August 17, 1981) (suspension of registered representative for unauthorized commodities transactions in customer account on the ground that such actions violated §1, Art. III of the NASD Rules of Fair Practice) and In the Matter of Andrew J. Remington, NYSE Hearing Panel Decision 81-42 (May 21, 1981) (Registered Representative barred from commodities trading for seven months for trading in commodities futures in customer accounts without written authorization).

As a vehicle for insuring the adequacy of information in credit decision-making, Rule 405 is deficient in that it does not provide specific information requirements. 302/ Indeed, the Supervision Manual in effect at the time of the silver crisis explicitly reserved to firms broad discretion in the Rule's application. The Manual describes that the Rule:

> is written so as to leave to the firm's judgment what facts are essential in the varying circumstances of each new account. The facts essential in the opening of one account may not be sufficient for the opening of another account. 303/

Although the text just quoted suggests that Rule 405 has been broadly written to permit or encourage firms to seek more information in accounts with greater exposure, the Rule's generality has also permitted firms to seek less information from customers. This can occur especially where such a practice may produce an advantage over competitors. Particularly in situations involving larger, more lucrative accounts, competitive considerations provide disincentives to vigorous pursuit of the Rule's objectives. Unless every broker-dealer insists on the same degree of financial disclosure by a customer, there will be a tendency for firms to relax standards to lure or retain profitable business from customers who resist disclosure of financial information. It is, ironically, these large, profitable accounts, frequently trading in size in volatile markets, that create the greatest exposure for a firm and hence require the most extensive customer information for effective risk management. Similarly, self-regulatory organizations may be reluctant to enforce strict interpretation of "know your customer" rules for fear that certain business that would otherwise go to its members would be driven into other markets. Both of these conditions were present during the events leading up to the silver crisis.

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302/ The "know your customer" rules serve several functions. One purpose is to protect brokers from defaulting customers. Another purpose is to provide a basis of information about customers so that brokers recommend suitable investments. Securities and Exchange Commission, Report of Special Study of Securities Markets, H. Doc. No. 95, 88th Cong., 1st Sess. 316 (1963).

303/ Supervision Manual at 7. Accord, Revised Manual at 41.

While it is neither currently applicable to commodity accounts, nor mandatory in its application, NYSE Rule 721, 304/ adopted as a part of the rigorous suitability requirements for options trading, is more specific than Rule 405 in delineating information required to be obtained. 305/ However, Rule 721 provides, in pertinent part, that:

> Refusal of a customer to provide any of the information called for in * * * this Rule shall be so noted on the customer's records at the time the account is opened. Information provided shall be considered together with the other information available in determining whether and to what extent to approve the account for options transactions. 306/

Customer refusal to supply information thus does not preclude opening the account, and the same competitive disincentives to compliance exist in Rule 721 as are created by Rule 405's lack of specificity. Thus, were the Commission to adopt financial information requirements, although Rule 721 would be helpful, as a model it is not sufficiently mandatory to be effective in this area.

In addition to the competitive disincentives to compliance already noted, existing "know your customer" rules have a number of other inadequacies as tools for risk management. Most notably, in light of experience in the silver crisis, existing regulations:

1. Do not require firms to obtain information about customers' positions at other firms;

2. Do not require firms to learn the extent or timing of customers' maturing debt or contractual obligations or the extent of the liquid resources available to meet them; and

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304/ New York Stock Exchange, Rules of Board, Opening of Accounts, Rule 721, N.Y.S.E. Guide (CCH) ¶ 2721.

305/ In its recent "Options Study", the Commission's staff thoroughly studied the existing "know your customer" rules, and discussed additional requirements, embodied in large part in NYSE Rule 721, necessary for options trading. Thus, the staff has recently revisited the current state of these "know your customer" rules. See generally, Report of the Special Study of the Options Market to the Securities and Exchange Commission, House Comm. on Interstate and Foreign Commerce, 96th Cong., 1st Sess. (1978).

306/ N.Y.S.E. Guide (CCH) ¶ 2721 at 4553.

3. Do not require firms to obtain the foregoing information on a current basis rather than solely upon the opening of an account.

It was precisely this information that broker-dealers lacked in the winter and spring of 1980 as they maintained or increased the Hunt silver positions they carried.

C. Requirements for Financial Information

The foregoing analysis suggests that existing "know your customer" rules are inadequate as risk management tools when the issue of sufficient information for exposure to loss and credit decision-making is considered. In resolving the issue of inadequate financial information of customers, however, there are a number of factors to consider.

Most fundamentally, the staff believes that the Commission must determine whether it wishes to continue broad discretion to the management of individual firms to make credit and exposure determinations that can affect the stability of the entire industry. If so, then the most appropriate response to the silver crisis may be to impose new financial information regulations to insure that firms have appropriate information to make responsible judgments, without placing any restrictions, as would exposure limitations, on the substance of the judgments made. If, on the other hand, the Commission wishes to protect the stability of individual firms and the industry by establishing limitations on exposure to loss, then detailed and mandatory financial information rules would not be as essential.

The staff favors limitations on exposure to loss for several reasons:

(1) Regulations requiring that firms obtain financial information from customers do not offer any assurance that broker-dealers will not incur excessive exposure to loss, overextend lending or make poor judgments. As such, these regulations cannot go as far as assuring the stability of broker-dealers as can a direct limitation on exposure to loss;

(2) Any adequate financial information regulation would necessarily require obtaining and frequently updating such detailed information;

(3) Jurisdictional problems, limited enforcement resources and the complexity inherent in such a provision would, as a practical matter, make it difficult to enforce its requirements so as to eliminate the competitive disincentives to compliance associated with present regulation; and

(4) Customer and firm resistance to such a regulation can be anticipated.

A limitation on exposure to loss would as discussed 307/ be less intrusive and more simple to prescribe, administer, and enforce. On balance, the staff does not recommend rules prescribing required customer financial information preferring as an alternative to a limitation on exposure to loss. Were such a limitation to loss put into place, the Commission will have time to evaluate its effectiveness and consider whether minimum financial information regulations are necessary or appropriate.

## V. DISCLOSURE OBLIGATIONS

### A. Introduction

Certain entities involved in the "silver crisis" were subject to a variety of disclosure obligations because of their or their parents' status as publicly held corporations. 308/ The staff found no disclosure to investors of the existence or extent of the exposure in certain firms that ultimately led to the crisis. 309/ As a consequence, public investors were not aware of the risks and exposure to loss due to the effects of the crisis at certain entities. It is important to again emphasize the need for issuers to timely disclose to the investing public material information and changes in financial condition.

#### 1. The Significance of Disclosure

It is difficult to overstate the significance of disclosure of information to the investing public. Congress and the Commission have reiterated the need for, and significance of, timely disclosure of information to investors.

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307/ *See* discussion *infra* at pages 252 to 256.

308/ Bache, Merrill Lynch, Paine Webber, Dean Witter and Hutton are, or were at the time of the crisis, principal subsidiaries of publicly held corporations. Edwards is a publicly held broker-dealer.

309/ In this discussion the staff offers no opinion on the adequacy of disclosure by the broker-dealers discussed in this report with respect to their responsibilities under the reporting and anti-fraud provisions of the federal securities laws.

Congress has, beginning in 1934, stated the significance for investors of adequate and accurate information about issuers. 310/ The Commission repeatedly has recognized these needs for information. 311/ The New York Stock Exchange has recognized the need for timely disclosure. 312/

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310/ The House Report on the Securities Exchange Act states:

> "No investor, no speculator, can safely buy and sell securities upon the exchanges without having an intelligent basis for forming his judgments to the value of the securities he buys or sells. The idea of a free and open public market is built upon the theory that competing judgments of buyers and sellers as to the fair price of a security brings about a situation where the market price reflects as nearly as possible a just price. Just as artificial manipulation tends to upset the true function of an open market, so the hiding and secreting of important information obstructs the operation of the markets as indices of real value. There cannot be honest markets without honest publicity." H.R. Rep. No. 1383, 73rd Cong., 2d Sess. 11 (1934).

311/ *See* "Timely Disclosure of Material Corporate Developments", Securities Act Release No. 5092, (October 15, 1970); "Publication of Information Prior to or After the Filing and Effective Date of a Registration Statement under the Securities Act of 1933", Securities Act Release No. 5009 (October 7, 1969); "Notice to Registrants Engaged in Defense and Other Long Term Contracts and Programs of the Need for Prompt and Accurate Disclosure of Material Information Concerning Such Activities", Securities Act Release No. 5263 (June 22, 1972); "Disclosure of the Impact of Possible Fuel Shortages on the Operation of Issuers Subject to the Registration and Reporting Provisions of the Federal Securities Laws", Securities Act Release No. 5447 (December 20, 1973); "Report of Investigation in the Matter of Sharon Steel Corporation as it Relates to Prompt Corporate Disclosure", Securities Exchange Act Release No. 18271 (November 19, 1981).

312/ The timely disclosure of information is especially significant to securities exchanges upon whose facilities the securities of listed companies are traded. The New York Stock Exchange Company Manual sets forth the affirmative disclosure obligations of New York Stock Exchange listed companies.

