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NASAA

Hand Delivery

November 7, 1991

The Honorable Glenn English
U.S. House of Representatives
2206 Rayburn House Office Bldg.
Washington, D.C. 20515

RE: Conference Committee Consideration of CFTC Reauthorization Legislation

Dear Congressman English:

It is my understanding that the House-Senate Conference Committee which will consider legislation reauthorizing the Commodity Futures Trading Commission (CFTC) has started its deliberations. On behalf of the North American Securities Administrators Association (NASAA),[1] I am writing to bring to your attention two issues of deep concern to the Association with respect to the proposed legislation. First, *NASAA respectfully urges the Conferees to reject a proposed change to Title III now being circulated by the Chicago exchanges which contemplates expanded preemption authority for the Commodity Futures Trading Commission (CFTC) to preempt state law. Second, it is NASAA's view that there are potentially disastrous (and, we assume, unintended) consequences for investors of what appears in Section 303 of Title III to be a codification, and indeed expansion, of the CFTC's Interpretative opinion (OGC 85-2) on bank-financed precious metals.* A discussion of these issues follows.

[1] In the U.S., NASAA is the national organization of the 30 state securities agencies devoted to investor protection and the efficient functioning of the capital markets at the grassroots level.

ISSUES RELATED TO PREEMPTION OF STATE LAW

Although we are unaware of any specific legislative language, it is our understanding that the Chicago futures exchanges have suggested that language be added to the bill which would amend Section 12(e) of the Commodity Exchange Act (CEA) to explicitly state that the reach of federal preemption of state laws extends to those transactions which the CFTC exempts from certain requirements of the Act – including the exchange-trading requirement – under the Commission's new general exemptive authority granted under proposed Title III.

When Congress adopted the CEA, it preempted the states from applying their laws to certain persons and transactions within the jurisdiction of the Act. In response to the outbreak of commodity-related fraud in the late 1970s and early 1980s, Congress in 1982 amended the Commodity Exchange Act to permit the states to enact and enforce laws against: (1) unregistered persons who engage in commodity operations requiring the person to be registered with the CFTC; and (2) commodity transactions that fail to comply with the requirement of the Act that the transaction be carried out on an approved contract market or exchange. NASAA responded to this grant of authority by drafting, in cooperation with the CFTC, a model commodity code for use by the individual states. Today, 18 states have adopted model code provisions to move aggressively against off-exchange commodity fraud.

NASAA generally supports delegation of exemptive powers to the CFTC as stated in Title III of the Senate bill, but those powers should only be made within the narrow bounds of clearly delineated authority. The expansion of preemption proposed by the futures exchanges is far too uncertain in its presently explained form and would poses grave concerns for state law enforcement officials. Under their proposal, the CFTC could be allowed to assert jurisdiction over any instruments with a flavor of futurity, exempt the instruments from CFTC regulation, and at the same time preempt the states from enforcing their otherwise applicable anti-fraud laws over the transactions, thus returning us to the days of unfettered commodity-related fraud and abuse.

Therefore, NASAA respectfully urges the Conferees to reject any proposed language expanding the CFTC's exemptive authority.

SECTION 303 OF TITLE III AND BANK-FINANCED PRECIOUS METALS

Our second concern involves proposed section 4c(j)(1)(A) & (B) of the CEA (Section 303, "Hybrid Commodity Instruments", Title III of the legislation). This provision appears not only to give explicit statutory recognition to the extremely controversial CFTC interpretative opinion (OGC 85-2) which excluded from regulatory oversight the sale of precious metals on a leveraged basis by means of bank financing ("bank-financed precious metals), but also appears to significantly expand the scope of the exclusion by opening up such transactions to credit unions and foreign banks. Under such a scenario, a boiler room operation offering these programs could sell gold to a widow in Little Rock, Arkansas, for storage in the vaults of the First National Bank of Chad.

While we are certain that the drafters of this provision did not intend to open up the floodgates for illicit boiler room operations peddling these programs, the Association fears that, unless explicitly clarified by the Conference Committee, such may well be the result of the proposed section 4c(j)(1)(A) & (B). *Therefore, NASAA respectfully suggests that the Conferees make abundantly clear the meaning and intent of this provision and that a review be undertaken with respect to CFTC authority to regulate bank-financed precious metals programs.* In the course of such deliberations, NASAA would recommend that the CEA be amended to specifically encompass the sale of precious metals and other physical commodities for speculative or investment purposes by any means of financing, perhaps limited to the public solicitation of the same, by mail or telemarketing.

