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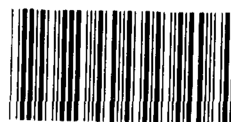
Report to the Chairman, Subcommittee on Oversight and Investigations, Committee on Energy and Commerce, House of Representatives

April 1988

LEVERAGE CONTRACTS

Commodity Futures Trading Commission's Regulation of Leverage Contracts



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April 14, 1988

The Honorable John D. Dingell
Chairman, Subcommittee on Oversight and
Investigations
Committee on Energy and Commerce
House of Representatives

Dear Mr. Chairman:

In your August 6 and December 1, 1986, and February 11, 1987, letters to the Comptroller General you asked us several questions concerning leverage contracts and their regulation. Leverage contracts are instruments for investing in precious metals and have been the subject of extensive congressional debate. They are sold through Leverage Transaction Merchants (LTM), which are registered with and regulated by the Commodity Futures Trading Commission (CFTC). There are three registered LTMs, only two of which were actively engaged in the business as of March 22, 1988.

In 1978 and 1979, CFTC imposed moratoria restricting entry into this business to those firms in operation selling leverage contracts in gold and silver on June 1, 1978, and those firms selling leverage contracts in any other commodity on February 2, 1979. However, the 1986 Futures Trading Act restricts leverage contracts to three precious metals and requires CFTC to lift its moratorium restricting new firms from entering the leverage business after making a study of relevant issues and transmitting a report to the appropriate congressional committees. The mandated study is required to deal with such topics as the economic purpose of leverage contracts; a survey of the number of firms interested in entering the leverage business; the most efficient way, consistent with the public interest, to allow new firms to enter the leverage contract business; and the appropriate regulatory scheme after the moratorium is lifted.

This letter is designed to answer your questions in turn, after briefly explaining what leverage contracts are and how they are regulated. In the appendixes to this letter, we describe in more detail provisions of leverage contracts, CFTC's regulations related to leverage contracts, the separate topic of third-party financing of precious metals, and the scope and methodology of our review.

Results in Brief

Our review of CFTC documents and discussions with its staff indicated that CFTC has generally taken the necessary oversight and review steps to determine LTM compliance with applicable laws and regulations, and when violations have been uncovered, they have been corrected by the LTMs. However, we have some reservations about the extent of certain CFTC sales practice examinations and procedures.

On the separate topic of third-party financing of precious metals, CFTC's Office of the General Counsel (OGC) issued an interpretative letter[1] in 1985 stating that financing arrangements of this type are neither futures contracts nor leverage contracts. Under this interpretation, these programs are, essentially, cash transactions that are not covered by the Commodity Exchange Act (CEA)[2] and, thus, not within the purview of CFTC.

Objective, Scope, and Methodology

The objective of our review was to answer questions you raised in your requests, which were supplemented and clarified in subsequent conversations with the Subcommittee. Specifically, we sought to

- determine if LTMs were complying with applicable laws and regulations;
- describe federal and state regulations governing leverage contracts;
- project how leverage contracts would have been regulated had an amendment proposed by Representative Dan Glickman to the 1986 Futures Trading Act been adopted;
- consider how the Securities and Exchange Commission (SEC) might regulate leverage contracts if they were declared to be securities instruments;
- ascertain the resource impact on CFTC when the moratorium is lifted;
- describe two other precious metals purchasing programs and third-party financing arrangements in general; and
- identify certain issues that we believe should be addressed by CFTC in its mandated study on leverage contracts and in its study of off-exchange futures.

To determine if the existing LTMs—Monex International, Ltd., International Precious Metals Corporation (IPMC), and First Asset Corporation (FAC)—were complying with applicable laws and regulations, we agreed with the Subcommittee to use CFTC evaluations, specifically their on-site

[1] OGC 85-2.

[2] 7 U.S.C. 1.

financial audits and sales practice examinations, as the basis for responding. This is because we lack legal authority to examine those private firms directly. As agreed with the Subcommittee, we did not look at work regarding FAC because it was registered with CFTC in December 1986 and had only seven open leverage contracts at the time we began this assignment.[3]

We studied results of the CFTC reviews and audits performed at Monex and IPMC between January 1985 and September 1987. In using this information, however, we also evaluated CFTC's plans and procedures for such reviews and the actual work performed by CFTC at Monex and IPMC. We also reviewed periodic reports submitted by the firms to CFTC, statistics of customer complaints for reparation[4] against leverage firms, and CFTC Enforcement Division actions against leverage firms.[5] We visited both Monex's and IPMC's offices to view their operations and interview various upper management personnel.

In order to answer your other questions, we interviewed officials at CFTC, SEC, and state regulatory officials in Florida and California where IPMC and Monex are located. We also spoke to officials of the North American Securities Administrators Association (NASAA) Commodities Committee.

We did our audit work in accordance with generally accepted government auditing standards. We conducted our review between August 1986 and September 1987. (See app. IV for a more detailed description of our objective, scope, and methodology.)

Background

Leverage contracts are designed for the long-term purchase or sale of certain precious metals, currently limited by law to bulk gold coins and bullion, bulk silver coins and bullion, and platinum.[6] They are primarily

[3]Since it was registered as an LTM, FAC has sold no new leverage contracts and as of December 31, 1987, FAC had no open leverage contracts.

[4]Complaints filed at CFTC where the customer seeks monetary reimbursement from the firm.

[5]The official term "Leverage Transaction Merchant" refers only to those firms registered with CFTC under the current leverage regulations in effect since 1984. Those firms doing leverage business before 1984 are referred to as leverage firms.

[6]Before the signing into law of the Futures Trading Act of 1986, leverage contracts involving copper and four foreign currencies were permitted. Although no new leverage contracts involving these commodities can be offered or entered into, existing open contracts must continue to be serviced.

used as a way for persons to speculate on price changes in those metals.[7] Such persons could also buy and sell futures contracts in the bullion form of those metals on an organized futures exchange. Generally, the bullion leverage contracts cover a smaller amount of metal than the actively traded futures contracts on those same metals.

In a typical long leverage contract, the customer enters into the contract with an LTM for a standardized quantity of metal at the LTM's offering price (ask price), and pays a portion of the cost up front (called the initial margin, usually set at approximately 20 percent).[8] The LTM charges the customer interest on the unpaid balance and other carrying costs as well as purchase and termination commissions. The LTM is required to have at least 90 percent of the amount of the commodity under contract covered either in inventory or by futures or options positions in the designated futures markets. At least 25 percent of the amount of the commodity under the leverage contract must be covered with the physical metal. The contracts are written for at least a 10-year period, but a customer may sell the commodity back to the LTM at its current bid price at any time the LTM is offering new contracts for sale on the same commodity. (See app. I for a description of leverage contract components.)

Leverage contracts are controversial and have been debated repeatedly in congressional hearings. The hearings have included topics related to the appropriate regulatory scheme for leverage contracts; the differences between securities, futures, and leverage contracts; and the disproportionate number of customer complaints filed with CFTC against leverage firms compared to other firms registered with CFTC. When Congress created the CFTC in 1974, it assigned CFTC regulatory jurisdiction over leverage contracts.

In third-party financed arrangements, which are different from leverage contracts and generally referred to as bank funding programs, the customer purchases precious metals from a dealer. A third party, such as a commercial bank, then finances the purchase and keeps the commodity until the customer has repaid the loan. (See app. III for a description of these programs.)

[7]During 1986 and 1987, fewer than 5 percent of leverage contracts terminated by customers resulted in delivery of the commodity.

[8]Short leverage contracts are also permitted and offered only by Monex. In a short leverage contract, the customer contracts to deliver a commodity to the LTM whereas, in a long contract, the customer contracts to purchase a commodity from the LTM. Short contracts are entered into at the LTM's bid price and offset at the ask price. Both long and short leverage contracts are written for at least a 10-year period. See appendix I for a further description.

Do the LTMs Comply With Applicable Laws and Regulations?

Our review of CFTC documents and discussions with its staff indicated that CFTC has generally taken the necessary oversight and review steps to determine LTM compliance with applicable laws and regulations, and when violations have been uncovered, they have been corrected by the LTMs.[9] However, we have some reservations about the extent of certain CFTC sales practice examinations and procedures.

Since 1984, up to October 1987, CFTC had conducted three sales practice examinations and three financial audits at IPMC and two sales practice examinations and four financial audits at Monex. CFTC's sales practice examinations at IPMC, conducted between July 1984 and January 1986, found no deficiencies in that firm's sales practices. However, CFTC's financial audit completed in April 1987 cited IPMC for 12 apparent violations. IPMC responded to the financial audit with corrective action on one violation but disputed the other 11. CFTC staff is reviewing IPMC's response to the financial audit.

At Monex, sales practice examinations between August 1984 and March 1986 uncovered five deficiencies, all of which Monex responded to with corrective action. CFTC financial audits at Monex have uncovered a number of violations since the first one conducted in 1984, although the number had decreased for 3 consecutive years with 17 in 1984, 9 in 1985, and 1 in 1986. For each violation, Monex formally responded with a plan for corrective action, and CFTC tracked its progress by maintaining a similar scope of review at Monex covering past deficiencies in each subsequent financial review. The most recent financial audit, completed in September 1987, cited Monex for nine apparent violations. Monex responded to this audit in October 1987. In its response, Monex disputed one finding and noted corrective action taken on the eight other apparent violations.

We found the financial audits to be comprehensive in coverage and included reviews of procedures and transactions. However, in sales practice examinations, CFTC did not include sufficient tests of customer transactions and other analysis of LTM practices to determine full compliance with sales practice regulations. Such tests and analysis are a normal part of examinations designed to determine compliance. Steps such as tracing a sample of LTM customer transactions and comparing the results with CFTC regulations would have provided additional evidence to verify that LTM systems are in compliance and corroborate the

[9] CFTC has never found a violation during a sales practice examination or financial audit of an LTM to be severe enough to warrant a referral to the Enforcement Division.

LTMs' verbal representations. CFTC staff members told us that other agency priorities did not permit more in-depth work.[10] Moreover, for the same reason, CFTC did not conduct a follow-up visit to check on corrective action taken on previously cited sales practice problems at Monex until a year after it had originally intended.

After we discussed these findings with CFTC staff members, they returned to each firm and conducted supplemental sales practice examination work. This additional work was conducted using a written plan and included tests of the LTMs' systems of internal control and supervision, as well as review and analysis of records related to customer transactions. This work revealed one apparent violation at each firm. IPMC responded with acceptable corrective action while Monex disputed the finding saying its actions were not in violation of CFTC regulations. The Division of Trading and Markets reviewed Monex's response and found it to be satisfactory.

Reparation complaints filed with CFTC against Monex and IPMC have averaged approximately 10 per year for each firm. That figure was about 6 percent of all futures industry complaints for reparations in 1986. Table II.1 shows a history of leverage industry complaints and all futures industry complaints received by CFTC. Since CFTC was given jurisdiction over leverage contracts, its Division of Enforcement has instituted 10 proceedings against four leverage firms; three of the proceedings have been against Monex or IPMC. (See p. 28 for the resolution of these proceedings.)