Footnote continued on next page.

In addition to recognizing needs for timely disclosure, the Commission has recently enhanced the mandatory disclosure system to require management's discussion and analysis of financial condition and results of operations. 313/ The staff believes that these obligations, by requiring, for example, identification of uncertainties that are reasonably likely to result in the registrant's liquidity increasing or decreasing in any material way, comprehensively address financial changes such as occurred in the silver crisis. 314/ These disclosures must be fully addressed by issuers in the annual report on Form 10-K 315/ and updated in the quarterly report on Form 10-Q. 316/

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Footnote continued from previous page.

> "A corporation whose securities are listed on the New York Exchange Inc. is expected to release quickly to the public any news or information which might reasonably be expected to materially affect the market for those securities. This is one of the most important and fundamental purposes of the listing agreement which each corporation enters into with the Exchange." New York Stock Exchange, N.Y.S.E. Company Manual, Section A2, Part 1 at A-18.

The N.Y.S.E. Company Manual "codifi[es] the policies, requirements, procedures, and practices of the Exchange relating to listed companies and their securities" (Id., Introduction).

313/ See SEC Integrated Disclosure Adoptions, Securities Act Release Nos. 6383, 6384, 6385 (March 11, 1982).

314/ See Item 303(a)(1) of Regulation S-K contained in Securities Act Release No. 6383. Regulation S-K is to be codified at 17 C.F.R. 240.100 et seq.

315/ See Sections 13 and 15(d) of the Exchange Act, 15 U.S.C. §78m and 78o (1976 & Supp. IV 1980). See description of Form and Form at Fed. Sec. L. Rep. (CCH) ¶ 27,047, 31,101. These disclosures must also be addressed in an issuer's annual report to shareholders.

316/ See Rules 13a-13 and 15d-13 under the Exchange Act, 17 C.F.R. §§240.13a-13; 240.15d-13 (1981). See description of Form and Form at Fed. Sec. L. Rep. (CCH) ¶¶ 27,045A, 31,031.

The dissemination of this report will again serve to caution issuers regarding their responsibilities under the federal securities laws and to remind issuers of the importance of disclosing on a timely basis to the market place material changes in a registrant's financial condition.

### 2. Improvements for Disclosure of Adverse Effects of Customer Defaults

It is important for investors to be aware on a timely basis if the total obligations of a single customer to, or directly affecting, a business segment of an issuer are so significant that an event of default by a customer would have an adverse effect on the segment. 317/

One framework to discuss these issues might be to recommend amending Regulation S-K to include disclosure of the adverse effects of customer default taking into consideration total lending to a customer, total obligations of a customer in effect guaranteed by the issuer, total receivables from a customer including margin calls or calls for other deposits of cash or other assets by an issuer, or other obligations which would result in loss to a segment upon the event of a default of a customer. 318/

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317/ The Commission has considered analogous disclosures of this type important. At the time of the events of the silver crisis, prior to the adoption of the integrated disclosure system (See Securities Act Release Nos. 6383, 6384, 6385; (March 11, 1982)) Item I(c)(vii) of Regulation S-K required disclosure of the dependency of a business segment upon a single customer or a few customers, the loss of anyone of whom would have an adverse effect on the segment. With certain amendments, this particular disclosure obligation has been included in the updated Regulation S-K. See Item 101(c)(vii) of Regulation S-K.

318/ The proposed change would elicit disclosure of futures positions because they are obligations where an issuer stands as guarantor of individuals' obligations under the futures contracts comprising positions. I P. Johnson, Commodities Regulation §2.43 at 279 (1982). The broker-dealer, as a member of exchange clearing organizations, is obligated to deposit cash clearing margins to support its customers positions and to perform on the obligations of each contract by standing for or making delivery of the underlying commodity.

Footnote continued on next page.

Again, because of the directed nature of this report, the staff has not considered on an issuer or industry wide basis, the appropriate timing or placement of such a disclosure obligation. This issue would appear ripe for the Commission to direct the staff to consider the appropriate form, placement and frequency for disclosure of the adverse effects of potential customer defaults.

Although the report has focused on concentrated commodities positions the staff believes that concentrated securities positions hold the potential for effects on broker-dealers and issuers similar, though in many respects less volatile, to concentrated commodities positions. The staff recommends that disclosure requirements in this area be reviewed to consider whether additional or amended requirements are appropriate.

3. Disclosure of Contingent Liabilities

As previously noted, broker-dealers carrying customer commodity positions stand as guarantors of customers' obligations to clearinghouses. Where the commodity futures obligations of particular customers, concentrated in one or a few markets, become so substantial as to be material to the financial condition of a firm, disclosure of firms' guarantee of these obligations as contingent liabilities may be warranted. While FASB 5 appears applicable to such a situation, it does not specifically address liabilities associated with customer commodity positions. There may be, accordingly, a need for guidance in this area.

The staff recommends that the groups with responsibility for the establishment of accounting standards, such as the FASB and the AICPA, in cooperation with the Commission staff, review current standards with a view to determining if clarification is required of disclosure obligations under these circumstances.

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Footnote continued from previous page.

Thus, if a customer defaults on margin calls, the broker-dealer is nevertheless liable to the clearing agency for clearing margin in full, and if the customer's positions are liquidated to a deficit, the broker-dealer bears the risk of loss.

The proposed improvement would elicit disclosure of loans from brokers secured by physical commodities because they are an obligation where a default exposes an issuer to loss.

## VI. SELF-REGULATORY ORGANIZATION OVERSIGHT

In the staff's view, the Exchange's failure to identify on a timely basis the crisis and the consequent failure to take timely remedial action, was due to the fact that the Exchange based its surveillance of its members involved in the silver crisis on a belief that it would be provided candid, accurate, and complete information promptly and spontaneously. As discussed in the part on the New York Stock Exchange, this did not occur. Based upon its review, the staff believes that the Exchange should implement better procedures for the conduct of surveys that, in cases of substantial consequence such as encountered during the silver crisis, would include, at a minimum, submission to the Exchange of hard copy data, field verification of such data, and attestation of the accuracy of data submitted to the Exchange by a senior officer of a firm. As detailed in this report, there was a significant breakdown in the coordination and exchange of information between the Field Examination Section and the Surveillance Coordination Section. The Exchange's organizational bifurcation of surveillance responsibilities between these sections clearly did not work. Although the Exchange has recently merged these sections, the Exchange should adopt procedures and supervisory controls to assure the closest possible coordination between the individuals performing the surveillance and examining functions.

## VII. SEGREGATION OF COMMODITIES AND SECURITIES ACTIVITIES

Most broker-dealers who engage in commodities and securities transactions generally conduct both in one entity. Since the occurrence of the events described in this report, at least one major broker-dealer, motivated in part by its experience in the silver crisis and in the wake of a long-term study begun before the crisis, has reorganized its corporate structure to place its commodities activities into a subsidary of the the broker-dealer. The concept of requiring commodities activities to be placed into a separate subsidiary raises policy and economic implications which go beyond the scope of this report. The discussion herein is merely to inform the Commission that this structure could be considered an alternative to further regulation of commodities activities. 319/ Segregation from a broker-dealer of the risks associated with commodities trading would, in theory, protect the broker-dealer if its commodities affiliate were to experience financial difficulty because of abusive practices or significant losses. 320/

Segregation may be costly and complex. There are several major components to the additional costs associated with creating a separate subsidiary. There may be substantial start-up costs associated with the creation of the new entity. In addition, the creation of a separate subsidiary would require allocation and possibly less efficient use of total available capital in order to support regulatory minimum financial requirements in the separately capitalized entities. The financial strength of each may be reduced. Moreover, the separate entities

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319/ Putting high risk activities outside the broker-dealer structure may remove them from effective regulation. For example, once the government securities activities of a broker-dealer are placed in a separate subsidiary of a corporate parent, generally speaking, the Uniform Net Capital Rule no longer functions to prevent the newly-formed government securities dealer from attaining over-leveraged positions. Therefore, while segregation is an alternative, it may be an alternative only at the cost of effective regulation. Thus, the staff is not recommending segregation, as it believes the detrimental effects of certain transactions are better addressed through direct analysis of their effects and appropriate regulation of those activities to insure financial stability for, and customer protection at, broker-dealers.

320/ It should be noted that in the collapse of bank-sponsored real estate investment trusts in 1974 and 1975 affiliated banks often made substantial loans or purchased assets from troubled entities in order to prevent economic disaster. Such activities are, from the point of view of the parent entity, very important, for the entry of an affiliated entity into insolvency may, at the very least, harm the reputation of the parent corporation. In addition, it may affect the ratings assigned to the parent entity's debt and thus affect the borrowing costs of the parent or the broker-dealer subsidiary.

may require duplicate regulatory and financial accounting, as well as other structural components which permit separate entities to do business creating additional overhead and associated expenses. The size necessary to support a complex structure and overhead may not be present in smaller broker-dealers.

The segregation concept merits further study. However, issues raised by the question are complex and would affect all broker-dealers, not only those the subject of this report. Thus, they are best addressed through additional study by the Commission, input from the financial community and the public comment process.

