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HEARING TO REVIEW IMPLICATIONS OF THE *CFTC* V. *ZELENER* CASE

HEARING

BEFORE THE

SUBCOMMITTEE ON
GENERAL FARM COMMODITIES
AND RISK MANAGEMENT

OF THE

COMMITTEE ON AGRICULTURE
HOUSE OF REPRESENTATIVES

ONE HUNDRED ELEVENTH CONGRESS

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HEARING TO REVIEW IMPLICATIONS OF THE *CFTC* V. *ZELENER* CASE

WEDNESDAY, June 4, 2009

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON GENERAL FARM
COMMODITIES AND RISK MANAGEMENT
COMMITTEE ON AGRICULTURE
Washington, D.C.

The Subcommittee met, pursuant to call, at 10:07 a.m., in Room 1300 of the Longworth House Office Building, Hon. Leonard L. Boswell [Chairman of the Subcommittee] presiding.

Members present: Representatives Boswell, Marshall, Walz, Schrader, Markey, Kissell, Pomeroy, Peterson (*ex officio*), Moran, Conaway, Latta, and Luetkemeyer.

Staff present: Claiborn Crain, Adam Durand, John Konya, Scott Kuschmider, Robert L. Larew, Clark Ogilvie, John Riley, Rebekah Solem, Kevin Kramp, and Jamie Mitchell.

OPENING STATEMENT OF HON. LEONARD L. BOSWELL, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF IOWA

The CHAIRMAN. Good morning. The hearing of the Subcommittee on General Farm Commodities and Risk Management to review implication of the *CFTC* v. *Zelener* case will come to order. I will make an opening statement and invite Mr. Moran to do the same and then ask if the rest of the members follow the normal procedure and not make opening statements and submit whatever they would like for the record, and, of course, participate in the question and answer period. So that would be the order of how we would like to go. First, I would like to thank all of you for joining us here today as we take this examination of the implication of *CFTC* v. *Zelener*. I would like to give special thanks to our witnesses for testifying before the committee and to offer their insight into the current issues facing the futures market. I very much look forward to hearing all your testimony.

In 2004 the Seventh Circuit Court made a decision in the *CFTC* v. *Zelener*. It adopted a narrow definition of the term "transactions for future delivery." What is held is that a 3-day contract offered to retail customers for foreign currency that on its face promised delivery was not a futures contract and was, therefore, outside the CFTC's jurisdiction. This was even though the contracts operated in practice as futures contracts. Following the *Zelener* decision, many frontsters were given a roadmap to evade CFTC jurisdiction and to scam customers or consumers. During the 2008 Farm Bill,

Congress narrowly fixed the *Zelener* problem as it pertains to foreign exchange, forex.

Today, I am interested in hearing—we are interested in hearing if this problem had shifted to other commodities such as metals or energy products, as many said it might if Congress merely didn't address the problem. To the extent fraudulent activity is taking place and hard-working Americans are getting taken to the cleaners by shysters, we need to find out if Federal regulators have the tools necessary to protect consumers. So at this time, I would like to turn it over to my good friend and colleague, Congressman Moran from Kansas for any remarks he would choose to make.

[The prepared statement of Mr. Boswell follows:]

SUBMITTED PREPARED STATEMENT OF HON. LEONARD L. BOSWELL, A REPRESENTATIVE IN CONGRESS FROM IOWA

I would like to thank everyone for joining me here today as we take a thorough examination of the implications of *CFTC* v.*Zelener*. I would like to give a special thanks to our witnesses for testifying before the Committee and to offer their insight into the current issues facing the future markets. I very much look forward to hearing all the witnesses' testimony.

In 2004, the 7th Circuit Court made a decision in the *CFTC* vs. *Zelener*. It adopted a very narrow definition of the term 'transactions for future delivery.' What it held is that a three-day contract offered to retail customers for foreign currency that, on its face promised delivery, was not a futures contract and was therefore outside the CFTC's jurisdiction. This was even though the contracts operated, in practice, as futures contracts.

Following the *Zelener* decision many fraudsters were given a roadmap to evade CFTC jurisdiction and to scam consumers.

During the 2008 Farm Bill Congress narrowly fixed the *Zelener* problem as it pertains to foreign exchange (forex). Today, I am interested in hearing if this problem has shifted to other commodities such as metals or energy products as many said it might if Congress narrowly addressed the problem. To the extent fraudulent activity is taking place and hard-working Americans are getting taken to the cleaners by shysters, we need to find out if federal regulators have the tools necessary to protect consumers.