What Federal Regulations Are Applicable to Leverage Contracts?

LTMs are subject to a variety of rules and regulations covering their financial operations and sales practices. The comprehensive leverage contract regulations became effective in 1984. The LTMs must register with CFTC, register their sales force with CFTC, have the commodities sold through registered leverage contracts, disclose the risk involved and the contract terms and conditions to prospective customers, submit periodic activity and financial reports to CFTC, abide by financial capitalization and segregation rules, and undergo periodic examinations by CFTC staff. (See app. II for a more detailed description of CFTC regulations for leverage contracts.)

[10] CFTC's Division of Trading and Markets is also responsible for audits of 15 self-regulatory organizations (SRO) as well as Futures Commission Merchants (FCM), where deemed appropriate.

How Do States Regulate Leverage Contracts?

State regulators have no jurisdiction over leverage contracts, per se. They are pre-empted from direct regulation by the CEA. However, under the CEA, states may enforce certain general anti-fraud statutes in state or federal court. According to the Chairman of the NASAA Commodities Committee, when a state brings an action under these statutes, it must go through a state attorney general's office and prove not only that victims were defrauded, but also that the accused firm intended fraud. He told us that this was a very time-consuming process. Nevertheless, securities commissioners in both Florida and California (where the LTMS are located) said they believe they have broad enough state laws to take an action against an LTM, if necessary. However, neither state has initiated a legal proceeding against the registered LTMS.

NASAA adopted a resolution in November 1986 stating that leverage contracts should be outlawed. Absent this, NASAA, in the same resolution, said that leverage contracts should be regulated as a security. Some state regulators equate leverage contracts to mutual funds which come under state Blue Sky laws.[11] If leverage contracts were regulated as securities, according to a NASAA official, the states would, at minimum, require LTMs to register with their securities boards. However, congressional action would be necessary to remove LTMs from exclusive jurisdiction of CFTC.

How Would Leverage Regulation Have Been Affected by Passage of the Glickman Amendment?

During debate on the 1986 Futures Trading Act, Congressmen Dan Glickman and Charles Schumer offered an amendment requiring leverage contracts to be traded on organized futures exchanges. Had the amendment been adopted, leverage contracts, as such, would have disappeared. Since these contracts were designed to be off-exchange products with designated counterparties, they would, by definition, be banned under such a requirement that all such arrangements be traded on exchanges, where prices are determined by an open outcry auction system and the customers do not contract with each other directly.

How Would the SEC Regulate Leverage Contracts?

In response to this hypothetical question, staff from the SEC postulated that leverage contracts might be treated like over-the-counter options currently sold by at least one firm under the SEC's jurisdiction. Because leverage contracts are bilateral agreements between a customer and a principal which, by their very nature, are highly leveraged instruments,

[11] State securities laws pertaining to registration requirements and procedures for issuers, broker/dealers, their employees, and other associated persons of those entities.

they might be viewed as similar to over-the-counter options which are also highly leveraged, bilateral agreements that contemplate the ability to buy or sell a specific underlying interest at a certain date for a fixed dollar amount.

Assuming leverage contracts would be regulated in a manner similar to the regulation of over-the-counter options, then the firm selling the contract would register with the SEC under the Securities Exchange Act of 1934; register with an industry SRO, in this case, the National Association of Securities Dealers (NASD); submit to oversight inspections by NASD; and provide periodic reports to customers in accordance with the securities laws. Currently, there is no SRO for the leverage contract industry. In addition, the offering of the leverage contract itself, depending on its structure, might be subject to the registration and disclosure requirements of the Securities Act of 1933. The firm would also be subject to state securities laws. Thus, both the applicable regulations and the regulatory structure would be different.

What Will the Resource Impact on CFTC Be When Its Moratorium Expires?

As agreed with the Subcommittee, we reviewed CFTC's estimates of the resource impact in order to respond to this question. The 1986 Futures Trading Act allows CFTC to gradually remove its moratorium in order to minimize the impact. Before the passage of this law, the agency made estimates of staff increases that would be required should the moratorium be lifted, depending on how many new firms entered the leverage contract business. In 1984, CFTC staff developed estimates using various entry assumptions and number of contracts offered which ranged from 30 to 132 additional staff years needed, or up to an approximate 25 percent increase over the agency's 1984 staff years.

In 1986, CFTC updated these figures. Based on an assumed entry of 100 new LTMS each offering 10 contracts, CFTC estimated it would need 25 more staff years in fiscal year 1989, an approximate 5 percent staff year increase over its fiscal year 1988 budget request. This latest estimate also assumed that the National Futures Association (NFA), a futures industry SRO, would take over the functions of registration, financial and sales practice audits, reviews of disclosure documents, and the registration of leverage commodities.

While we did not review the methodology used in this study, its accuracy depends heavily on how many firms choose to enter the industry, and CFTC did not attempt to predict this. Rather, the study was intended

to show what the resource impact might be given a certain level of registered LTMS. Our interviews with CFTC, state, and industry officials showed a wide variety of opinion about how many firms would enter, from fewer than 10 to over 100. CFTC and NFA have recently conducted a survey of prospective LTMS as required by the 1986 Futures Trading Act. The survey results, issued in February 1988, indicated that 46 firms were interested in registering as LTMS when the moratorium is lifted. However, it is unclear at this time how many of these firms could meet CFTC's registration requirements.

How Do Two Other Precious Metals Purchasing Arrangements Fit Into CFTC's Leverage Regulations?

The two programs cited in your February 11, 1987, letter are the Dominion Bank Precious Metals Certificate, offered by Dominion Bank in Virginia, and the Monex Atlas Account, offered through Monex Credit Corporation (MCC), an affiliate of Monex International which is separate from Monex's leverage contract business. Both of these programs for precious metals purchases are separate from leverage contracts and, therefore, are not encompassed by leverage contract regulations.

CFTC staff, after reviewing the Dominion Bank brochure outlining its metals program, indicated that it appears to be a cash purchase of metals with the full cost paid up front by the customer. Cash purchase programs are not under the jurisdiction of CFTC.

The Monex Atlas Account is a form of third-party financing of precious metals and is one of at least eight programs of this type offered in the United States. Seven of these programs are offered through banks, all of which are members of the Federal Deposit Insurance Corporation (FDIC), while MCC is registered with the State of California as a Commercial Financial Lender. Third-party financing of precious metals is not subject to CFTC jurisdiction. In 1985, CFTC's OGC issued an interpretative letter stating that financing arrangements of this type are neither futures contracts nor leverage contracts. Under this interpretation, these programs are, essentially, cash transactions that are not covered by the CEA and, thus, not within the purview of CFTC.

Issues for CFTC to Consider in Its Reports

As agreed with the Subcommittee, we identified some issues which we believe CFTC should consider in its two ongoing studies, one of leverage contracts, which is mandated by the 1986 Futures Trading Act, and the other of third-party financing of precious metals, which is included as part of a study of off-exchange futures requested by the CFTC commissioners.

The issue with leverage contracts concerns the regulatory structure that will be used when the moratorium is lifted, specifically, whether an SRO should be used in the regulation of LTMS and what the resource impact will be on CFTC. The issue with third-party financing is whether CFTC should regulate the transactions (or parts of the transactions) and what roles do other regulatory authorities assume over these transactions.

Leverage Contract Issues

The primary structural difference between the way leverage contracts and other futures or securities products are regulated is the existence of self-regulatory bodies in the latter two cases.[12] Both NFA and the futures exchanges are the first line of regulation in the futures industry, and NASD and the securities exchanges are the first line of regulation in the securities industry. Such a structure, using NFA, for example, could ease the pressure on CFTC resources if a number of new firms enter the leverage business once the moratorium is lifted. It would, however, add a layer of regulation onto the leverage industry. The pros and cons of alternative regulatory structures and the impact on CFTC's resource requirements, with and without an SRO, would appear to be issues relevant to CFTC's determination of the appropriate regulatory scheme for leverage contracts.

Third-Party Financing Issues

Although CFTC staff has determined that third-party arrangements are not subject to its jurisdiction, the question of having it regulate them has been raised. In March 1987, the NASAA Board of Directors passed a resolution requesting CFTC to reexamine its position. This issue was also a major topic at February and October 1987 CFTC/State Advisory Committee hearings. One of the complicating factors is that banks financing these arrangements are already regulated by other regulatory agencies, but those agencies are primarily concerned with the safety and soundness of the banks themselves. In addition, the dealers who solicit customers and actually sell the metals are regulated mainly by general antifraud statutes. To more fully understand this issue, it would be helpful if the roles of the various regulatory authorities were explained so as to establish the extent of oversight currently in existence and whether a regulatory void exists in this area.

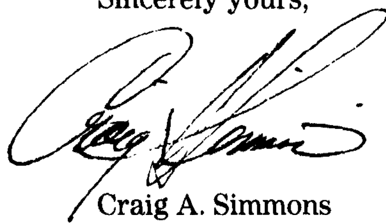
[12]For a full description of the regulatory structure of the securities and futures industries see, Securities and Futures: How the Markets Developed and How They Are Regulated (GAO/GGD-86-26, May 15, 1986).

Agency and Other Organization Comments

We provided copies of this report to CFTC, Monex, IPMC, and NASAA for the purpose of receiving official comments on its content. During this time, we discussed the report with each of these organizations to correct any technical inaccuracies in the original draft. We then received official comments based on the updated version of the draft from CFTC, Monex, and NASAA. These comments have been reproduced in their entirety and included in this report as appendixes. The comments varied among the organizations: CFTC generally agreed with the report's contents; Monex took exception to several technical points; and NASAA generally agreed with the accuracy of the report but stated that other factors such as the future regulatory structure and the future incidence of leverage-related fraud should be considered when discussing leverage. In some cases we changed the text, and we include a disposition of all comments in the appendixes.

As arranged with the Subcommittee, unless it publicly announces the contents of the report earlier, we plan no further distribution until 30 days from the date of this report. At that time, we will send copies to interested parties and make copies available to others upon request.

Sincerely yours,



Craig A. Simmons
Senior Associate Director

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Abbreviations

AP	Associated Person
CEA	Commodity Exchange Act
CFTC	Commodity Futures Trading Commission
COMEX	Commodity Exchange, Inc.
FAC	First Asset Corporation
FCM	Futures Commission Merchant
FDIC	Federal Deposit Insurance Corporation
FNMC	First National Monetary Corporation
GAO	General Accounting Office
ICTA	Industry Council for Tangible Assets
IPMC	International Precious Metals Corporation
LTM	Leverage Transaction Merchant
MCC	Monex Credit Corporation
NASAA	North American Securities Administrators Association
NASD	National Association of Securities Dealers
NFA	National Futures Association
OGC	Office of the General Counsel
SEC	Securities and Exchange Commission
SRO	Self-regulatory organization

What Are Leverage Contracts?