# APPENDIX I

## BACKGROUND INFORMATION ON FUTURES MARKETS

# BACKGROUND INFORMATION ON FUTURES MARKETS

[From CFTC, Report to Congress In Response to Section 21 of the Commodity Exchange Act (May 29, 1981)]

## The Operation of the Futures Market

In general, commodity futures contracts on organized exchanges involve standardized agreements that obligate the contracting parties to deliver or receive a specified quantity and grade of a commodity at a certain time in the future and are ordinarily entered into for the purpose of assuming or shifting the risk of price change. Since the contracts are usually not used for merchandising the actual commodity, the parties typically cancel their contractual obligations by liquidating their futures positions through offsetting transactions prior to the maturation of the contract. 1/ Futures contracts in the United States are lawfully traded on eleven licensed commodity exchanges that have been designed as "contract markets." The exact terms of the futures contracts are established by the individual commodity exchanges, but the terms must be approved by the CFTC before being placed into effect.

The price of a futures contract is determined by open and competitive bidding by sellers and buyers in a designated trading area (often called a "pit" or "ring") on the trading floor of the contract market. Whenever a bid or offer made in the pit is accepted, a contract is formed. The party to the contract agreeing to make delivery of the commodity is referred to as the "short". The party agreeing to take delivery of the commodity is the "long". Futures trading, however, is generally not utilized as or intended to be a vehicle for delivery of the actual commodity. Delivery occurs in approximately only 2-3 percent of all futures transactions. The remaining contracts are liquidated by offsetting transactions.

Participants in commodity futures markets may be divided into three general classifications--hedgers, speculators, and spreaders. Typically, a hedger is engaged in the production, distribution, processing or consumption of the actual commodity or its byproducts. In a representative situation, the

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1/ Contract liquidation through offsetting transaction is accomplished by selling an equal number of futures contracts against long positions or purchasing an equal number of futures contracts against short positions. The liquidating purchases or sales must have the same delivery month as the previously acquired positions.

hedger holding an inventory of the physical commodity may establish an offsetting short position in the corresponding futures markets. In contrast, the speculator does not endeavor to reduce the price risk of a cash market position but rather to profit by anticipating the price movement of a commodity in which a futures position has been established. In effect, the speculator assumes the risk of price movements that the hedger seeks to avoid. The participation of knowledgeable, price-taking speculators increases trading volume and liquidity in the market, thereby lowering transaction costs and enhancing the markets' hedging and pricing functions.

The third trading category is known as spreading. The primary motive of the traders engaging in this activity is the profitable exploitation of discrepancies between futures prices corresponding to different delivery months on the same contract market or different contract markets trading the same commodity. Since these actions tend to reduce price divergencies, spreading serves to maintain an economic link between different markets or contract months. Spreading is technically a speculative endeavor and enhances market liquidity.

Generally, an individual or firm wanting to trade futures contracts must do so through an FCM that is a member of a commodity exchange or, alternatively, through a non-member FCM or foreign broker that has a customer omnibus account with a member FCM. 2/ Before a futures position can be established for a customer, however, exchange-established margin requirements must be met. Under exchange rules and regulations, customers are required to deposit with member FCMs a specified sum as margin for each futures contract purchased or sold. Normally, non-member FCMs collect required margins from their customers and, in turn, deposit those funds as margin with the member FCM. Margin payments commonly consist of cash or U.S Treasury bills. Also, FCMs may engage in or arrange loan agreements whereby their customers may pledge physical commodities or other assets as collateral and thereby obtain funds for margining futures positions.

The purpose of margin on futures contracts is to insure FCMs against losses on customers' positions and ultimately to guarantee the financial integrity of the futures market. In accordance with this, there are both initial and maintenance margin levels. The initial margin is the margin posted by a customer when a new futures position is opened. The maintenance margin, which is lower than the initial margin, is the

2/ An exception is a firm or individual that is a clearing member of an exchange. Such firms or individuals can trade for their own account without using an FCM.

sum that must be maintained on deposit at all times. If the equity in a customer's account drops to or under the maintenance level because of adverse price movement, the FCM issues a margin call to restore the customer's equity position to the initial margin level. This is usually done at the close of the trading day when futures accounts at FCMs are credited with position gains and debited with position losses.

Minimum customer margin levels are established by the exchanges; however, FCMs may and often do require larger margin deposits from all or selected customers. The exchanges usually set margin requirements for hedge and spread positions at a lower level than margins or speculative trades. Also, margin requirements differ for various commodities and change over time. 3/ For example, between September 1979 and March 1980, margin requirements on speculative positions in silver varied from $2,000 to $75,000 per contract on the Comex and $1,500 to $30,000 on the CBOT.

Although futures trades are executed between exchange members, subsequent financial transactions associated with trades, deliveries, or open futures positions are conducted between members of the exchange clearing organization. 4/ Additionally, the clearing organization secures and assures performance on all open futures contracts. To this end, clearing organizations require the posting of margin deposits on open accounts of clearing member firms. The clearing margin consists of original margin, which is the margin on new open positions, and variation margin, which is based upon changes in the equity value of clearing accounts with open positions.

After trades are executed on an exchange, the clearing organization takes the opposite side of every trade and thus serves as an intermediary between clearing members, and, indirectly, between member FCMS that are not also members of the clearing organization. If, for example, during a trading

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3/ Generally, futures margin requirements are considerably lower than margin requirements in securities. For example, the minimum margin for stocks and industrial bonds are currently 50 and 30 percent respectively, whereas speculative margin levels for futures contracts are generally about five percent of the value of the contract.

4/ Clearing membership is distinct from exchange membership. Some, but not all, exchange members are also members of their respective clearing organizations. For this reason all trades executed by a firm that is a member of the exchange but not a member of the clearing organization must be eventually settled through a clearing member.

session a futures transaction is executed at \$3.20 a bushel in a particular corn future that subsequently closes at \$3.25 a bushel, then the short has lost 5 cents a bushel and the long has gained 5 cents a bushel. In this example, the clearing organization would collect losses from the short's clearing firm and pay the gains to the long's clearing firm.

At the close of trading, accounts of members of the clearing organization are debited or credited for the change in equity value of their positions in each contract on that day. In turn, clearing members, that are also FCMs, calculate the profits or losses of each of their customers' positions at the close of trading each business day. If, as a result of trading losses, funds in a customer's account fall below the maintenance margin level, a margin call is issued to the customer. In the event the customer fails to meet the margin call in a timely manner, the FCM may liquidate some or all of the customer's positions.

In some instances, the FCM may be unable to liquidate positions quickly enough and the customer account may incur further losses resulting in a deficit balance in the account. If this problem occurs simultaneously in the accounts of many small customers, or a few large customers, the net capital of the firm is used to make up the deficit and the FCM could become financially threatened.

Statutory and Regulatory Financial Requirements for FCMs

Several statutory and regulatory provisions have been instituted to protect the financial positions of customers from the threat of FCM insolvency.

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. 5/ 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 (CFTC) 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.

5/ The Commodity Exchange Act, as amended, Section 4d(2), 7 U.S.C. Section 6d(2).

In the event of FCM insolvency, customers' financial interests should find adequate protection, so long as CFTC segregation provisions have been maintained. The use of equity from one customer's account as margin for other accounts is prohibited, and the financial positions of customers should be unaffected by FCM insolvency. However, if an insolvent firm violated account registration requirements, customer compensation can only be obtained through legal action against the firm's assets. Also, the insolvency of an individual firm could involve other bankruptcy-related litigation and, if the firm's assets are frozen by judicial action, there could be substantial delays in the return of customers' funds. In addition, there may be insufficient funds remaining in the estate of a bankrupt firm to fully settle all customer claims.

To permit early detection of FCM-related financial difficulties and financially protect their customers, the CFTC has established minimum financial requirements that must be met by FCMs. 6/ The CFTC regulations also include an early warning system under which FCMs must notify the Commission (CFTC) and their designated self-regulatory organization if they are experiencing financial difficulty. At the onset of the study period, June 30, 1979, each person registered as an FCM was required to maintain net capital amounts equal to or in excess of the greater of $50,000 or 6-2/3 percent of aggregate indebtedness, or alternatively, four percent of segregated funds. 7/ Exchanges can, however, set financial requirements for their members which meet or exceed CFTC standards. An FCM violating CFTC standards can be required to transfer all customer accounts, trade for liquidation purposes only or cease business operations.

The clearing organization has the responsibility of reconciling the trading liabilities between FCMs that are clearing members. As a result, defaulting clearing-member FCMs are responsible directly to the clearing organization

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6/ 17 C.F.R. Section 1.17a(1) (1980).

7/ The $50,000 per person net capital requirement applies only to FCMs who are members of a designated self-regulatory organization. For non-members, net capital of $100,000 per person is required. Changes to these requirements have been recently proposed by the Commission (CFTC). Some of the proposals have been adopted; others remain under review. Note also that FCMs dealing in security markets could satisfy CFTC Minimum Financial Requirements if they maintain net capital equal to four percent of aggregate debit items in accordance with Securities and Exchange Commission requirements.

for these liabilities. If the margin deposits and other assets of the defaulting FCM are insufficient to cover its obligations, clearing organizations have various contingencies for meeting the deficiency.