At this time I would like to turn it over to my good friend and colleague, Jerry Moran from Kansas for any opening remarks he would like to make.

STATEMENT OF HON. JERRY MORAN, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF KANSAS

Mr. MORAN. Mr. Chairman, thank you very much. Thank you for the consideration of opening this hearing just a few minutes late to adjust to my arrival. As a Kansan, I never take into account enough time to get any place in Washington, D.C. I thank you for having this hearing. As you said, in 2004 we had the *Zelener* case. We responded. We tried to create CFTC jurisdiction for anti-fraud over retail forex transactions that were *Zelener* like. We are here, I think, to determine the success of that fix, and I hope we learn that from the CFTC. We also are interested in knowing, as you said, whether there is an expansion of fraud challenges that the CFTC cannot address. I would say that we need to be cautious in addressing what could be a small problem. We don't want to excessively regulate legitimate market participants that are not causing any harm, and I hope that today's witnesses reveal the extent to which fraud and futures look alike contracts have moved into other commodity markets and potential solutions if that is occurring.

So it seems like we have been dealing with *Zelener* for a long time. We have been. And I am looking forward to hearing whether

we are having any success and what more might need to be done, and I thank you, Mr. Chairman, for conducting this hearing.

Mr. BOSWELL. Thank you for your comments. And I have driven up and down the streets, so I understand this trying to predict how long it takes to get anywhere.

The chair would request that other Members submit their opening statements for the record.

[The prepared statements of Mr. Peterson and Mr. Walz follow:]

PREPARED STATEMENT OF HON. COLLIN C. PETERSON, A REPRESENTATIVE IN CONGRESS FROM MINNESOTA

Thank you, Chairman Boswell, for calling this hearing today.

Policing fraud in retail foreign currency trading, or forex for short, has at times been very difficult for the Commodity Futures Trading Commission.

In 1974, Congress included in the Commodity Exchange Act an exemption for contracts based on foreign exchange and Treasury securities from CFTC regulation. The idea was that common interbank transactions in currency would not get swept up in the web of futures regulation.

While this worked well for a time, a 9th Circuit Court ruling in 1996 held that the law also protected forex boiler rooms, bucket shops, and other scammers that preyed on retail customers.

The CFTC and Congress addressed this question in 2000 with passage of the Commodity Futures Modernization Act, with provisions giving the Commission clear authority to police the sales of forex contracts to small investors. However, a 2004 court case, *CFTC v. Zelener*, held that certain retail foreign exchange contracts were outside the Commission's legal authority. That case involved a boiler room selling off-exchange forex contracts with the CFTC powerless to stop them because the contracts in question were not futures despite the CFTC's contention. Even worse, scam artists used the *Zelener* decision as a blueprint to thread the regulatory loophole and go after unsuspecting retail customers with no real risk of being shut down.

When Congress reauthorized CFTC as part of the Food, Conservation, and Energy Act of 2008, we sought to stem the unintended consequences of *Zelener* by clarifying the CFTC's anti-fraud authority over retail agreements and contracts in foreign currency.

Retail foreign exchange dealers now must register with the CFTC and are subject to commission rules and anti-fraud authority along with Futures Commission Merchants that engage in retail forex transactions.

Congress also strengthened qualifications and minimum capital requirements for FCMs and retail foreign exchange dealers.

However, because the scope of the *Zelener* fix was limited to foreign exchange contracts, we need to be aware that similar problems could arise in other product areas like metals, energy, or any other commodity that can be sold to the public without effective regulation.

The work we did in the Farm Bill restored the CFTC's ability to stop unscrupulous persons who write and market contracts in foreign currencies that are nothing more than scams to defraud the public. However, we are here to learn if there are still problems that exist today from the *Zelener* decision.

I welcome our witnesses and I hope that they can give us some perspective on problem areas that may exist outside of the CFTC's enforcement reach.

I welcome today's witnesses and I look forward to their testimony. I yield back my time.

SUBMITTED STATEMENT OF HON. TIMOTHY J. WALZ, A REPRESENTATIVE IN CONGRESS FROM MINNESOTA

Mr. Chairman, thank you for holding this hearing today review implications of the *Zelener* case and how that will effect future commodity regulation.Since 1974, when the CFTC began to oversee trading in derivatives, it has been necessary for the CFTC to strike an appropriate balance to find the ″sweet spot″ of regulation that would protect investors but not stifle the industry.