NASAA members have repeatedly warned the CFTC and others that the lack of proper regulation of bank-financed precious metals programs has resulted in a proliferation of commodity boiler room activity. One NASAA member testified before Congress that bank-financed precious metals programs are "probably the most complex boiler room problem yet faced by enforcement authorities." The Colorado Securities Commissioner in 1989 told the CFTC that "bank-financing has become one of the top two, if not the most, fertile ground of fraud in the precious metals area." The root of the problem is found in the 1985 CFTC interpretative opinion (OGC 85-2) in which it was concluded that bank-financed precious metals programs did not involve the offer and sale of futures contracts subject to the Commission's jurisdiction. As such, neither the offering nor the sales personnel are required to be registered with any government regulatory agency.

A bank-financed precious metals program generally works as follows: A program sales organization, usually telemarketers, contacts a potential customer and offers an opportunity to "control" a large quantity of precious metal. The customer then makes a down payment of 20 percent for a quantity of precious metals and a financial institution finances the remaining 80 percent of the purchase price and holds the entire amount of the precious metal as collateral for the loan obligation. The CFTC has concluded that this type of arrangement is tantamount to "cash and carry," where the purchaser pays for the metal and immediately receives it, and that the financing aspect and retention by the bank of the metal as collateral does not alter the fundamental nature of the transaction. Since the metal is delivered immediately and is held in the name of the investor, the CFTC has said there is no futures contract involved.

In the Commodity Exchange Act, Congress saw fit to recognize and mandate CFTC regulation over so-called leverage contracts. After a great deal of controversy, consideration and development, the CFTC finally promulgated rules to regulate the leverage business. Only three or four firms ever qualified as leverage transaction merchants. At present, the CFTC does not have any active leverage transaction merchants. The reason? Complying with the leverage rules was burdensome and expensive when compared to bank-financing. OGC 85-2 provided a blueprint under CFTC aegis to go forward with a product -- bank-financing programs -- virtually indistinguishable in a practical and consumer sense from leverage contracts, with no regulatory cost or oversight at all.

These programs have been characterized by significant and widespread fraud and abuse and have resulted in the victimization of many hundreds of small investors across the country. While bank-financed precious metals programs initially were offered by just two California-based financial institutions, they later attracted considerable interest and the programs themselves now are sold not by financial institutions but by a network of so-called "independent dealers," with whom the financial institutions claim they maintain an arm's length relationship. Since many financial institutions agreed to do business with any outfit willing to peddle the precious metals programs to consumers, boiler room operations sprung up.

State securities regulators have found that the program sales organizations attempt to create a sense of legitimacy for the program by emphasizing in their sales pitches the role of financial institutions in the precious metals programs. What consumers often are not told is that, as a result of the hefty up-front costs collected by both the financial institution and the sales organization (including interest charges, fees and commissions), the break-even point for the customer may require that the metal increase in value by as much as 30 percent or more! Further, although both the securities and commodities industries have suitability rules, the precious metals sales organizations are under no such constraints and may sell to anyone. (And, given the rather high break-even point, it may be argued that there are extremely few people for whom these investments are suitable.)

NASAA members also have uncovered fraud in other areas of bank-financed precious metals programs. For example, sales organizations may have made false margin calls and pocketed the money. Some sales organizations have forwarded to the financial institution only a portion of the down payment made by the customer. Accounts have been liquidated without the knowledge of the customer. And, there have been occasions whereby the entire financing plan has been falsified, with the sales organization keeping all of the customer's money and buying no metal at all.

The banks and dealers who have altered their programs to impose and require investor suitability and other safeguards are to be highly commended. Unfortunately, as it now stands, at least one major financial institution involved in bank-financed precious metals programs continues to do business with what seems to be anyone who is able generate many new customers, with an almost callous disregard for how they got them.

In approving interpretative Opinion OGC 85-2, the Commission did not merely provide an exemption from certain areas of regulation; the Commission declared an exclusion from jurisdiction. Exempt instruments or transactions are still subject to anti-fraud provisions, but excluded instruments and transactions are not subject to even that minimal level of oversight. The result is that no one at the federal level has direct and clear jurisdiction over these programs. It is NASAA's view that the CFTC should be given clear authority over bank-financed precious metals and that this regulatory loophole should be closed.

CONCLUSION

Finally, I want to commend Congress for advancing a comprehensive CFTC reauthorization measure which would significantly improve the CFTC's ability to oversee the futures markets.

The widespread fraud and manipulation uncovered in the 1989 federal investigation into Chicago's commodities markets raised critical questions about the integrity of the futures trading process and its regulation at the federal and exchange levels. The reforms included in the reauthorization bill will go a long way toward restoring integrity to the commodities markets and investor confidence in their operations and fairness.

If you have any questions or would like additional information on NASAA's position on these issues, please contact me at 804/786-9006 or Maureen Thompson, NASAA's legislative adviser, at 703/276-1116.

Sincerely,

Lewis W. Brothers, Jr.
Director, Virginia Corporation Commission,
Division of Securities and Retail Franchising
President, North American Securities Administrators Association