The major commodity exchanges use similar methods to restore deficits, resulting from member default, in the clearing organization's accounts. The principal sources of funds for restoration of such a deficit are excess operational and capital funds, security deposits of clearing members, and membership assessments.

# APPENDIX II

## GLOSSARY

## GLOSSARY 1/

Aggregation: The discounts under which all futures positions owned or controlled by one trader are combined to determine reporting status and speculative limit compliance.

Appreciation: An increase in value.

Back Month: Any maturity of futures contracts for a particular commodity other than the spot month. [Source: Commodity Exchange, Inc., Original Margin Rule Q.1.(b) (1982)]. See definition of "spot", below.

Break: A rapid and sharp price decline.

Cash Commodity: The physical or actual commodity as distinguished from the "futures". Sometimes called spot commodity or actuals.

Cash Price: The price in the marketplace for actual cash or spot commodities to be delivered via customary market channels.

Certificated or Certified Stocks: Stocks of a commodity that have been inspected and found to be of a quality deliverable against futures contracts, stored at the delivery points designated as regular or acceptable for delivery by the commodities exchange.

Clearing House: An adjunct to a commodity exchange through which transactions executed on the floor of the exchange are settled. Also charged with assuring the proper conduct of the exchange's delivery procedures and the adequate financing of the trading.

Clearing Member: A member of the Clearing House or Association. All trades of a non-clearing member must be registered and eventually settled through a clearing member.

Commitment or Open Interest: The number of contracts in existence at any period of time which have not as yet been satisfied by an offseting sale or purchase or by actual contract delivery.

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1/ Source (unless noted): CFTC, Glossary of Some Terms Commonly Used In the Futures Trading Industry (Government Printing Office, 1980)

Congestion: (1) A congested market situation, basically, is a situation in which the market is "clogged". When shorts attempt to cover their positions they are not likely to find an adequate supply of contracts provided by longs willing to liquidate or by new sellers willing to enter the market, except at sharply higher prices. A congested market situation is one which is likely to result in a "natural" squeeze or which could be exploited by a manipulator; (2) in technical analysis, an era of repetitious and limited price fluctations.

Depository or Warehouse Receipt: A document issued by a bank, warehouse or other depository indicating ownership of a stored commodity. In the case of many commodities deliverable against futures contracts, transfer of ownership of an appropriate depository receipt may effect contract delivery.

Equity: The residual dollar value of a futures trading account assuming it were liquidated at current prices.

Excess: The dollar amount by which the equity exceeds the margin requirements in a trader's commodity futures account.

Exchange for Physical: A transaction in which the buyer of a cash commodity transfers to the seller a corresponding amount of long futures contracts, or receives from the seller a corresponding amount of short futures, at a price difference mutually agreed upon. In this way, the opposite hedges in futures of both parties are closed out simultaneously.

Ex-Pit Transaction: Trades executed, for certain technical purposes, in a location other than the regular exchange trading pit or ring.

Futures Commission Merchant: Individuals, associations, partnerships, corporations and trusts that solicit or accept orders for the purchase or sale of any commodity for future delivery on or subject to the rules of any contract market and that accept payment from or extend credit to those whose orders are accepted.

Haircut: (1) In determining whether assets meet capital requirements, a percentage reduction in the stated value of assets; (2) in computing the worth of assets deposited as collateral or margin, a reduction from market value.

Hedging: Taking a position in a futures market opposite to a position held in the cash market to minimize the risk of financial loss from an adverse price change; a purchase or sale of futures as a temporary substitute for a cash transaction that will occur later.

Initial margin: Customers' funds put up as security for a guarantee of contract fulfillment at the time a futures market position is established.

Limit (Up or Down): The maximum price advance or decline from the previous day's settlement price permitted in one trading session.

Limit Move: A price that has advanced or declined the permissible limit permitted during one trading session, as fixed by the rules of a contract market.

Liquidation: Making a transaction that offsets or closes out a long futures position.

Long: (1) One who has bought a futures contract to establish a market position; (2) a market position which obligates the holder to take delivery; (3) one who owns an inventory of commodities.

Margin: The amount of money or collateral deposited by a client with his broker, or by a broker with the clearinghouse, for the purpose of insuring the broker or clearinghouse against loss on open futures contracts. The margin is not a part payment on a purchase. (1) Original or initial margin is the total amount of margin per contract required by the broker when a futures position is opened. (2) Maintenance margin is a sum which must be maintained on deposit at all times. If a customer's equity in any futures position drops to or under the level because of adverse price action, the broker must issue a margin call to restore the customer's equity.

Margin Call: A request from a brokerage firm to a customer to bring margin deposits up to minimum levels. (2) a request by the clearinghouse to a clearing member to bring clearing margins back to minimum levels required by the clearinghouse rules.

Net Position: The difference between the open long contracts and the open short contracts held in any one commodity.

Omnibus Account: An account carried by one futures commission merchant with another futures commission merchant in which the transactions of two or more persons are combined and carried in the name of the originating broker rather than designated separately.

Open Interest: The sum of futures contracts to one delivery month or one market that has been entered into and not yet liquidated by an offsetting transaction or fulfilled by delivery. Also called "open contracts" or "open commitments".

<u>Original Margin</u>: Term applied to the initial deposit of margin money required of clearing member firms by clearinghouse rules; parallel to the initial margin or security deposit required of customers by exchange regulations.

<u>Position</u>: An interest in the market, either long or short, in the form of one or more open contracts.

<u>Position Limit</u>: The maximum position, either net long or net short, in one commodity future or in all futures of one commodity combined which may be held or controlled by one person as prescribed by an exchange or by the CFTC.

<u>Price Movement Limit</u>: Maximum price advance or decline from the previous day's settlement price permitted for a commodity in one trading session.

<u>Pryamiding</u>: The use of profits or existing futures positions as margin to increase the size of the position, normally in successively smaller increments.

<u>Roll Forward</u>: Lifting a near futures position and re-establishing it in a more deferred delivery month.

<u>Settlement or Settling Price</u>: The daily price at which the clearinghouse clears all trades and settles all accounts between clearing members for each contract month. Settlement prices are used to determine both margin calls and invoice prices for deliveries. The term also refers to a price established by the exchange to even up position which may not be able to be liquidated in regular trading.

<u>Short</u>: (1) The selling side of an open futures contract; (2) a trader whose net position in the futures market shows an excess of open sales over open purchases.

<u>Speculator</u>: An individual who does not hedge, but who trades in commodities futures with the objective of achieving profits through the successful anticipation of price movements.

<u>Spot</u>: Market of immediate delivery of the product and immediate payment. Also refers to the nearest delivery month on futures contracts.

<u>Spot Commodity</u>: The actual commodity as distinguished from futures. <u>Same as Actuals or Cash Commodity.</u>

<u>Spot Price</u>: The price at which a physical commodity is selling at a given time and place. <u>Same as Cash Price</u>.

Spread (or Straddle): The purchase of one futures delivery month against the sale of another futures delivery month of the same commodity, the purchase of one delivery month of one commodity against the sale of that same delivery month of a different commodity, or the purchase of one commodity in one market against the sale of that commodity in another market, to take advantage of and profit from a change in price relationships. The term "spread" is also used to refer to the difference between the price of one futures month and the price of another month of the same commodity.

Switch: Offsetting a position in one delivery month of a commodity and simultaneous initiation of a similar position in another delivery month of the same commodity.

Transfer Trades: Entries made upon the books of futures commission merchants for the purpose of (1) transferring existing trades from one account to another within the same office where no change in ownership is involved or (2) transferring existing trades from the books of one commission merchant to the books of another commission merchant where no change in ownership is involved; (3) exchanging futures for cash commodities; (4) exchanging futures positions, one of which was taken to fix the price of a commodity involved in a call sale.

Variable Limit Margins: The performance deposit required whenever the daily trading limits on prices of a commodity are raised in accordance with exchange rules. In periods of extreme price volatility, some exchanges permit trading at price levels that exceed regular daily limits. At such times, margins also are increased.

Warehouse Receipt: A document evidencing possession by a warehouse (licensed under the U.S. Warehouse Act, or under the laws of a state) of the commodity named in the receipt. Warehouse receipts, to be tenderable on futures contracts, must be negotiable receipts covering commodities in warehouses recognized for delivery pruposes by the exchange on which such futures contracts are traded.

# APPENDIX III

## SUMMARIES OF HUNT-RELATED ACCOUNTS WITH BROKER-DEALERS

## PRELIMINARY NOTE

This appendix contains, for selected dates before and during the silver crisis, summaries of aggregate Hunt family and related entities' positions with the broker-dealers the subject of this report. The summaries of positions with broker-dealers are derived exclusively from the monthly statements and daily commodity account profiles generated in the automated bookkeeping systems of those firms and produced to the Commission. The summaries of Hunt positions with Bache Group's two non-broker-dealer subsidiaries are derived from account statements and other documentation produced to the Commission.