Unlike other futures instruments regulated by the CFTC, leverage contracts are "off-exchange" products.[1] LTMs act as the sole buyer and seller in all such transactions with their customers. In these investments, the customer contracts for the long-term purchase or sale (at least 10 years) of a commodity, currently limited by law to gold, silver, or platinum from an LTM registered with CFTC to sell such instruments. The commodity's price is set by the LTM, another variation from futures contracts where the price is determined by the open outcry auction system on the futures exchange floor. The customer makes an initial payment that is a percentage of the total contract value, plus commissions, and locks in the price of the commodity as of the time the contract is entered into. For example, an individual wanting to purchase $10,000 worth of silver through a leverage contract must typically deposit 20 percent, in this case $2,000, plus commissions. On a long leverage contract, a monthly charge is assessed each customer as interest on the unpaid balance and for other carrying costs associated with the contract. On a short leverage contract, the customer is credited with interest by the LTM.

Primarily because of the way contract prices and customer charges are determined, and due also to the CFTC regulatory requirements, the terms and conditions of the contracts are detailed and lengthy. A description of the major provisions and characteristics of the contracts follows.

LTMs May Offer "Long" or "Short" Contracts

Leverage customers may speculate on an anticipated rise or decline in a commodity's market price by choosing between a long or short leverage contract. Both Monex and IPMC offer long leverage contracts where a customer contracts to purchase a commodity at a fixed price. The customer hopes the market price of the commodity will increase, in which case the customer can either take delivery or sell the contract back to the LTM realizing the difference between the contract ask price and the current bid price. The other choice, offered only at Monex, is a short leverage contract where, conversely, the purchaser agrees to sell a commodity to an LTM at a fixed price. The customer anticipates a price decline. Here, the customer may deliver the leverage commodity to the LTM or buy the contract back realizing the difference between the contract bid price and the current ask price.

In either a long or short contract, should the commodity's price move in the direction opposite from that anticipated by the customer, or if the

[1] All futures contracts must be traded on the 14 designated futures exchanges located in the United States.

change in price of the commodity is not large enough to cover commissions, bid/ask spread, and other charges, the customer realizes a net loss.

Bid/Ask Spread and Commissions Account Largely for LTM Income

LTMS derive their income primarily through the bid/ask spread and through commissions charged at point of sale and termination.

LTMS continuously monitor the market prices of each commodity at various sources through their on-line computer system. Some of the sources used for monitoring bullion prices include the Commodity Exchange, Inc. (COMEX), a futures exchange in New York where futures contracts are sold for some of the same commodities that LTMS sell, and Mocatta Metals and Handy & Harman, both New York based metals dealers. For coins, various coin dealers' prices are monitored as metal bought in coin form comes with a "premium" associated with it, reflecting such factors as the cost of minting and the underlying value that coins may have. Thus, coins usually sell for a higher price than does an equivalent metallic amount of bullion. CFTC regulations require LTMS to specify a cash price series[2] for each leverage commodity offered. The source of the cash price series must be included in the LTM's disclosure document and must be included in the customer's transaction confirmation statements. According to CFTC's Division of Economic Analysis staff, the purpose of the cash price series is to provide a leverage customer an indication of the economic value of the leverage commodity independent of an LTM's quoted prices.

LTMS establish a bid/ask spread, one of the profit-making aspects of the contracts for LTMS. The bid/ask spread is the difference between the price at which the LTM will sell a commodity to a customer and the price the LTM will buy it back from a customer. This is analogous to the LTM selling the commodity to a customer at retail price and buying it back at wholesale price. CFTC regulations require an LTM to disclose its bid/ask spread. The regulations do not, however, fix prices or establish limits on the bid/ask spread. Generally, the bid/ask spread has been approximately 2 to 3 percent. Table I.1 illustrates a hypothetical bid/ask spread.

[2]The regulations require specification of a widely disseminated and accepted cash price series for the commodity underlying the leverage contract. One example is the Handy & Harman cash price series, which can be found in the Wall Street Journal.

Table I.1: Example of Bid/Ask Spread

Cash price for silver	–	$7.00/ounce	
LTM ask price for silver	–	$7.10/ounce	($7.00 + 1.5%)
LTM bid price for silver	–	$6.90/ounce	($7.00 – 1.5%)

LTMs charge a commission on initiating a leverage contract. The commission, based on a sliding scale depending on the number of contracts purchased, ranges from 3.5 percent of the contract value to less than 1 percent, depending on the LTM. LTMs generally charge a commission for contract terminations based on the contract value. IPMC and Monex each have a sliding scale for contract terminations depending on the number of contracts terminated and the length of time the contracts remained open. IPMC's scale ranges from 1 percent to 0.1 percent, while Monex's ranges from 3 percent to 0.

First-Time Customers May Rescind Their Contracts

Customers may rescind their first leverage contract purchase up to 3 days after they receive notice from the LTM confirming the contract. If a long contract is properly rescinded, the customer is liable only for the change in the ask price at the time of purchase and the ask price at the time of rescission. In a short contract, the customer is liable only for the change in the bid price between the time of purchase and rescission. No other costs are to be assessed, such as opening and termination commissions, carrying charges, and any other fees.

Customers Are Assessed Monthly Carrying Charges

LTMs assess customers monthly carrying charges on long leverage contracts representing a variety of costs. The carrying charges include interest on the unpaid balance, insurance, and commodity storage costs. These costs have been referred to, by both LTM and CFTC officials, as similar to the contango[3] associated with futures contracts.

LTMs charge interest on the unpaid balance of a leverage contract. CFTC requires full disclosure of interest charges although no specific range of rates has been prescribed. As of July 28, 1987, Monex was charging interest on long leverage contracts of 9.5 percent for all commodities except platinum where the interest was 8.5 percent. On short contracts,

[3]Contango represents the difference between the cost of a commodity on a cash market and the cost for the same commodity in a futures contract. The futures price is more than the cash price because the costs of interest, insurance, and storage are imputed in the futures price. In most cases, the cost of a commodity based on a futures contract moves closer to, or converges with, the cash market price as the futures contract nears expiration.

Monex was paying 8.5 percent on all commodities except platinum which was 7.5 percent. Monex calculates other service charges separately and adds them on for the total monthly carrying charge. IPMC charges 11.75 percent interest on the unpaid balance. However, this rate includes all monthly service charges and therefore the effective interest rate is lower than the figure indicated. For comparison, the prime interest rate on the same date was 8.25 percent.[4]

Interest rates charged may change from month to month and in all cases the customer's monthly statements must include notice that the rate has changed. If the rate changes during a month, customers must be notified by the LTM through first-class mail.[5] The LTM derives earnings from the extent of the difference between the interest rate the LTMs pay for their borrowings and the interest rate they charge on unpaid account balances, in addition to commissions and the bid/ask spread.

Customers Must Deposit an Initial Margin That Is Tied to Fluctuations in Daily Market Prices

When a leverage contract purchase is initiated, the customer makes a down payment based on the value of the leverage contract. This is the initial margin and is set by the LTM. As of July 28, 1987, both Monex and IPMC required a 20 percent initial margin on all their contracts. If the market price of the commodity falls in a long leverage contract, the equity in the account also falls. Likewise, if the price of the commodity increases, the equity also increases. In this case, the customer may withdraw funds as long as the initial margin level is maintained, or he/she may leave the excess equity in the account. However, a gain of equity does not decrease, and a decline in equity does not increase, the unpaid balance of the account.

Daily market price fluctuations of commodities affect the equity in customer accounts. As the LTM's bid and ask price of the commodity purchased through a leverage contract varies, so does the customer's equity. Customers must keep a minimum equity in their accounts throughout the life of the contract and are subject to margin calls if equity decreases to a specified level.

Customers are, however, given some leeway before LTMs request that the margin be increased and are so apprised in the contract terms and conditions. When the equity in the account falls below a specified level, the

[4]Wall Street Journal, July 29, 1987, p. 29.

[5]Monex and IPMC have each been granted an exemption to this regulation in that the interest rate must change by 1 percent or more during a month before notification to customers is required.

"minimum" margin level, the LTM makes a margin call to the customer who, within the time stated in the contract, must either (1) deposit enough funds in the account to establish the margin back to the "maintenance" margin level or (2) instruct the LTM to liquidate enough of the contracts to bring the margin back to the maintenance level. The maintenance margin level at IPMC is 17 percent and the minimum margin level is 12 percent while, at Monex, the maintenance margin is the same as initial margin, 20 percent, with a 12 percent minimum margin for all metals.

Customer contact, either by phone or in writing, must be made when a margin call is made. If the customer fails to respond in a reasonable time to the margin call,[6] the LTM may sell enough contracts in the account to reestablish the required maintenance margin level.

If the equity falls to one-half the minimum margin level, currently 6 percent, the LTM may "force liquidate" enough contracts in the account so that the equity in the account will at least equal the minimum margin level. This may be done by the LTM even if the customer cannot be contacted. CFTC has established rigid regulations related to forced liquidations. Among other things, the regulations require notice to customers that a forced liquidation has occurred and of the customer's right to reestablish the contracts liquidated in the account without commission charges if customer contact was not made before liquidation. The customer is liable only for the change in the price of the commodity between the dates of the forced liquidation and reestablishment of those contracts which were force liquidated.

Contracts May Be Terminated by Repurchase or Delivery

Leverage contracts may be terminated by the customer in two ways. The first, and most prevalent, is where the purchaser sells the contract back to the LTM, commonly referred to as repurchasing or offsetting the contract. The second form of termination is where the customer takes delivery of the commodity. As with exchange-traded futures contracts, delivery on leverage contracts is often not taken.

As required by CFTC regulations, an LTM must offer to repurchase leverage contracts from customers at any time that it is offering leverage contracts for sale on the same commodity. When this option is taken, the

[6]CFTC's regulations define a reasonable time to be 24 hours, excluding Saturdays, Sundays, and holidays.

customer sells the contract to the LTM at the current bid price (long contract) or current ask price (short contract). Unlike futures contracts and securities, leverage contracts cannot be traded or resold to anyone other than the original seller (the LTM).

When a contract is terminated by delivery of the commodity, the customer pays the balance owed on the account. The customer and the LTM establish a delivery point and the means by which the commodity will be transferred to the customer. The customer pays all delivery charges, which include costs for handling, packaging, insuring, and shipping.

LTMs Must Fully Disclose Risk to Customers

All customers must receive a risk disclosure statement and the terms and conditions of leverage contracts before purchasing their first leverage contract. This statement must be signed by the customer and returned to the LTM before a purchase can be made, as required by CFTC regulations.

Wording of the first part of the statement, included on page 22, is prescribed, verbatim, in CFTC regulations. The statement warns that prices of metals are unpredictable, investing in them involves a high degree of risk, and investments of this type may not be suitable for many people. It also discusses margin calls and rights to rescission as well as explains that the LTM is the only party who can repurchase the contract.

The second part of the document, provisions of leverage contracts, must explain many aspects of the contract including

- pricing policies and the bid/ask spread;
- initial, carrying, and termination charges;
- margin requirements, including initial and maintenance margin, margin calls, and forced liquidations;
- lack of a market in which to sell the contract other than to the LTM;
- first-time customer rights to rescission;
- sample confirmation statement; and
- the customer's break-even point, after considering all charges associated with the contract.