**HUNT FAMILY POSITIONS: BACHE HALSEY, BACHE METALS AND BACHE LONDON**
**At Selected Dates in 1979 and 1980 1/**

| | | SILVER | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | | NET FUTURES POSITION | | FORWARDS | | PHYSICAL 5/ | | | | | |
| DATE | ENTITY | NO. OF CONTRACTS LONG<SHORT> | UNREALIZED PROFIT<LOSS>2/ ($ MILLIONS) | OUNCES (MILLIONS) | UNREALIZED PROFIT<LOSS> ($ MILLIONS) | OUNCES (MILLIONS) | VALUE ($ MILLIONS) | UNREALIZED PROFIT <LOSS> 2/ ON OTHER COMMODITIES ($ MILLIONS) | TREASURY BILLS 3/ ($ MILLIONS) | STOCKS 4/ ($ MILLIONS) | LOANS AND LEDGER BALANCES CREDIT<DEBIT> ($ MILLIONS) | EQUITY <DEFICIT> ($ MILLIONS) |
| July 31, 1979 | Bache Halsey 6/ | 2549 | 1.2 | | | | | | N/A | | <5.2> | N/A |
| | Bache Metals | | | | | 5.7 | 51 | | | | <39> (est.) | 12 (est.) |
| | Bache London | | | | | | | | | | | |
| Dec. 31, 1979 | Bache Halsey | 7304 | 242 | | | | | .08 | 109 | | <189> | 162 |
| | Bache Metals | | | | | | | | | | <40> | 155 |
| | Bache London | | | | | | | | | | | |
| Jan. 31, 1980 | Bache Halsey 7/ | 7165 | 470 | | | | | <7.2> | 87 | | <68> | 482 |
| | Bache Metals | | | | | 5.7 | 195 | | | | <42> | 154 |
| | Bache London | | | | | | | | | | | |
| Feb. 29 1980 | Bache Halsey | 5553 | <6.0> | | | | | <8.9> | 90 | | <21> | 54 |
| | Bache Metals | | | | | 11.2 | 395 | | | | <235> | 160 |
| | Bache London | | | | | | | | | | | |
| Mar. 14, 1980 | Bache Halsey | 4580 | <192> | | | | | <15.7> | 177 | | 160 | 130 |
| | Bache Metals | | | | | 15.0 | 315 | | | | 233 | 82 |
| | Bache London | | | | | | | | | | | |
| Mar. 25, 1980 | Bache Halsey | 4756 | <326> | | | 6.6 | 133 | 1.1 | 256 | 5.4 | 194 | 260 |
| | Bache Metals | | | | | 18.4 | 372 | | | | 233 | 139 |
| | Bache London | | | .75 | <19.6> | | | | | | | <19.6> |
| Mar. 26, 1980 | Bache Halsey | 4376 | <333> | | | 7.8 | 123 | | 62.0 | 5.2 | 374 | 231 |
| | Bache Metals | | | | | 17.2 | 271 | | | | <233> | 38.3 |
| | Bache London | | | .75 | <21.2> | | | | | | | <21.2> |
| Mar. 27, 1980 | Bache Halsey | 3648 | <362> | | | 7.8 | 120 8/ | | 3.2 | 2.8 | 415 | <178 |
| | Bache Metals 9/ | | | | | 11.3 | 122 | | | | <155> | 33.0 |
| | Bache London | | | - 0 - | <22.8> | | | | | | | <22.8> |
| Mar. 28, 1980 | Bache Halsey | <199> | <128> | | | 7.8 | 120 | | | 2.8 | 26.6 | 21.1 |
| | Bache Metals | | | | | 6.9 | 82.3 | | | | <105> | 22.4 |
| | Bache London | | | - 0 - | <22.8> | | | | | | | <22.8> |
| Mar. 31, 1980 | Bache Halsey | <62> | <121> | | | 6.6 | 100 | | | 2.8 | 13.2 | <4.7> |
| | Bache Metals | | | | | 6.4 | 90.2 | | | | <97.0> | <6.8> |
| | Bache London | | | - 0 - | <22.8> | | | | | | | <22.8> |
| Apr. 30, 1980 | Bache Halsey | - 0 - | - 0 - | | | - 0 - | - 0 - | | | | - 0 - | - 0 - |
| | Bache Metals | | | | | - 0 - | - 0 - | | | | - 0 - | - 0 - |
| | Bache London | | | - 0 - | - 0 - | | | | | | | - 0 - |

## NOTES TO THE BACHE GROUP POSITION SUMMARY

1/ All Hunt-related accounts with each Bache Group subsidiary are aggregated.

2/ Unrealized profit (loss) on futures positions is computed using futures prices.

3/ Treasury bills are valued at face.

4/ Stocks are valued at full market value. The Hunts' Bache Group stockholdings are not included.

5/ Does not include the value of 159 bags of silver coins.

6/ Unless otherwise noted, positions with Bache Halsey are shown as they appear in its monthly statement and daily commodity account profiles. This summary is prepared on a cash basis and, after March 25, may not reflect adjustments for debits or credits attributable to settlement of, or later adjusting entries for, transactions that occurred on dates shown in the table. Bache Halsey's practice during the crisis was to book all liquidating transactions in the Hunt accounts into a single account, later reclassifying the transactions and proceeds as needed to close out the various Hunt family positions. As a result of this practice, Commission broker-dealer examiners have been unable to entirely reconcile account documentation for the period of the Hunt liquidations as generated by Bache Halsey's automated bookkeeping system with documents manually prepared at the time, with other information supplied to the Commission by Bache Halsey and with the testimony of witnesses.

7/ For January 31, February 29 and March 14, 1980, the Hunt futures position with Bache Halsey includes 150 contracts and a corresponding unrealized loss attributable to the Huddlestons' 750,000 ounce long forward position on LME. On March 25 and thereafter, that position and the associated losses are shown in account with Bache London to reflect the March 24 reledgering of that position.

8/ Physical silver received by Bache Halsey as collateral for margin calls is valued prior to liquidation at spot prices and included in stated equity (deficit). Such collateral is shown remaining in account at Bache Halsey following liquidation until the date upon which it was delivered in settlement of the transaction effecting the liquidation. In the interim, the collateral is valued at the trade price and included in stated equity.

9/ Liquidation of Bache Metals' loan collateral is shown on an accrual basis, with loan amounts outstanding being reduced as of the trade dates of collateral sales.

HUNT FAMILY AND RELATED ENTITIES POSITIONS—MERRILL LYNCH, PIERCE, FENNER & SMITH, INC.
(Silver, Other Assets, Loans And Equity)

| | SILVER | | | | | | OTHER ASSETS | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | NET FUTURES POSITION | | FORWARDS | | PHYSICAL | | OTHER FUTURES | | | | |
| | NUMBER OF CONTRACTS LONG<SHORT> | UNREALIZED PROFIT <LOSS> 1/ | NUMBER OF CONTRACTS | UNREALIZED PROFIT <LOSS> | NUMBER OF OUNCES | MARKET VALUE | UNREALIZED PROFIT <LOSS> 1/ | TREASURY BILLS 2/ | STOCKS & OTHER INVESTMENTS 3/ | LOANS AND <DEBIT> CREDIT BALANCES | EQUITY <DEFICIT> |
| **July 31, 1979** | | | | | | | | | | | |
| Hunt Family | 2,506 | 8,328,985 | - 0 - | - 0 - | 5,000 | 44,850 | 1,622,223 | 8,265,000 | - 0 - | <11,858,842> | 6,402,216 |
| IMIC | - 0 - | - 0 - | - 0 - | - 0 - | - 0 - | - 0 - | - 0 - | - 0 - | - 0 - | - 0 - | - 0 - |
| Placid | - 0 - | - 0 - | - 0 - | - 0 - | - 0 - | - 0 - | - 0 - | - 0 - | 84,081,225 | <40,796,774> | 43,284,451 |
| HIRCO | - 0 - | - 0 - | - 0 - | - 0 - | - 0 - | - 0 - | - 0 - | - 0 - | - 0 - | - 0 - | - 0 - |
| Penrod | - 0 - | - 0 - | - 0 - | - 0 - | - 0 - | - 0 - | - 0 - | - 0 - | - 0 - | - 0 - | - 0 - |
| TOTAL | | 8,328,985 | | | 5,000 | 44,850 | 1,622,223 | 8,265,000 | 84,081,225 | <52,655,616> | 49,686,667 |
| **Dec. 31, 1979** | | | | | | | | | | | |
| Hunt Family | 2,473 | 221,818,140 | 1,300(m) | 15,356,960 | 1,100,000 | 37,895,000 | <3,454,467> | 47,575,000 | 43,057,524 | <219,436,687> | 142,811,470 |
| IMIC | 3,808 | 362,135,760 | 650(m) | 7,699,230 | 6,210,000 | 213,934,500 | 10,371,425 | 74,355,000 | 112,180,000 | <388,084,324> | 392,591,591 |
| Placid | - 0 - | - 0 - | - 0 - | - 0 - | - 0 - | - 0 - | - 0 - | - 0 - | 210,768,062 | <109,449,868> | 101,318,194 |
| HIRCO | - 0 - | - 0 - | - 0 - | - 0 - | - 0 - | - 0 - | 3,134,779 | 1,300,000 | - 0 - | <4,908,376> | <473,597> |
| Penrod | - 0 - | - 0 - | - 0 - | - 0 - | - 0 - | - 0 - | - 0 - | - 0 - | - 0 - | - 0 - | - 0 - |
| TOTAL | | 583,953,900 | | 23,056,190 | 7,310,000 | 251,829,500 | 10,051,737 | 123,230,000 | 366,005,586 | <721,879,255> | 636,247,658 |
| **Jan. 31, 1980** | | | | | | | | | | | |
| Hunt Family | 835 | <9,338,525> | 2,437(m) | 12,190,516 | 2,100,000 | 72,660,000 | <16,169,222> | 63,570,000 | 62,395,475 | <13,164,024> | 172,144,220 |
| IMIC | 3,808 | 489,870,235 | 1,093(m) | 6,487,876 | 6,210,000 | 214,866,000 | 20,785,425 | 81,365,000 | 156,870,000 | <547,668,753> | 422,575,783 |
| Placid | - 0 - | - 0 - | - 0 - | - 0 - | - 0 - | - 0 - | - 0 - | - 0 - | 274,484,613 | <120,158,446> | 154,326,167 |
| HIRCO | - 0 - | - 0 - | - 0 - | - 0 - | - 0 - | - 0 - | 28,567,112 | 2,500,000 | - 0 - | <21,234,035> | 9,833,077 |
| Penrod | - 0 - | - 0 - | - 0 - | - 0 - | - 0 - | - 0 - | - 0 - | - 0 - | - 0 - | - 0 - | - 0 - |
| TOTAL | | 480,531,710 | | 18,678,392 | 8,310,000 | 287,526,000 | 33,183,315 | 147,435,000 | 493,750,088 | <702,225,258> | 758,879,247 |
| **Feb. 29, 1980** | | | | | | | | | | | |
| Hunt Family | <94> | <60,000,925> | 2,467(m) | 13,286,343 | 7,820,000 | 276,046,000 | <29,943,407> | 116,845,000 | 57,813,637 | 29,950,370 | 403,997,018 |
| IMIC | 3,808 | 488,269,285 | 1,093(m) | 7,056,263 | 4,590,000 | 162,027,000 | 14,779,750 | 166,000,000 | 69,379,200 | <521,473,310> | 386,058,188 |
| Placid | - 0 - | - 0 - | - 0 - | - 0 - | - 0 - | - 0 - | <1,490,000> | 3,845,000 | 271,631,855 | <120,701,240> | 153,285,615 |
| HIRCO | - 0 - | - 0 - | - 0 - | - 0 - | - 0 - | - 0 - | 50,241,363 | 5,000,000 | - 0 - | <45,201,957> | 10,039,406 |
| Penrod | - 0 - | - 0 - | - 0 - | - 0 - | - 0 - | - 0 - | <826,650> | 1,670,000 | - 0 - | 716,400 | 1,559,750 |
| TOTAL | | 428,268,360 | | 20,342,606 | 12,410,000 | 438,073,000 | 32,781,056 | 293,360,000 | 398,824,692 | <656,709,737> | 954,939,977 |
| **Mar. 14, 1980** | | | | | | | | | | | |
| Hunt Family | 1 | 981,800 | 1,267(m) | <19,184,501> | 10,125,000 | 212,625,000 | <40,852,245> | 97,150,000 | 50,414,437 | <10,926,970> | 290,207,521 |
| IMIC | 3,808 | 345,057,685 | 493(m) | <7,559,146> | 5,190,000 | 108,990,000 | 4,789,753 | 166,000,000 | 6,943,200 | <454,545,532> | 169,675,960 |
| Placid | - 0 - | - 0 - | - 0 - | - 0 - | - 0 - | - 0 - | <5,037,400> | 4,585,000 | 227,098,892 | <114,245,272> | 112,401,020 |
| HIRCO | - 0 - | - 0 - | - 0 - | - 0 - | - 0 - | - 0 - | 19,060,610 | 5,905,000 | - 0 - | <26,769,639> | <1,804,029> |
| Penrod | - 0 - | - 0 - | - 0 - | - 0 - | - 0 - | - 0 - | <2,486,950> | 2,250,000 | - 0 - | 2,198,050 | 1,961,100 |
| TOTAL | | 346,039,485 | | <26,743,647> | 15,315,000 | 321,615,000 | <24,526,432> | 275,890,000 | 284,456,529 | <604,289,363> | 572,441,572 |
| **Mar. 25, 1980** | | | | | | | | | | | |
| Hunt Family | <77> | <85,564,350> | 1,167(m) | <24,114,951> | 10,225,000 | 206,545,000 | <42,838,585> | 81,895,000 | 39,326,612 | <23,305,363> | 151,943,363 |
| IMIC | 3,808 | 219,537,685 | 443(m) | <9,430,146> | 5,240,000 | 105,848,000 4/ | 2,053,627 | 166,000,000 | 6,982,800 | <450,181,749> | 40,810,217 4/ |
| Placid | 90 | <312,350> | - 0 - | - 0 - | - 0 - | - 0 - | <5,163,600> | 12,500,000 | 204,907,033 | <116,722,318> | 95,208,765 |
| HIRCO | - 0 - | - 0 - | - 0 - | - 0 - | - 0 - | - 0 - | 14,231,594 | 4,840,000 | - 0 - | <22,677,563> | <3,605,969> |
| Penrod | - 0 - | - 0 - | - 0 - | - 0 - | - 0 - | - 0 - | <2,546,550> | 2,590,000 | - 0 - | 2,188,050 | 2,231,500 |
| TOTAL | | 133,660,985 | | <33,545,097> | 15,465,000 | 312,393,000 | <34,263,514> | 267,825,000 | 251,216,445 | <610,698,943> | 286,587,876 |