In addition, LTMs must provide to all customers a description of the firm, biographies of its principals, any material administrative or civil action related to various futures or securities statutes, and any material criminal action against the firm within the preceding 5 years.

Sample Risk Disclosure Statement

AS A LEVERAGE CONTRACT CUSTOMER, IT IS YOUR RESPONSIBILITY TO READ AND UNDERSTAND ALL OF THE PROVISIONS OF THIS RISK DISCLOSURE STATEMENT AND LEVERAGE ACCOUNT AGREEMENT ("Agreement").

RISK DISCLOSURE STATEMENT AND LEVERAGE ACCOUNT AGREEMENT

BECAUSE OF THE UNPREDICTABLE NATURE OF THE PRICES OF PRECIOUS AND OTHER METALS AND FOREIGN CURRENCIES, LEVERAGE CONTRACTS INVOLVE A HIGH DEGREE OF RISK AND ARE NOT SUITABLE FOR MANY MEMBERS OF THE PUBLIC. THE LEVERAGE CUSTOMER SHOULD BE AWARE THAT THE VALUE OF A LEVERAGE CONTRACT ORIGINALLY PURCHASED BY A CUSTOMER ("LONG LEVERAGE CONTRACT") MUST EXCEED THE BREAK-EVEN PRICE BEFORE IT IS POSSIBLE TO REALIZE A PROFIT ON THE CONTRACT. A FILLED-IN VERSION OF THE CUSTOMER CONFIRMATION STATEMENT REFLECTING A SINGLE TRANSACTION IN A REPRESENTATIVE LEVERAGE COMMODITY FOR A LONG LEVERAGE TRANSACTION WHICH INCLUDES A FORMULA FOR CALCULATING AN ESTIMATE OF THE LEVERAGE CONTRACT'S BREAK-EVEN VALUE IS ATTACHED TO THIS DOCUMENT. THIS IS IN THE SAME FORMAT AS THE CONFIRMATION STATEMENT YOU WILL RECEIVE TO CONFIRM YOUR ACTUAL TRANSACTION. BE CERTAIN THAT YOU UNDERSTAND THE INFORMATION PROVIDED BY THIS STATEMENT BEFORE YOU ENTER INTO A LEVERAGE TRANSACTION.

YOU SHOULD ALSO UNDERSTAND THAT THE CHARGES FOR SIMILAR LEVERAGE CONTRACTS WHICH ARE REFLECTED ON THE FILLED-IN CONFIRMATION STATEMENT AS ESTIMATED MAY VARY AMONG LEVERAGE FIRMS, AND THAT SUCH FIRMS HAVE COMPLETE DISCRETION IN SETTING THEIR CHARGES AND THE PRICE OF THE LEVERAGE CONTRACTS THEY OFFER. PRIOR TO ENTERING INTO ANY LEVERAGE CONTRACT A PROSPECTIVE LEVERAGE CUSTOMER SHOULD COMPARE THE CHARGES AND PRICES OF SUCH FIRMS WITH EACH OTHER AND WITH THE COMMISSIONS FOR AND PRICES OF FUTURES CONTRACTS TRADED ON DESIGNATED EXCHANGES.

YOU SHOULD ALSO BE AWARE THAT YOU ARE SUBJECT TO MARGIN CALLS. THE LEVERAGE FIRM RESERVES THE RIGHT TO LIQUIDATE YOUR POSITION IF YOU DO NOT RESPOND TO A MARGIN CALL WITHIN THE TIME SPECIFIED IN YOUR LEVERAGE AGREEMENT. IN ANY EVENT, IF THE EQUITY IN YOUR CONTRACT AT ANY TIME FALLS BELOW 50% OF THE MINIMUM MARGIN, YOUR CONTRACT MAY BE LIQUIDATED WITHOUT PRIOR NOTICE. YOU MUST, HOWEVER, BE NOTIFIED OF LIQUIDATION WITHIN NO MORE THAN 24 HOURS THEREAFTER AND PERMITTED TO REESTABLISH YOUR CONTRACT FOR A PERIOD OF 5 BUSINESS DAYS. LEVERAGE CONTRACTS PURCHASED FROM A LEVERAGE TRANSACTION MERCHANT ARE REESTABLISHED AT THE THEN PREVAILING BID PRICE WITHOUT COMMISSIONS, FEES OR OTHER MARK-UPS OR CHARGES UNDER RULES SET BY THE COMMODITY FUTURES TRADING COMMISSION, AS MORE COMPLETELY DESCRIBED IN THIS DISCLOSURE DOCUMENT. IN CASE OF LIQUIDATION, ALL OF YOUR FUNDS MAY BE USED TO SETTLE THE DEFICIT IN THE ACCOUNT, AND YOU MAY BE LIABLE FOR ADDITIONAL FUNDS TO SETTLE IN FULL.

IF YOU ARE A FIRST-TIME LEVERAGE CUSTOMER, YOU MAY RESCIND YOUR FIRST LEVERAGE TRANSACTION SUBJECT ONLY TO ACTUAL PRICE LOSSES BUT OTHERWISE WITHOUT PENALTY FOR THREE BUSINESS DAYS FOLLOWING AND INCLUDING THE DAY OF RECEIPT OF THE CONFIRMATION.

YOU SHOULD BE AWARE THAT IN ORDER TO REALIZE ANY VALUE FROM A LONG LEVERAGE CONTRACT, THE LEVERAGE TRANSACTION MERCHANT WHICH SOLD YOU THE LEVERAGE CONTRACT MUST REPURCHASE IT, OR YOU MUST PAY THE LEVERAGE TRANSACTION MERCHANT THE FULL PURCHASE PRICE FOR THE LEVERAGE CONTRACT, TAKE DELIVERY OF THE LEVERAGE COMMODITY, AND THEN SELL THE LEVERAGE COMMODITY, POSSIBLY AT A LOWER PRICE THAN THE PRICE PAID TO PURCHASE THE LEVERAGE COMMODITY FROM THE LEVERAGE TRANSACTION MERCHANT.

THERE IS NO MARKET FOR THE LEVERAGE CONTRACT ITSELF OTHER THAN TO HAVE IT REPURCHASED BY THE LEVERAGE TRANSACTION MERCHANT. A LEVERAGE TRANSACTION MERCHANT IS UNDER NO OBLIGATION TO OFFER TO REPURCHASE A LEVERAGE CONTRACT AT ALL TIMES, ALTHOUGH THE LEVERAGE TRANSACTION MERCHANT MUST OFFER TO REPURCHASE ANY LONG LEVERAGE CONTRACT PREVIOUSLY PURCHASED BY A LEVERAGE CUSTOMER AT ANY TIME DURING WHICH THE LEVERAGE TRANSACTION MERCHANT IS OFFERING TO ENTER INTO NEW LONG LEVERAGE CONTRACTS WITH CUSTOMERS INVOLVING THE SAME LEVERAGE COMMODITY. AS NOTED ABOVE, HOWEVER, A LEVERAGE TRANSACTION MERCHANT HAS COMPLETE DISCRETION IN SETTING THE PRICE AND ANY CHARGES RELATED THERETO.

THE COMMODITY FUTURES TRADING COMMISSION HAS NOT PASSED UPON THE MERITS OF THESE LEVERAGE CONTRACTS AS AN INVESTMENT VEHICLE NOR UPON THE ACCURACY OR ADEQUACY OF THIS DISCLOSURE DOCUMENT. ANY REPRESENTATION TO THE CONTRARY IS A VIOLATION OF THE COMMODITY EXCHANGE ACT AND THE REGULATIONS THEREUNDER.

What Is the Current Regulatory Structure Governing Leverage Contracts?

CFTC has promulgated leverage contract regulations by which LTMs must abide. The regulations dictate, among other things, that the contract be for at least 10 years and the prices, monthly carrying charges, and risk of the investment be properly disclosed.

CFTC regulations regarding leverage contracts[1] are intended to prevent manipulation, misrepresentations, and other abusive practices as well as to guard against the financial insolvency of an LTM. LTMs are not members of an SRO, as are all other firms in the futures industry, and, thus, the CFTC is the sole regulatory body overseeing the industry.

The current regulatory structure developed by CFTC for LTMs is more complex and more stringent than the regulatory structure designed for those trading on futures exchanges. A former CFTC chairman has stated in congressional hearings that leverage regulation is complex and resource intensive in its enforcement due, among other things, to the nature of the instruments being regulated, the operational differences of the leverage firms, and the absence of an SRO to oversee LTMs. In addition, the regulations are more stringent due to a disproportionate number of customer complaints of fraud and customer abuse concerning leverage contracts compared to other futures products. (See p. 29 for historical data.)

CFTC regulations require registration of LTMs and their associated persons (AP).[2] CFTC also requires registration of all commodities sold through leverage contracts. The regulations impose financial requirements related to net capital and "cover" of obligations. Net capital regulations require LTMs to maintain a minimum of $2.5 million of adjusted net capital. Cover means that LTMs must cover at least 90 percent of open leverage contracts with physical inventory and positions taken on futures exchanges. At least 25 percent of the amount of the commodity in the contract must be covered with the physical metal. Leverage contracts must include provisions for the LTM to repurchase all contracts at any time when they are offering new contracts for sale on the same commodity. The regulations specify, in detail, the contents of the risk disclosure statement which must be included in the contracts' terms and conditions. Leverage contract transactions with a customer may not

[1] 17 CFR Part 31.

[2] A natural person associated with an LTM as a partner, officer, employee, consultant, or agent (or any natural person occupying a similar status or performing similar functions), in any capacity that involves: (a) the solicitation or acceptance of customers' orders (other than in a clerical capacity) or (b) the supervision of any person or persons so engaged.

commence until the LTM receives a signed disclosure statement from the customer.

Further, the regulations require LTMs to segregate customer funds from the firm's own funds and separately account for them. LTMs must mail to customers, within 24 hours, confirmation statements of all purchases made and provide monthly statements of account status to customers. LTMs must also provide customers an illustrative break-even point equation so the customer can calculate the value to which the commodity must rise to offset commissions, carrying charges, and the bid/ask spread. Some other provisions of the CFTC regulations relate to LTM's use of promotional material and customers' rights to rescind their first leverage contract purchase.

LTMs Must Register With CFTC Before Conducting Business

Before a firm can legally offer and sell leverage contracts, it must meet the CFTC's requirements for registration. As discussed below, among the steps that are completed before granting LTM registration are fitness checks of principals and APs, review of disclosure documents, registration of all leverage contract commodities, review of moratorium compliance materials, and audits of financial operations and sales practices.

Some of these steps are an ongoing process once a firm is registered. For example, CFTC conducts fitness checks (see below) on any new principals, registers new APs, and registers new leverage commodities to be offered by LTMs. Proposed changes to an LTM disclosure document must be submitted to CFTC before it can be publicly circulated. Also, CFTC conducts periodic sales practice examinations and financial audits to determine an LTM's compliance with regulations.

Fitness Checks

A fitness check is intended to show whether the principals of the firm or the APs have ever violated commodities or securities laws. CFTC requires individuals in those firms to submit an application showing, among other things, their previous work experience, education, and past and present residences. CFTC also requires fingerprint cards which are, in turn, submitted to the Federal Bureau of Investigation for a records check. If a principal or AP has been convicted of a felony or has willfully submitted a false or misleading application, among other things, the CFTC has grounds for statutory denial of registration.

Disclosure Documents

CFTC reviews prospective LTMs' disclosure documents describing the distinguishing characteristics of the leverage commodity to be purchased or sold and defining the terms of the contract including, among other things, length of contract, provisions for disclosure of changes in contract terms, and the appropriate cash price series (and source of the price) so customers can ascertain the current economic value of the underlying leverage commodity from a source other than the LTM. In addition, the document must detail any material administrative or civil actions related to various futures or securities statutes and any material criminal action brought within 5 years preceding the date of the disclosure document.

Registration of Leverage Commodities

Commodities sold through leverage contracts must meet certain specifications so that they are of sufficient quality and size to be sold in a market outside the LTM. This is required because a commodity without a normal marketing channel may lose substantial value if there is no market in which a customer could sell the commodity should delivery be taken.

Moratoria Compliance[3]

CFTC has adopted rules which have imposed moratoria on the entry of new firms into the leverage contract business. Specifically, in 1978, CFTC imposed a temporary moratorium, effective January 4, 1979, on the entry of new firms into the gold and silver leverage field. Exempted from this rule are firms that were engaged in the gold or silver leverage transaction business on June 1, 1978.

Subsequently, in 1979, CFTC imposed a similar temporary moratorium on the entry of new firms into the business of offering or selling leverage contracts involving commodities other than gold or silver which were not engaged in that business on February 2, 1979.

Audits of Financial Operations and Sales Practices

CFTC conducts a financial audit and a sales practice examination before granting an LTM registration. CFTC reviews the firm's operating systems to ensure they are capable of complying with leverage contract regulations.

[3]The Futures Trading Act of 1986 requires CFTC to lift its moratorium on new firms and restricts leverage contracts to three precious metals. Therefore, this will cease to be a requirement for registration in the future.

CFTC Conducts Sales Practice Examinations and Financial Audits After a Firm Is Registered As an LTM

CFTC has conducted sales practice examinations and financial audits of IPMC and Monex. These examinations and audits are designed to determine whether the LTMs are operating in compliance with leverage regulations. Between 1984, when the leverage contract regulations went into effect, and October 1987, CFTC conducted a total of 12 sales practice examinations and financial audits at the two LTMs.

We found the financial audits to be comprehensive in coverage and include reviews of procedures and transactions. However, in sales practice examinations, CFTC did not include sufficient tests of customer transactions and other analysis of LTM practices to determine full compliance with sales practice regulations. Such tests and analysis are a normal part of examinations designed to determine compliance. Steps such as tracing a sample of LTM customer transactions and comparing the results with CFTC regulations would have provided additional evidence to verify that LTM systems were in compliance and corroborate the LTMs' verbal representations. CFTC staff members told us that other agency priorities did not permit more in-depth work.[4] Moreover, for the same reason, CFTC did not conduct a follow-up visit to check on corrective action taken on previously cited sales practice problems at Monex until a year after it had originally intended.

After we discussed these findings with CFTC staff members, they returned to each firm and conducted supplemental sales practice examination work. This additional work was conducted using a written plan and included tests of the LTMs' systems of internal control and supervision, as well as review and analysis of records related to customer transactions.

CFTC Requires Regular LTM Reporting of Sales Volume, Pricing, and Customer Profits/Losses

CFTC requires LTMs to report the level of customer activity and the profitability of their leverage contracts. Included in monthly reports are, for each commodity sold through leverage contracts, the length of the contracts; open contracts at the end of the month; open contracts in commercial accounts at the end of the month; number of contracts entered into during the month; number of contracts entered into by commercial firms during the month, and repurchases, liquidations, deliveries, and contract rescissions during the month. Records of the bid/ask prices for each commodity as of the close of each business day in the month must be submitted as well.

[4]CFTC's Division of Trading and Markets is also responsible for audits of 15 SROs as well as FCMs where deemed appropriate.

LTMs must also submit quarterly reports containing information on the profitability to customers on each commodity for which leverage contracts are sold. Included are the number of contracts resulting in gains and losses to customers, the number of contracts delivered, the largest gains and losses as well as total gains and losses, the net of gains to losses, and the percentage of contracts gaining versus losing. In addition, LTMs are required to submit quarterly financial reports as well as a year-end financial report that is certified by an independent public accountant.

CFTC Has Processed Customer Complaints Against Leverage Firms

CFTC, through the Complaints Section in the Office of Proceedings, Office of the Executive Director, provides a forum for customers seeking reparations from LTMs and its APs.[5] A customer alleging that an LTM's violation of the CEA or CFTC regulations has caused monetary loss may request a CFTC hearing to find fault and award damages. These hearings are before either a CFTC judgment officer or an Administrative Law Judge, depending on the dollar amount of the claim and the stated preference of the parties involved.

Reparations complaints against Monex and IPMC have averaged approximately 10 per year for each firm since 1982, the first year when complaints were identified by firm. In fiscal year 1986, complaints against these LTMs were approximately 6 percent of all complaints for reparations received, down from the approximately 11 percent annual rate for leverage firms in business between 1980 and 1985. Part of the decrease in complaints is attributable to two firms, Premex and First National Monetary Corporation (FNMC), going out of the leverage business.[6] See page 29 for historical data on total complaints and leverage complaints received by CFTC.

[5]This forum is available to any customer seeking reparations against any firm or individual registered with CFTC and is not confined to complaints against LTMs.

[6]Although FNMC and Premex have generally been referred to as leverage firms, neither firm was ever registered by CFTC as an LTM.

CFTC Has Investigated and Litigated Alleged Leverage Firm Violations

Since CFTC began regulating leverage contracts, its Division of Enforcement has instituted 10 enforcement proceedings against four leverage firms, three of which involved IPMC or Monex. The other seven actions involved two leverage firms no longer in business.

CFTC took one enforcement action against IPMC for, among other things, fraudulent sales practices, including understatement of risk and failure to remedy deficiencies in its customer accounting system. IPMC settled the case in December 1982 by agreeing to pay a $200,000 fine. CFTC filed two actions against Monex. The first action, instituted in 1979, was dismissed in 1985. In the second action, CFTC claimed that Monex had offered leverage contracts for commodities not approved by CFTC. Monex settled this case in November 1984 by agreeing to pay a $125,000 fine. This latter action is the first one CFTC has taken under its leverage regulations effective in 1984.

Of the remaining seven actions, four involved a leverage firm, Premex, that later went into bankruptcy. CFTC took these actions between 1978 and 1984. In these actions for fraudulent sales practices, there were several injunctions and the firm was cited for civil contempt on two occasions. Premex had its registration with CFTC revoked in 1984 and, ultimately, proceedings were dismissed when the firm went into bankruptcy. CFTC took the other three actions against FNMC between 1979 and 1986. Of these, one was dismissed, one was settled with a $225,000 fine against the firm, and one led to a permanent injunction issued in U.S. District Court in February 1986. Before this injunction, however, FNMC withdrew its application with CFTC for LTM registration.

Table II.1: Historical Data on Complaints for Reparations Filed at CFTC for All Registrants[7] and Leverage Firms

Fiscal year	Total complaints	Leverage complaints	Leverage complaints as percent of total
1976	63	2	3.2
1977	540	3	.5
1978	873	2	.2
1979	903	29	3.2
1980	1401	170	12.1
1981	1415	161	11.4
1982	1079	97	9.0
1983	916	95	10.4
1984	522	56	10.7
1985	454	47	10.4
1986	297	19	6.4
1987[a]	387	5	1.3

[a](as of Aug. 3, 1987)
Source: CFTC Office of Proceedings

Table II.2: Summary of Complaints for Reparations Filed at CFTC, by Leverage Firm

Fiscal year	FNMC	Premex	Monex	IPMC	Total
1976[a]					2
1977[a]					3
1978[a]					2
1979[a]					29
1980[a]					170
1981[a]					161
1982	38	25	18	16	97
1983	50	15	12	18	95
1984	23	13	13	7	56
1985	25	—[b]	10	12	47
1986	—[b]	—[b]	12	7	19
1987[c]	—[b]	—[b]	5	0	5
Total	**136**	**53**	**70**	**60**	**686**

[a]Complaints against leverage firms were not segregated by firm.

[b]Firm no longer selling leverage contracts.

[c](as of Aug. 3, 1987)
Source: CFTC Office of Proceedings

[7]This group includes FCMs, commodity Trading Advisors, Commodity Pool Operators, and Introducing Brokers, as well as leverage firms.

Third-Party Financing of Precious Metals

In addition to being offered through leverage contracts, precious metals are now offered for sale through third-party financing agreements, also referred to as bank funding programs. These purchasing agreements are a separate means from leverage contracts for purchasing precious metals. According to CFTC's OGC, this type of agreement does not fall within the purview of the CEA and, thus, is not within CFTC's jurisdiction.

Recently, the question of whether CFTC should re-examine its legal position and claim jurisdiction over third-party financing has surfaced. This question was addressed during public meetings at CFTC in February and October 1987, and the NASAA Board passed a unanimous resolution in March 1987 requesting CFTC to re-examine its OGC's position on third-party financing. In addition, the CFTC Commissioners have directed a task force, comprised of CFTC staff, to study the legal and economic characteristics of off-exchange futures products. One of the sections of the study, scheduled for completion in April 1988, is to deal specifically with bank financing programs, including a review of the legal issues and answers to questions concerning the number and type of bank financing programs available.

The Subcommittee Chairman asked us to review two programs for purchasing precious metals and explain how they fit into the current regulatory structure of leverage contracts. The programs cited are the Dominion Bank Precious Metals Certificate, offered by Dominion Bank in Virginia, and the Monex Atlas Account, offered through MCC, an affiliate of Monex International which is separate from Monex's leverage contract business. Both of these programs for precious metals purchases are different from leverage contracts and therefore are not covered by leverage contract regulations.

CFTC staff, after reviewing the Dominion Bank brochure materials, indicated that the program appears to be for cash purchase of metals with the full cost paid up front by the customer. Since this is a cash program, it is not regulated by CFTC.

The Monex Atlas Account is a form of third-party financing of precious metals and is but one of at least eight programs of this type offered in the United States. Seven of these programs are offered through banks, all of which are members of the Federal Deposit Insurance Corporation (FDIC), while MCC is registered with the State of California as a Consumer Financial Lender.

Third-Party Financing of Precious Metals: How It Works

Although third-party financing of precious metals varies among the respective sellers, the following is a general description of how these agreements work.[1] The three participants are a precious metals dealer, a bank (or, in the case of MCC, a Consumer Financial Lender), and a customer. Each has a distinctive role in the transaction. It is initiated through the metals dealer contacting a prospective customer offering metals for purchase. (The prospective customer may also initiate the inquiry.) If the customer wishes to make a metals purchase requiring a loan, the metals dealer arranges for the customer to contact a specific bank about financing. Should the customer agree to make a purchase using the bank's financing, the bank then enters the picture.