| | SILVER | | | | | | OTHER ASSETS | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | NET FUTURES POSITION | | FORWARDS | | PHYSICAL | | OTHER FUTURES | | | | |
| | NUMBER OF CONTRACTS LONG<SHORT> | UNREALIZED PROFIT<LOSS> | NUMBER OF CONTRACTS | UNREALIZED PROFIT<LOSS> | NUMBER OF OUNCES | MARKET VALUE | UNREALIZED PROFIT <LOSS> 1/ | TREASURY BILLS 2/ | STOCKS & OTHER INVESTMENTS 3/ | LOANS AND <DEBIT> CREDIT BALANCES | EQUITY <DEFICIT> |
| **Mar. 26, 1980** | | | | | | | | | | | |
| Hunt Family | <94> | <86,483,250> | 1,167(m) | <26,138,910> | 10,225,000 | 161,555,000 | <44,063,506> | 81,895,000 | 108,958,871 | <28,759,376> | 166,963,829 |
| IMIC | 3,744 | 188,036,885 | 443(m) | <10,198,219> | 5,240,000 | 82,792,000 5/ | <284,872> | 166,000,000 | 6,553,800 | <447,865,957> | <14,966,363> 5/ |
| Placid | 100 | <510,350> | - 0 - | - 0 - | 50,000 | 790,000 | <5,901,100> | 12,500,000 | 198,966,883 | <118,012,215> | 87,833,218 |
| HIRCO | - 0 - | - 0 - | - 0 - | - 0 - | - 0 - | - 0 - | 18,897,883 | 4,840,000 | - 0 - | <17,760,986> | 5,976,897 |
| Penrod | - 0 - | - 0 - | - 0 - | - 0 - | - 0 - | - 0 - | <2,934,050> | 2,590,000 | - 0 - | 2,546,550 | 2,202,500 |
| TOTAL | | 101,043,285 | | <36,337,129> | 15,515,000 | 245,137,000 | <34,285,645> | 267,825,000 | 314,479,554 | <609,851,984> | 248,010,081 |
| **Mar. 27, 1980** | | | | | | | | | | | |
| Hunt Family | <94> | <75,869,250> | 1,167(m) | <31,941,682> | 10,225,000 | 110,430,000 | <29,605,963> | 81,895,000 | 131,622,854 | <57,829,829> | 128,701,130 |
| IMIC | 3,239 | 140,498,560 | 443(m) | <12,400,815> | 5,240,000 | 56,592,000 6/ | <358,637> | 166,000,000 | 6,111,600 | <442,687,512> | <86,244,804> 6/ |
| Placid | 100 | <1,135,350> | - 0 - | - 0 - | 50,000 | 540,000 | <6,058,200> | 12,500,000 | 188,389,033 | <119,752,917> | 74,482,566 |
| HIRCO | - 0 - | - 0 - | - 0 - | - 0 - | - 0 - | - 0 - | 13,915,814 | 4,840,000 | - 0 - | <15,292,685> | 3,463,129 |
| Penrod | - 0 - | - 0 - | - 0 - | - 0 - | - 0 - | - 0 - | <2,741,150> | 2,590,000 | - 0 - | 1,976,050 | 1,824,900 |
| TOTAL | | 63,493,960 | | <44,342,497> | 15,515,000 | 167,562,000 | <24,848,136> | 267,825,000 | 326,123,487 | <633,586,893> | 122,226,921 |
| **Mar. 28, 1980** | | | | | | | | | | | |
| Hunt Family | <119> | <53,501,510> | 417(m) | <32,543,074> | 10,225,000 | 122,700,000 | <9,716,599> | 81,895,000 | 128,501,766 | <32,928,362> | 204,407,221 |
| IMIC | 2,662 | 102,560,185 | 3,717(m) | <13,175,156> | 5,240,000 | 62,880,000 | <569,985> | 166,000,000 | 6,718,800 | <439,983,465> | <115,569,621> |
| Placid | 129 | <2,598,750> | - 0 - | - 0 - | - 0 - | - 0 - | <5,322,850> | 12,500,000 | 200,066,995 | <115,958,127> | 88,687,268 |
| HIRCO | - 0 - | - 0 - | - 0 - | - 0 - | - 0 - | - 0 - | 4,753,873 | 4,840,000 | - 0 - | <10,307,330> | <713,457> |
| Penrod | - 0 - | - 0 - | - 0 - | - 0 - | - 0 - | - 0 - | <2,351,200> | 2,590,000 | - 0 - | 2,741,150 | 2,979,950 |
| TOTAL | | 46,459,925 | | <45,718,230> | 15,465,000 | 185,580,000 | <13,206,761> | 267,825,000 | 335,287,561 | <596,436,134> | 179,791,361 |
| **Mar. 31, 1980** | | | | | | | | | | | |
| Hunt Family | <2> | <62,572,760> | 417(m) | <31,510,951> | 10,225,000 | 145,195,000 | <11,375,423> | 78,495,000 | 111,122,678 | <20,232,645> | 209,120,899 |
| IMIC | 1,436 | 109,797,935 | 7,082(m) | <33,825,194> | 7,075,000 | 100,465,000 | <590,625> | 166,000,000 | 6,619,800 | <451,307,232> | <102,840,316> |
| Placid | 125 | <3,135,750> | - 0 - | - 0 - | - 0 - | - 0 - | <5,411,950> | 12,500,000 | 200,673,733 | <115,068,477> | 89,557,556 |
| HIRCO | - 0 - | - 0 - | - 0 - | - 0 - | - 0 - | - 0 - | 8,302,011 | 4,840,000 | - 0 - | <8,701,114> | 4,440,897 |
| Penrod | - 0 - | - 0 - | - 0 - | - 0 - | - 0 - | - 0 - | <2,400,700> | 2,590,000 | - 0 - | 2,351,200 | 2,540,500 |
| TOTAL | | 44,089,425 | | <65,336,145> | 17,300,000 | 245,660,000 | <11,476,687> | 264,425,000 | 318,416,211 | <592,958,268> | 202,819,536 |
| **Apr. 30, 1980** | | | | | | | | | | | |
| Hunt Family | 498 | <55,501,590> | 1,167(m) | <791,422> | 8,135,000 | 101,687,500 | <6,272,887> | 56,555,000 | 126,178,595 | <33,058,478> | 188,796,718 |
| IMIC | 532 | 8,675,660 | 100(m) | <13,993,780> | 3,060,000 | 38,250,000 | <664,000> | 44,000,000 | 1,605,120 | <215,552,328> | <137,679,328> |
| Placid | 125 | <8,631,250> | - 0 - | - 0 - | - 0 - | - 0 - | <6,300,500> | 12,500,000 | 205,795,140 | <111,140,484> | 92,222,906 |
| HIRCO | - 0 - | - 0 - | - 0 - | - 0 - | - 0 - | - 0 - | 23,247,694 | 2,320,000 | - 0 - | <21,938,419> | 3,629,275 |
| Penrod | - 0 - | - 0 - | - 0 - | - 0 - | - 0 - | - 0 - | <2,852,650> | 2,590,000 | - 0 - | 2,467,700 | 2,205,050 |
| TOTAL | | <55,457,180> | | <14,785,202> | 11,195,000 | 139,937,500 | 7,157,657 | 117,965,000 | 333,578,855 | <379,222,009> | 149,174,621 |

**NOTES TO MERRILL LYNCH POSITION SUMMARY**

1/ Unrealized profit (loss) on futures positions computed using futures prices.

2/ Treasury Bills valued at face.

3/ Stocks valued at full market value. Commercial paper valued at face.

4/ Figures for March 25 and thereafter do not include the value of approximately seven million ounces of coin option collateral assigned to Merrill by IMIC on March 21, 1980.

5/ Figures for March 26 through 31 do not include the value of five million ounces of silver bullion assigned to Merrill by IMIC that day.

6/ Figures for March 27 and thereafter do not include the value of three million ounces of silver leased to industrial users that IMIC assigned to Merrill Lynch that day.

## HUNT FAMILY POSITIONS—E.F. HUTTON & CO. INC.
## (Silver, Other Assets, Loans And Equity)

| | SILVER | | | | OTHER ASSETS | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | NET FUTURES POSITION | | PHYSICAL | | OTHER FUTURES | | | | |
| | NUMBER OF CONTRACTS LONG<SHORT> | UNREALIZED PROFIT <LOSS> 1/ | NUMBER OF OUNCES | MARKET VALUE | UNREALIZED PROFIT<LOSS> 1/ | TREASURY BILLS 2/ | STOCKS & OTHER INVESTMENTS 3/ | LOANS AND <DEBIT> CREDIT BALANCES | EQUITY <DEFICIT> |
| July 31, 1979 | - 0 - | - 0 - | - 0 - | - 0 - | - 0 - | - 0 - | - 0 - | - 0 - | - 0 - |
| Dec. 31, 1979 | 913 | 60,028,050 | 1,910,000 | 65,799,500 | - 0 - | 15,710,000 | 2,282,500 | <79,005,480.97> | 64,814,569.03 |
| Jan. 31, 1980 | 677 | <1,500> | - 0 - | - 0 - | - 0 - | 45,100,000 | 2,873,750 | <6,097,716> | 41,874,534 |
| Feb. 29, 1980 | 677 | 1,663,800 | - 0 - | - 0 - | <1,295,650> | 46,770,000 | 2,921,875 | 2,379,080 | 52,439,105 |
| Mar. 14, 1980 | 677 | <19,851,500> | 7,710,000 | 159,597,000 | <3,058,150> | 46,770,000 | 2,598,750 | <84,400,711> | 101,655,389 |
| Mar. 25, 1980 | 677 | <43,546,500> | 8,745,000 | 176,447,000 | <3,605,650> | 46,770,000 | 2,337,500 | <60,501,447> | 117,900,903 |
| Mar. 26, 1980 | 677 | <46,931,500> | 8,745,000 | 138,171,000 | <3,733,150> | 46,770,000 | 2,337,500 | <57,100,048> | 79,513,702 |
| Mar. 27, 1980 | <162> 4/ | <46,033,600> | 8,745,000 | 94,446,000 | <4,085,650> | 46,770,000 | 2,138,125 | <57,032,197> | 36,202,678 |
| Mar. 28, 1980 | <1,177> | <41,104,000> | 8,745,000 | 104,940,000 | - 0 - | 46,770,000 | 2,241,250 | <55,980,992> | 56,866,258 |
| Mar. 31, 1980 | <1,028> | 2,148,000 | 3,445,000 | 48,919,000 | - 0 - | 46,770,000 | 2,227,500 | <94,125,107> | 5,939,393 |
| Apr. 30, 1980 | - 0 - | - 0 - | - 0 - | - 0 - | - 0 - | - 0 - | 2,805,000 | <503,060> | 2,301,940 |

1/ Unrealized profit (loss) computed using futures prices.

2/ Treasury bills valued at face.

3/ Stocks valued at full market value.

4/ On March 27, 28 and 31, the net futures positions includes a short position established in the account as part of the liquidation of loan collateral and the long futures position. The net futures position presented herein does not reflect subsequent entries that closed out these positions.