The general terms of the bank loan include a 20 percent down payment from the customer, who borrows the remainder to purchase the metals. The bank pays the precious metals dealer the full price for the quantity of metals purchased. The dealer transfers the full amount of metals purchased to the bank within several days of the contract's initiation. At this point, the precious metals dealer is no longer a party to the transaction.

The bank stores the metal, in a segregated manner, and passes title to the customer subject to a lien for full payment of the loan. The bank monitors the fluctuations in metals prices to assess the current value of the metals on deposit, which are now collateral on the unpaid portion of the loan. If the value of the metal falls to a specified level, the bank issues a margin call to the customer and can liquidate the account if the margin call is not met.

Banks assess service fees for, among other things, storage and initiation of the loan agreement. The length of the loan agreement varies with some banks offering unlimited loan repayment time and others having standard 180-day loan periods.[2] At the end of 180 days, if the customer wishes to maintain the loan rather than pay it off, a new loan agreement is entered into with the customer paying new loan initiation charges. Also, the bank sets the interest to be charged the customer on the unpaid loan balance. The interest rate is generally the prime interest rate plus approximately 1.5 percent.

[1]Some of the general information presented here was taken from transcripts of a February 5, 1987, open hearing of the Advisory Committee on CFTC/State Cooperation.

[2]The Monex Atlas Account has a 5-year loan agreement.

Regulation of Third-Party Financing of Precious Metals Is Limited

In its 1985 interpretative letter,[3] CFTC's OGC stated that these types of purchasing agreements were neither contracts for future delivery of a commodity nor leverage contracts. Under this interpretation, these agreements are viewed as cash transactions and, thus, they are not within the confines of the CEA and CFTC's jurisdiction.

It appears that the only federal regulations applicable to any degree to these financing arrangements are the responsibility of the federal banking regulatory agencies,[4] and such regulation applies to the banks' financial risks and secure safekeeping of the metal. In this regard, the loans involved are 100 percent collateralized, by virtue of the bank holding on deposit the full quantity of metals purchased. General anti-fraud statutes are the main applicable rules concerning the sales practices of the precious metals dealers soliciting customers for these purchasing arrangements.

CFTC Asked to Reassess Its Legal Interpretation Concerning Third-Party Financing of Precious Metals

State regulators are vocal opponents of third-party financing agreements and have asked CFTC to reconsider the interpretation of its authority regarding these agreements. For example, during an Advisory Committee on CFTC/State Cooperation meeting in February 1987, some state regulators maintained that third-party financing agreements, specifically the sales practices of certain metals dealers, are similar to fraudulent commodity "boiler room" operations.[5] At this meeting, and a unanimous resolution passed by the NASAA Board on March 15, 1987, the states requested CFTC to re-examine its OGC's interpretative letter.

At that same meeting, the Advisory Committee questioned representatives of the Industry Council for Tangible Assets (ICTA), an industry association of banks, precious metals dealers, and coin dealers, some of whom are involved in the business, as to whether such agreements were subject to any regulation. The Committee suggested that this type of financing is, essentially, unregulated.

[3]OGC 85-2.

[4]Federal Deposit Insurance Corporation, Federal Home Loan Bank Board, Federal Reserve Board, and Office of the Comptroller of the Currency.

[5]An enterprise which often is operated out of inexpensive, low-rent quarters (hence the term "boiler room") that uses high pressure sales tactics (generally over the telephone) and possibly false or misleading information in an attempt to get unsophisticated investors to invest in questionable commodity or stock transactions.

ICTA representatives said they have formulated a set of rules for banks and precious metals dealers designed to prevent abusive practices. However, ICTA has no enforcement powers or oversight authority to ensure membership compliance. In addition, precious metals dealers and banks are under no obligation to join ICTA. In February 1988, ICTA issued a consumer guide to precious metals financing that explains several aspects of this type of purchasing agreement. The guide is intended to provide potential customers with answers to questions about risk and procedures of precious metals financing.

CFTC has initiated a study into third-party financing programs as part of a broad off-exchange futures study scheduled for completion in April 1988. CFTC has contacted the federal bank regulatory authorities alerting them to the study and requested any assistance they think may be helpful.

Objective, Scope, and Methodology

We prepared this report in response to an August 6, 1986, request of Congressman John D. Dingell, Chairman of the Subcommittee on Oversight and Investigations, House Committee on Energy and Commerce. We agreed with the Subcommittee to

- describe the nature and components of leverage contracts,
- determine if LTMs were complying with applicable laws and regulations,
- describe the various federal and state regulations governing LTMs,
- identify issues for CFTC to explore in its mandated report on leverage contracts,
- explain whether leverage contracts could be traded on a registered futures exchange, and
- explain what regulatory structure the SEC might apply to leverage contracts if these were deemed to be a security and thus subject to SEC regulation.

The Chairman supplemented his request in a February 11, 1987, letter asking us to explain the nature of two precious metals purchasing programs, identifying the role of CFTC in their regulation. The Subcommittee then asked us to identify issues concerning these programs for CFTC to address in its study of off-exchange futures.

To understand CFTC's regulations and oversight programs, we conducted interviews with CFTC headquarters officials in its Divisions of Trading and Markets, and Economic Analysis. We reviewed and analyzed sales practice examinations and financial audits done at Monex and IPMC by the Division of Trading and Markets from 1984 to 1987. We analyzed the coverage of all pertinent leverage contract regulations to determine the extent of CFTC regulatory oversight. We also reviewed the supplemental sales practice audit work done by CFTC staff at IPMC and Monex in October and November 1986, respectively.

We reviewed monthly trading reports submitted to CFTC by the LTMs between January 1985 and May 1987 to determine the volume of leverage contract activity. We gathered reparations statistics[1] involving leverage transactions from the CFTC Office of Proceedings and reviewed all enforcement actions taken by the CFTC against Monex, IPMC, and other leverage firms.

[1]Reparations cases are based on customer complaints filed at CFTC where the customer is requesting monetary reimbursement for loss where the CEA was violated.

Since we do not have statutory authority to audit private sector firms, we did not conduct an independent evaluation of each firm to measure their compliance with the CEA and CFTC regulations. Rather, as agreed with the Subcommittee, we evaluated CFTC's reviews of IPMC and Monex. We did, however, visit both IPMC and Monex and enjoyed good cooperation from the firms. We observed each firm's operations, including their sales floors, customer records sections, computer rooms where sales are recorded, and trading rooms where contract prices are determined and monitored to adjust for daily market price fluctuations. We observed both their front office (sales) and back office (accounting) operations. We interviewed each of the firms' compliance officials to determine the methods which Monex and IPMC employ to ensure compliance with the CEA. We concentrated on gathering information about the nature of the leverage contract business and the procedures each firm uses to ensure compliance with the CEA and CFTC regulations. We did not request access to specific LTMs' records relating to transactions with specific customers. Also, we did not visit FAC because of the minimal business (seven contracts)[2] at that firm when we began our assignment.

To determine the impact on CFTC's resources to regulate leverage trading when the moratorium is lifted in fiscal year 1989, we reviewed an internal CFTC document, requested by the Commissioners in 1984 and completed in 1985, in which each CFTC division developed estimates of anticipated additional costs to regulate leverage trading if the moratorium were to be lifted.

We interviewed state regulatory officials in California and Florida to obtain information on their regulatory role concerning the leverage firms in question. We obtained their opinions and those of officials of the NASAA Commodities Committee on the ramifications at the state level of lifting the moratorium on new firms entering the leverage business.

We interviewed officials at the SEC to discuss with them, in a hypothetical sense, how leverage contracts might be regulated by the SEC should Congress define them as securities.

We interviewed Monex officials about the Monex Atlas Account, a product separate from a Monex leverage contract, and contacted ICTA, an association of metals dealers and banks involved in precious metals sales, including third-party financing. We found that third-party financing of precious metals encompasses at least seven banks in the United

[2] As of December 31, 1987, FAC had no open contracts.

States and Monex Credit Corporation. Therefore, we reviewed the overall subject of third-party financing. We contacted officials in Florida and at NASAA to determine the position of the states with regards to third-party financing. Finally, we reviewed the terms and conditions of several third-party financing agreements.

Our audit work was performed in accordance with generally accepted government auditing standards. We conducted our review between August 1986 and September 1987.

Comments From the Commodity Futures Trading Commission

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

DIVISION OF TRADING AND MARKETS

COMMODITY FUTURES TRADING COMMISSION
2033 K STREET, N.W., WASHINGTON, D.C. 20581

December 4, 1987

Mr. Craig A. Simmons
Senior Associate Director
General Government Division
United States General Accounting Office
441 G Street, N.W.
Washington, D.C. 20548

Re: Report on Leverage Contracts

Dear Mr. Simmons:

We were pleased to have an opportunity to review the GAO's draft report entitled Leverage Contracts: Commodity Futures Trading Commission Regulation of Leverage Contracts submitted under cover of your letter to Acting Chairman Hineman dated November 6, 1987. Commission staff members discussed their comments on that draft with Mr. Campbell and Mr. Maurello at a meeting on November 30, 1987, and we note that many suggestions made by the Commission's staff have been incorporated in a subsequent draft.

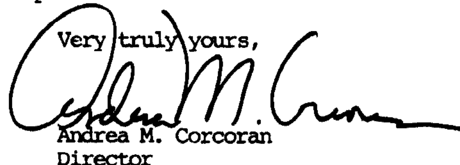
We also wish to reiterate certain points which we made at the November 30 meeting regarding the examinations of the sales practices of the leverage transaction merchants ("LTMs") that are conducted by staff members of the Division of Trading and Markets. The regulation of LTM sales practices is still a relatively new regulatory program. The leverage contract business consists of only three firms, one of which is inactive while the leverage contract business of the other two has been declining. It must also be pointed out that unlike most regulated activities which do not begin until the regulations to govern them are in place, the LTMs were ongoing businesses which first became subject to detailed regulations in 1984. Because of these circumstances and because no additional resources were provided by Congress or specifically set aside by the Commission to deal exclusively with the LTMs, the Commission's staff members who have been involved in the regulation of leverage contracts also have other responsibilities which sometimes have been of a higher priority. Nevertheless, we appreciate the suggestions made as to ways to improve the examinations of sales practices of LTMs, and we note that we have already begun to carry out the additional testing procedures which were suggested in the report.

See comment 1.

See comment 2.

See comment 3.

Very truly yours,



Andrea M. Corcoran
Director

GAO Comments

1. We state on page 1 that only three firms are registered as LTMs and on page 3 we show that one LTM has no business. We did not address the business activity of the other two LTMs because of the proprietary nature of the information.

2. We added language to the text on page 6 stating that the comprehensive leverage regulations have been in effect since 1984.

3. We have information on page 6 concerning the other work which the Division of Trading and Markets must do. We did not, however, do a budget analysis of CFTC.

Comments From Monex International, Ltd.

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

Louis E. Carabini
President

December 17, 1987

VIA FEDERAL EXPRESS

Mr. Craig A. Simmons
Senior Associate Director
General Government Division
U.S. General Accounting Office
Washington, D.C. 20548

Re: General Accounting Office Draft Report on Leverage Contracts

Dear Mr. Simmons:

Monex International, Ltd. has the following comments on various statements made in the General Accounting Office's draft report "Leverage Contracts: Commodity Futures Trading Commission Regulation of Leverage Contracts:"

Page

Now on pp. 3 and 4.

4-5 Statement - "They [leverage contracts] are used as a way for persons to speculate on price changes in those metals. Such persons could also buy and sell futures contracts in the bullion form of those metals on an organized futures exchange."

See comment 1.

Comments - The context of the first sentence appears to imply that leverage contracts are used only for speculation. They are also used as a means of purchasing commodities on time for actual latter delivery and as a means of hedging against currency devaluation. The second and third sentences appear to imply that investors can buy futures contracts on essentially the same commodities as those on which leverage contracts as sold. This is not the case for gold and silver coins, on which no futures contracts are actively traded.

See comment 2.

Monex International Ltd. 4910 Birch Street Newport Beach, CA 92660 714-752-1400

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Now on p. 7.

10 Statement - "NASAA adopted a resolution in November 1986 stating that leverage contracts should be outlawed. Absent this, NASAA, in the same resolution, said that leverage contracts should be regulated as a security. Some state regulators equate leverage contracts to mutual funds which come under state Blue Sky laws."

See comment 3.

Comment - Both federal and state courts have considered the question and concluded that leverage contracts are not securities. See, for example, Moody, et al. v. Monex International, Ltd., et al., Fed.Sec.L.Rptr. (CCH) D. Utah (1980) and State of Texas v. Monex International, Ltd., (CCH) Comm.Fut.L.Rptr. (1975-1977 Transfer Binder) Para. 20,083 (Texas 1975). Leverage contracts are commodity purchase or sale agreements that are more effectively regulated in a manner different from securities. For example, the Federal minimum net capital and segregation of customer funds requirements applicable to leverage merchants considerably enhance the level of customer protection over the typical state or federal securities law schemes, which emphasis (in some cases, exclusively) only disclosure of material information to potential investors. The later, of course, is also a requirement under the federal regulations governing leverage transactions.

Now on p. 9.

13 Statement - "The [NFA] survey results indicated 46 firms interested in registering as LTMs when the moratorium is lifted. However, it is unclear at this time as to how many of these firms could meet CFTC's registration requirements."

See comment 4.

Comment - A review of the CFTC's leverage regulations should demonstrate that less than 10 firms which expressed an interest in entering the leverage business could meet the CFTC's current financial requirements for leverage merchants.

Now on p.10.

16 Statement - "In addition, no regulations currently apply, other than general fraud statutes, to the dealers who solicit customers and actually sell the metals [in third-party financing programs]."

Monex International Ltd. 4910 Birch Street P.O. Box 1800 Newport Beach, CA 92658-8917 714-752-1400

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See comment 5.

Comment - This statement is incorrect. California, Florida and New York, for example, all impose regulatory requirements on dealers who sell precious metals under third-party financing programs. In addition, all the states have the power to regulate dealers involved in third-party financings of precious metals directly in any fashion they choose.

Now on p. 16.

20 Statement - "Unlike other futures instruments regulated by the Commodity Futures Trading Commission (CFTC), leverage contracts are 'off-exchange' products."

See comment 6.

Comment - Leverage contracts are not futures contracts. They are unique instruments having their own unique characteristics. See "Leverage Contracts: The Facts," a report published by Monex on February 25, 1986, a copy of which is attached to these comments and herein incorporated by reference, for a description of the elements of leverage contracts and a comparison of their characteristics with futures.

Now on p. 16.

20 Statement - "The customer makes an initial payment that is a percentage of the total contract value, plus commissions, and locks in the price of the commodity, if delivered, as of the time the contract is entered into."

See comment 7.

Comment - The price of the commodity subject to a leverage contract is locked in at the time the transaction is opened, regardless of whether the commodity is delivered or the position is offset prior to delivery.

Now on p. 17.

22 Statement - "Thus, coins usually sell for a higher price than does an equivalent metallic amount of bullion."

See comment 8.

Comment - This statement is not accurate. Coins and bullion are different commodities with different attributes relative to their pricing. While gold coins generally have sold at higher prices than gold bullion, silver coins have very often sold at a discount to their bullion value. Factors such as a particular coin's popularity, bullion and coin supply, coin minting costs and market volatility determine whether a coin will sell at a premium or discount to its bullion value.

Monex International Ltd. 4910 Birch Street P.O. Box 1800 Newport Beach, CA 92658-8917 714-752-1400

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Now on p.17.

See comment 9.

23 Statement - "Generally, the bid/ask spread has been approximately 3%."

Comment - Historically, Monex' bid/ask spread for leverage commodities has been between 2 and 3%. The average spread has been approximately 2.3% over the past 5 years.

Now on p. 18.

See comment 10.

23 Statement - "LTMs charge a commission of approximately 3% when a customer opens a leverage contract. Commissions are sometimes based on a sliding scale whereby the larger the number of contracts purchased, the smaller the commission percentage."

Comment - LTM's opening commissions have always been based on a sliding scale depending upon how many contracts are purchased or sold. Monex' opening commissions for leverage contracts are generally as follows:

PRIMARY FEE SCHEDULE

Units Purchased or Sold	Charges
1	2 1/2%
2	2%
3-5	1 1/2%
6 +	1%

VOLUME FEE SCHEDULE

Units Purchased or Sold	Charges
5-9	1%
10 +	1/2%

Now on p. 18.

24 & 25 Statement - "These costs [carrying charges] have been referred to, by both LTM and CFTC officials, as similar to the contango associated with futures contracts."

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See comment 11.

Comment - Leverage carrying charges are not similar to contango on futures. Contango is charged or paid on the full amount of a future and is composed of interest charges. Leverage carrying charges are assessed only on the unpaid balance (in the case of interest) and on the number of units (in the case of service charges) and reflect interest, storage and insurance costs.

Now on p. 20.

27 Statement - "[6]CFTC's regulations define a reasonable time [to respond to a margin call] to be 24 hours, excluding Saturdays, Sundays and holidays."

See comment 12.

Comment - For reasons having to do with the safety of all customer's funds, CFTC regulations do not specify what is a reasonable time for a customer to meet a margin call in futures, options or leverage.

Now on p. 21.

29 Statement - "Unlike futures contracts and securities, leverage contracts cannot be traded or resold to anyone other than the original seller (the LTM)."

See comment 13.

Comment - Even though a leverage contract may not be resold to any dealer other than the original LTM, the contract can be transferred by gift or devise or by the customer's assignment to another person for value. The customer may pay the balance in his account at any time and have Monex immediately deliver the commodity to any one to whom he has sold the commodity.

Now on p. 25.

36 Statement - "Commodities sold through leverage contracts must meet certain specifications so that they are of sufficient quality and size to be sold in a market outside the LTM. This is required because a commodity without a normal marketing channel may lose substantial value if there is no market in which a customer could sell the commodity should delivery be taken. For example, gold bullion must be in certain size bars and with a specified purity level that is identical to standards in other marketing channels."

Monex International Ltd 4910 Birch Street P.O Box 1800 Newport Beach, CA 92658-8917 714-752-1400

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See comment 14.

Comment - While the identification of an independent retail cash price series is a prerequisite to registration of a leverage commodity, nothing in the rules requires bullion to be sold in bar form, in units of a particular size or of a specified purity identical to standards in other marketing channels.

Now on p. 32.

47 Statement - "No regulations currently apply, other than general fraud statutes, to the sales practices of the precious metals dealer soliciting customers for these purchasing arrangements."

See comment 15.

Comment - See our comment with respect to page 16.

I hope that our comments are helpful in clarifying the matters addressed. We appreciate the courtesy shown by the GAO staff in the conduct of their inquiry. Please contact me if you need any further information.

Very truly yours,

Louis E. Carabini
President
Monex International, Ltd.

LEC/bjg
Enclosure

Monex International Ltd. 4910 Birch Street P.O. Box 1800 Newport Beach, CA 92658-8917 714-752-1400

GAO Comments

1. It is not our intent to say that leverage contracts are used solely for speculative purposes. However, data shows that only a small percentage of leverage contract terminations result in the customer taking delivery of the commodity. Thus, we have added "primarily" to the sentence and have added a footnote with the percentage of leverage contracts terminated by delivery. See pages 3 and 4.

2. We agree that gold and silver coin futures contracts are not actively traded. This is why the report states "such persons could also buy or sell futures contracts in the bullion form of those metals."

3. These are the opinions of NASAA and are attributed to that organization.

4. We are unable to comment on the accuracy of Monex's conclusions without doing a thorough review of the firms with affirmative responses to the survey.

5. Wording on page 10 has been changed to "In addition, the dealers who solicit customers and actually sell the metals are subject mainly to general anti-fraud statutes."

6. We agree that leverage contracts, by definition, are not futures contracts which is why we refer in the text to futures "instruments."

7. It is our intent to show that when a leverage contract is offset, the LTM repurchases at the bid price, not the ask price. However, we have deleted "if delivered" from the text. See page 16.

8. We agree that coins do not always sell for a higher price than bullion. Our statement that coins "usually" sell for a higher price takes this into account.

9. We have changed the text on page 17 to show that the bid/ask spread has been approximately "2 to 3 percent."

10. Sentences now say "LTMs charge a commission on initiating a leverage contract. The commission, based on a sliding scale depending on the number of contracts purchased, ranges from 3.5 percent of the contract value to less than 1 percent, depending on the LTM." See page 18.

11. We disagree. According to CFTC officials, contango includes more than interest charges. Also, according to The Language of Commodities

by the New York Institute of Finance, contango includes "payments for insurance, warehousing, etc."

12. We disagree. This language is taken directly from 17 CFR 31.18(b).

13. Our point is that the contract itself may not be resold to anyone other than the LTM. To elaborate, the LTM risk disclosure statement, as mandated by 17 CFR 31.11(a)(1), states, "THERE IS NO MARKET FOR THE LEVERAGE CONTRACT ITSELF OTHER THAN TO HAVE IT REPURCHASED BY OR RESOLD TO THE LEVERAGE TRANSACTION MERCHANT."

14. We agree. Last sentence in paragraph deleted.

15. We have deleted our reference to "no regulation" to take this point into account. See page 32.

Comments From the North American Securities Administrators Association

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

NASAA

NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, INC.

555 New Jersey Avenue N.W. Suite 750
Washington D.C. 20001
202 737-0900

December 18, 1987

Mr. Craig A. Simmons
Senior Associate Director
General Government Division
United States General
Accounting Office
441 "G" Street, N.W., Room 3858A
Washington, DC 20548

Re: Leverage Contracts: Commodity Futures Trading Commission Regulation of Leverage Contracts

Dear Mr. Simmons:

On behalf of the North American Securities Administrators Association, Inc. ("NASAA"), I thank you for affording us the opportunity to review and comment on your draft report entitled Leverage Contracts: Commodity Futures Trading Commission Regulation of Leverage Contracts.