HUNT FAMILY AND RELATED ENTITIES POSITIONS--PAINE WEBBER INC.
(Silver Futures, Other Assets, Loans And Equity)

| | SILVER NET FUTURES POSITION | | OTHER ASSETS | | | | |
|---|---|---|---|---|---|---|---|
| | NUMBER OF CONTRACTS LONG<SHORT> | UNREALIZED PROFIT <LOSS> 1/ | OTHER FUTURES UNREALIZED PROFIT<LOSS> 1/ | TREASURY BILLS 2/ | STOCKS & OTHER INVESTMENTS 3/ | LOANS AND <DEBIT> CREDIT BALANCES | EQUITY <DEFICIT> |
| **July 31, 1979** | | | | | | | |
| Hunt Family | 1,713 | <1,330,110> | <6,588,756> | 9,280,000 | - 0 - | 8,623,567 | 9,984,701 |
| Placid | - 0 - | - 0 - | - 0 - | - 0 - | 56,344,850 | <19,260,872> | 37,083,978 |
| TOTAL | | <1,330,110> | <6,588,756> | 9,280,000 | 56,344,850 | <10,637,305> | 47,068,679 |
| **Dec. 31, 1979** | | | | | | | |
| Hunt Family | 2,046 | 181,251,025 | <3,096,041> | 24,815,000 | - 0 - | <167,100,054> | 35,869,930 |
| Placid | - 0 - | - 0 - | - 0 - | - 0 - | 59,661,798 | <29,770,151> | 29,891,647 |
| TOTAL | | 181,251,025 | <3,096,041> | 24,815,000 | 59,661,798 | <196,870,205> | 65,761,577 |
| **Jan. 31, 1980** | | | | | | | |
| Hunt Family | 710 | 59,254,900 | <22,928,288> | 25,115,000 | - 0 - | <38,655,003> | 22,786,609 |
| Placid | - 0 - | - 0 - | - 0 - | - 0 - | 101,702,850 | <30,074,847> | 71,628,003 |
| TOTAL | | 59,254,900 | <22,928,288> | 25,115,000 | 101,702,850 | <68,729,850> | 94,414,612 |
| **Feb. 29, 1980** | | | | | | | |
| Hunt Family | 710 | 59,574,400 | <38,168,419> | 41,425,000 | - 0 - | <18,950,147> | 43,885,834 |
| Placid | - 0 - | - 0 - | - 0 - | - 0 - | 107,095,125 | <30,469,711> | 76,625,414 |
| TOTAL | | 59,574,400 | <38,168,419> | 41,425,000 | 107,095,125 | <49,419,858> | 120,511,248 |
| **Mar. 14, 1980** | | | | | | | |
| Hunt Family | 710 | 37,244,900 | <36,954,581> | 40,985,000 | - 0 - | <4,497,073> | 36,778,246 |
| Placid | - 0 - | - 0 - | - 0 - | - 0 - | 94,326,000 | <29,982,930> | 64,343,070 |
| TOTAL | | 37,244,900 | <36,954,581> | 40,985,000 | 94,326,000 | <34,480,003> | 101,121,316 |
| **Mar. 25, 1980** | | | | | | | |
| Hunt Family | 710 | 12,394,900 | <48,064,046> | 40,985,000 | - 0 - | 30,618,010 | 35,933,864 |
| Placid | - 0 - | - 0 - | - 0 - | - 0 - | 89,811,300 | <30,209,900> | 59,601,400 |
| TOTAL | | 12,394,900 | <48,064,046> | 40,985,000 | 89,811,300 | <408,110> | 95,535,264 |
| **Mar. 26, 1980** | | | | | | | |
| Hunt Family | 710 | 8,844,900 | <46,907,893> | 40,985,000 | - 0 - | 35,673,010 | 38,595,017 |
| Placid | - 0 - | - 0 - | - 0 - | - 0 - | 87,067,275 | <30,209,900> | 56,857,375 |
| TOTAL | | 8,844,900 | <46,907,893> | 40,985,000 | 87,067,275 | <5,463,110> | 95,452,392 |
| **Mar. 27, 1980** | | | | | | | |
| Hunt Family | 186 | <14,716,500> | <17,966,868> | 9,425,000 | - 0 - | 11,218,113 | <12,040,255> |
| Placid | - 0 - | - 0 - | - 0 - | - 0 - | 84,281,625 | <30,209,900> | 54,071,725 |
| TOTAL | | <14,716,500> | <17,966,868> | 9,425,000 | 84,281,625 | <18,991,787> | 42,031,470 |
| **Mar. 28, 1980** | | | | | | | |
| Hunt Family | - 0 - | - 0 - | <2,265,531> | - 0 - | - 0 - | <6,182,806> | <8,448,337> |
| Placid | - 0 - | - 0 - | - 0 - | - 0 - | 86,448,525 | <30,209,900> | 56,238,625 |
| TOTAL | | | <2,265,531> | | 86,448,525 | <36,392,706> | 47,790,288 |
| **Mar. 31, 1980** | | | | | | | |
| Hunt Family | - 0 - | - 0 - | - 0 - | - 0 - | - 0 - | <8,647,398> | <8,647,398> |
| Placid | - 0 - | - 0 - | - 0 - | - 0 - | 87,219,375 | <30,353,423> | 56,865,932 |
| TOTAL | | | | | 87,219,375 | <39,000,821> | 48,218,554 |
| **Apr. 30, 1980** | | | | | | | |
| Hunt Family | - 0 - | - 0 - | - 0 - | - 0 - | - 0 - | - 0 - | - 0 - |
| Placid | - 0 - | - 0 - | - 0 - | - 0 - | 92,076,675 | <30,744,989> | 61,331,686 |
| TOTAL | | | | | 92,076,675 | <30,744,989> | 61,331,686 |

1/ Unrealized profit (loss) on futures positions is computed using futures prices.

2/ Treasury bills valued at face.

3/ Stocks valued at full market value.

HUNT FAMILY POSITIONS—DEAN WITTER REYNOLDS
(Silver Futures, Other Assets, And Equity)

| | SILVER | | OTHER ASSETS | | | | |
|---|---|---|---|---|---|---|---|
| | NET FUTURES POSITION | | FUTURES | | | | |
| | NUMBER OF CONTRACTS LONG<SHORT> | UNREALIZED PROFIT <LOSS> 1/ | UNREALIZED PROFIT <LOSS> 1/ | TREASURY BILLS 2/ | STOCKS & OTHER INVESTMENTS 3/ | <DEBIT> CREDIT BALANCES | EQUITY <DEFICIT |
| July 31, 1979 | 310 | <172,000> | - 0 - | 780,000 | 6,174,575 | <3,344,704> | 3,597,171 |
| Dec. 31, 1979 | 310 | 30,526,500 | 3,800 | 1,810,000 | 11,157,650 | <31,480,871> | 12,017,079 |
| Jan. 31, 1980 | 310 | 19,630,000 | 23,895 | 1,910,000 | 13,667,350 | <23,364,047> | 11,857,198 |
| Feb. 29, 1980 | 310 | 19,759,500 | <656,502> | 16,810,000 | 14,205,312 | <21,134,256> | 28,984,054 |
| Mar. 14, 1980 | 310 | 10,010,000 | <1,126,575> | 16,810,000 | 12,456,225 | <13,983,799> | 24,165,851 |
| Mar. 25, 1980 | 310 | <840,000> | <1,373,317> | 16,810,000 | 11,114,875 | <2,975,838> | 22,735,720 |
| Mar. 26, 1980 | 310 | <2,390,000> | <1,438,340> | 16,810,000 | 10,218,762 | <2,975,838> | 20,224,584 |
| Mar. 27, 1980 | 310 | <3,940,000> | <232,140> | 16,810,000 | 9,839,662 | <4,377,475> | 18,100,047 |
| Mar. 28, 1980 | - 0 - | - 0 - | - 0 - | 16,810,000 | 10,638,950 | <22,827,638> | 4,621,312 |
| Mar. 31, 1980 | - 0 - | - 0 - | - 0 - | 16,810,000 | 10,581,675 | <22,836,143> | 4,555,532 |
| Apr. 30, 1980 | - 0 - | - 0 - | - 0 - | - 0 - | 8,626,012 | <3,651,648> | 4,974,364 |

1/ Unrealized profit and loss computed using futures prices.

2/ Treasury Bills valued at face.

3/ Stocks valued at full market value.

## HUNT FAMILY POSITIONS--A.G. EDWARDS & SONS, INC.
## (Silver Futures, Treasury Bills And Equity)

| | SILVER NET FUTURES POSITION | | | | |
|---|---|---|---|---|---|
| | NUMBER OF CONTRACTS LONG<SHORT> | UNREALIZED PROFIT <LOSS> 1/ | TREASURY BILLS 2/ | <DEBIT> CREDIT BALANCES | EQUITY <DEFICIT> |
| July 31, 1979 | 100 | <172,000> | 85,000 | 114,935 | 27,935 |
| Dec. 31, 1979 | 200 | 15,641,375 | 1,815,000 | <14,455,303> | 3,001,072 |
| Jan. 31, 1980 | 100 | <375,000> | 1,815,000 | 28,401 | 1,468,401 |
| Feb. 29, 1980 | 100 | <830,000> | 1,965,000 | 1,284,940 | 2,419,940 |
| Mar. 14, 1980 | 100 | <3,475,000> | 1,965,000 | 4,084,940 | 2,574,940 |
| Mar. 25, 1980 | 100 | <6,975,000> | 1,965,000 | 6,510,000 | 1,500,000 |
| Mar. 26, 1980 | 100 | <7,475,000> | 1,965,000 | 6,510,000 | 1,000,000 |
| Mar. 27, 1980 | 100 | <7,975,000> | 1,965,000 | 6,510,000 | 500,000 |
| Mar. 28, 1980 | - 0 - | - 0 - | 1,965,000 | <5,989,000> | <4,024,700> |
| Mar. 31, 1980 | - 0 - | - 0 - | 1,908,156 | <5,989,000> | <4,081,544> |
| Apr. 30, 1980 | - 0 - | - 0 - | - 0 - | - 0 - | - 0 - |

1/ Unrealized profit (loss) computed using futures prices.

2/ Treasury Bills valued at face.