NASAA is a non-profit corporation composed of the securities regulatory agencies of the fifty states, the District of Columbia, the Canadian provinces, Mexico and Puerto Rico. NASAA and its members are dedicated to the principle of consumer and investor protection. Although NASAA's Board of Directors has resolved to oppose the continued legalization of leverage as currently constituted, the comments which follow must be construed solely as those of NASAA's Commodities Committee, and not binding on the Board or NASAA as a whole.

TRUE LEVERAGE CONTRACTS

See comment 1.

With regard to your discussion of true leverage contracts, i.e. those sold by Monex, IPMC and First Asset, your report is comprehensive and generally accurate. It describes what leverage contracts are and how they are regulated by the Commodity Futures Trading Commission ("CFTC"). However, we believe the report focuses on the empirical to the exclusion of other important factors which must be considered in any discussion of leverage.

Historically, leverage contracts arose in the early 1970's before the enactment of the Commodity Exchange Act and the creation of the CFTC. When the silver value of U.S. silver coins began to exceed their face value, trade

President: James C. Meyer (Tennessee) • **Executive Vice President:** Craig A. Goettsch (Iowa) • **Secretary:** John C. Baldwin (Utah)
Treasurer: Debra M. Bollinger (South Dakota) • **Directors:** F. Daniel Bell III (North Carolina) Robert M. Lam (Pennsylvania) Richard D. Latham (Texas) John R. Perkins (Missouri) and Merrill B. Wigginton (Prince Edward Island) • **Vice President/Chief Executive Officer:** Hon. Andrew M. Maguire

Letter to Mr. Craig A. Simmons
Re: Leverage Contracts
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in $1,000 face value bags of the coins emerged. Coin dealers initiated an investment program wherein investors could invest 10% of the value and "control" the remainder, with the dealer responsible for covering the difference.

The Wisconsin Commissioner of Securities held these "leverage" contracts to be investment contract securities in In the Matter of American Coin Exchange, et al., CCH Blue Sky Law Rptr. Paragraph 71,163 (1974). The Securities and Exchange Commission filed an injunctive action against Monex on December 12, 1974 in the U.S. District Court for the Central District of California. Monex consented to entry of a permanent injunction on August 20, 1975. A federal district court in Minnesota held leverage contracts to be securities under federal law in Jenson v. Continental Financial Corporation, CCH Federal Securities Law Rptr. Paragraph 95,436 (DC Minn. 1975). The New York Attorney General obtained an injunction against Monex for fraud in connection with the offer and sale of leverage contracts, held to be securities, in People v. Monex International, Ltd., CCH Blue Sky Law Rptr. Paragraph 71,247 (1976). The Minnesota Attorney General brought an action against another leverage merchant for sale of unregistered securities, fraud, consumer fraud and false advertising, and in response to request for declaratory judgment, the Minnesota Supreme Court held the leverage contracts to be securities under Minnesota law, in State of Minnesota v. Coin Wholesalers, Inc., CCH Blue Sky Law Rptr. Paragraph 71,339 (1976). Leverage contracts were also held to be securities under Canadian law in a Canadian action.

See comment 2.

It was in the midst of this litigation by the SEC, state regulators and private parties under state and federal securities laws that leverage contracts gained a form of legitimacy when the leverage companies succeeded in lobbying Congress for recognition and inclusion in the Commodity Exchange Act. The states were totally preempted from regulating leverage. The economic carnage to unsuspecting investors which ensued is well documented. Only recently have the most flagrant abuses been curbed by attrition of the number of leverage merchants, the imposition of stringent regulation and disproportionate devotion of resources by the CFTC, and internal protections and remedies undertaken by the firms themselves.

See comment 3.

From a legal and regulatory perspective, leverage contracts do not fit well within the structure of commodity futures regulation. Your report provided that leverage contracts are long term agreements for the purchase or sale of precious metals, but you omitted to state that in only a very small percentage of the cases is any metal ever purchased or sold by the customer. These contracts are sold and purchased almost exclusively for speculative purposes. Delivery is rarely contemplated. To this extent, leverage contracts are seemingly within the general realm of futures regulation.

Letter to Mr. Craig A. Simmons
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See comment 4.

However, the fact that leverage merchants act as principals, not brokers, in these transactions distinguishes leverage from virtually all other consumer-oriented CFTC regulated investment products. There is no exchange. There is no clearinghouse. Leverage contracts and positions are nontransferable. The customer is a captive of the originating merchant. Prices are set not by open outcry in an exchange pit but unilaterally by the company. Therefore, unlike the market and exchange-oriented world the CFTC is designed to regulate, leverage is a stranger in a strange land.

See comment 5.

Most importantly, leverage is unique among the programs regulated by the CFTC in that the Commission staff has repeatedly held that leverage contracts serve no valid economic purpose. They are speculative instruments with no liquidity or hedging function in the marketplace. In base terms, leverage is gambling for gambling's sake.

Leverage contracts are securities under both federal and state law which are now exclusively regulated by the nation's futures regulator. The initiative to eliminate leverage appears to have been lost, at least for the present. Thus, we must turn to some very practical considerations.

See comment 7.

The CFTC already devotes an inordinate amount of its resources to leverage regulation and enforcement. If 46 new leverage firms were to enter the business, the demand on these resources would increase by a proportional 23 times. Drawing from your report, from 1976 through 1987, complaints about leverage filed with the CFTC averaged about 6.6% of all complaints filed. Four firms accounted for 6.6% of all complaints. What percentage of the total will be generated when there are 49 companies instead of 4?

See comment 6.

It has been suggested, even assumed, that the National Futures Association ("NFA") would take over the registration and some disciplinary duties relevant to the proposed new leverage industry. The NFA is supported by levies on the futures industry dealing on recognized exchanges. It must certainly be questioned if sufficient funds can be generated from leverage trading to provide the resources necessary to register and police the old and new leverage merchants; or will the futures industry be assessed to police leverage; or will there be a net decrease in the NFA's ability to deal with its main emphasis, futures trading, to accomodate leverage oversight. Also, with futures trading, the exchanges provide additional self-regulatory oversight which will not be applicable to leverage contracts trading.

See comment 7.

The expansion of leverage will represent the creation of an off-exchange market neither the CFTC nor the NFA is equipped to regulate alone. In August of 1987, Monex provided NASAA representatives information which indicated a total Monex clientele of over 33,000. Even a conservative extrapolation causes the mind to boggle. What resources would be necessary to cope with a 49 firm industry with half a million customers when only four firms historically accounted for almost 7% of all complaints filed with the CFTC?

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See comment 8.

The off-exchange securities market has been the source of both enormous economic benefit and significant enforcement concern over the years. On the whole, the system works due in large part to the full participation and involvement of the state blue sky agencies in both regulation and enforcement. The partnership between the SEC, the National Association of Securities Dealers and the states in joint regulation and enforcement regarding off-exchange securities dealings makes the system viable.

See comment 2.

Rightly or wrongly, state regulation of futures trading was preempted based on a Congressional perception of the needs and demands of interstate commerce and protection of the national public interest. It is difficult to formulate such an argument for preemption regarding a product already held to be a state and federal security, sold in principal transactions directly to customers without the involvement of an exchange, consistently held by CFTC economists to be without valid economic purpose or value, and facing an expansion which will be beyond the resources of the regulator currently charged with their oversight.

See comment 8.

In practical reality, state securities regulators are much more involved in the regulation of initial public offerings, non-public offerings and off-exchange activities than they are involved with exchange traded securities regulation. In fact, state regulators have demonstrated a unique ability and proficiency in dealing with these high-risk aspects of the investment spectrum. Leverage fits squarely in this investment classification.

The prospect of a woefully undermanned CFTC and the NFA undertaking registration, regulation and enforcement duties over a new leverage industry without full state jurisdiction and participation is a chilling thought indeed. It is but one aspect of the even greater concern being studied now by the CFTC; the entire subject of off-exchange commodities instruments.

See comment 9.

The states have no real burning desire to regulate leverage. We have more than enough to regulate already. Nonetheless, leverage is being thrust on the public not on its merits but as a result of Congressional infighting, jurisdictional squabbles between regulators, and special interest lobbying. Given that leverage will be, we have a duty and obligation as investor protection agencies to provide such protection. This must include state registration of these securities, licensure of sales entities and individuals, and anti-fraud jurisdiction. Without this participation, there will be no "cop on the beat" and there is every reason to believe that the abuses of the past will revisit a new generation of unsuspecting investors.

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BANK FINANCING PROGRAMS

Those experienced in the investigation and prosecution of commodity-theme frauds all agree that bank financing is the next in a regrettable series of precious metals scams. As with all scams of the past, clever minds have discerned a "loophole" in the regulatory fabric and the scammers are "running to daylight." Certainly, not every retailer who sells silver with bank financing is a crook; it is just that every crook selling silver is using bank financing (either in fact or as a ploy).

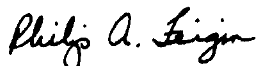
See comment 10.

The arguments have all been made and submitted to the CFTC Task Force for consideration. The determinations to be reported this Spring will likely have significant impact on the subject. It should be noted that contrary to the opinions stated by the General Counsel in OGC-85-2 regarding the applicability of the Model State Commodity Code to bank financing, the jurisdictions which have enacted the Code and the NASAA Commodities Committee are uniform in their rejection of said analysis. We believe bank funding programs are squarely within the jurisdiction of the Code and at a minimum are subject to the Code's anti-fraud provisions.

Little more can or should be said at this juncture about the subject of bank financing. Much more will be known in the next few months.

We thank you for providing us with the opportunity to comment both on your report and on leverage and bank financing in general.

Respectfully,



Philip A. Feigin
Assistant Securities Commissioner

Chairman, NASAA Commodities
Committee

PAF:dmr

8193S

GAO Comments

1. This report is not intended to cover all aspects of leverage contracts. Because of this, we focused on the empirical aspects of leverage contracts and their regulation.

2. We recognize the state preemption on page 7.

3. We have added a footnote with the percentage of leverage contracts terminated by delivery on page 4.

4. We note most of these points on pages 16, 20, and 21.

5. We note that leverage contracts are a unique regulatory function of CFTC. See pages 10 and 16. Also, CFTC has been asked to address the economic purpose of leverage contracts in the study mandated by the Futures Trading Act of 1986. See page 1.

6. We do not make the assumption that NFA will take over the registration and some disciplinary duties related to the new leverage industry. In order for us to address these conclusions, we would have to do a resource impact study of NFA which was beyond the scope of this report.

7. Without doing a full resource impact study of the effects on CFTC of the lifting of the leverage contract moratorium, we cannot reach a conclusion.

8. State regulation of securities markets is beyond the scope of this report.

9. We have noted the state regulatory concerns on page 11.

10. We have noted NASAA's concerns about bank funding programs on pages 30 and 32.

*U.S. G.P.O. 1988-201-749:80053

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