Three years ago, the *Zelener* case limited the CFTC's ability to address foreign currency fraud and the question of what type of authority the CFTC should possess in this area is an important issue for many in the forex market. I have met with some of the stakeholders who are involved in the forex market and I believe I can

speak to the perspective of many of them. They do not fear government regulation, they welcome it.

Forex traders realize that there is a role for the government to play in creating a level playing field and making sure everyone plays by the rules. But what they do not want is heavy-handed regulation that will impede development of a new market that is widely used by many investors overseas but is just getting its footing in the United States.

I think it is very important that Congress get this question right. It should not be our goal to treat every commodity the same when it comes to regulation. It should not be our goal to interfere with a market that is operating fairly and efficiently.

Mr. Chairman, I look forward to the opportunity to hear the testimony of our witnesses today and the chance to ask them questions about how they believe commodity regulation should be addressed.

We welcome the panel, and we will go from my left to right, and ask you to make your 5-minute statement and then be available for questions, if you would, so we will start off with Mr. Stephen Obie, Acting Director, Division on Enforcement, Commodity Futures Trading Commission, Washington, D.C. Mr. Obie.

STATEMENT OF STEPHEN J. OBIE, ACTING DIRECTOR, DIVISION ON ENFORCEMENT, COMMODITY FUTURES TRADING COMMISSION, WASHINGTON, D.C.

Mr. OBIE. Good morning, Chairman Boswell and Members of this distinguished subcommittee. I am Stephen Obie, the Acting Director of the Division of Enforcement of the United States Commodity Futures Trading Commission. My remarks today represent my views in my capacity as the Acting Director, and I am not testifying on behalf of the Commission. In 2003, the CFTC filed what came to be known as the *Zelener*. The CFTC complaint alleged that Michael *Zelener* operated a foreign currency boiler room. Mr. *Zelener* fraudulently solicited millions of dollars from over 200 unsuspecting customers. The contracts that *Zelener* peddled claimed to require delivery of currency within 2 days. In reality, the contracts were repeatedly rolled over and no delivery of currency was ever made.

Unfortunately, the trial court ruled that the CFTC lacked jurisdiction over these rolling spot contracts at issue and the Seventh Circuit Court of Appeals upheld that ruling in 2004. Recently, Michael *Zelener* pled guilty to criminal fraud charges. *Zelener* admitted to operating a forex boiler room which caused substantial customer harm. Justice will soon be served when *Zelener* is sentenced for his crimes in August. Following the *Zelener* rulings, another Circuit Court of Appeals and other trial courts also handed down adverse decisions on CFTC jurisdiction. The lasting effect of these decisions set the CFTC's Division of Enforcement forex program back half a decade. Fortunately, Congress clarified the CFTC's jurisdiction over the types of forex contracts sold by *Zelener* and other boiler room operators like him with the passage of the CFTC Reauthorization Act of 2008. Since that time, the CFTC has aggressively used its clarified anti-fraud authority.

The CFTC's Enforcement Division has opened 84 investigations involving foreign currency frauds and has already filed nine Federal Court enforcement actions alleging that more than $134 million was misappropriated from customers. Because the *Zelener* fix was limited to contracts in foreign currency, swindlers have moved

on. Fraud schemes through marketing of *Zelener* type rolling spot contracts, which actually look like futures contracts, are now occurring in other commodities, especially precious metals like gold, silver and platinum, thus, the investing public is now being defrauded arguably beyond the CFTC's enforcement jurisdiction. Even worse, *Zelener* and the cases that followed provided a roadmap to these fraudsters on how to draft their contracts to escape prosecution by the CFTC. From my perspective, it appears that these *Zelener* type contracts are proliferated and mailer fraudsters are offering these contracts, which they believe are out of the CFTC's anti-fraud jurisdiction.

Since the enactment of the farm bill, the CFTC has received more than 50 complaints from the public relating to potential boiler room frauds involving commodities other than foreign currency. In addition, the National Futures Association has identified approximately 30 farms offering potentially too good to be true investments and purportedly spot metals and energy contracts. Unfortunately, the *Zelener* decision remains a profound impediment to the CFTC's ability to prosecute these firms and protect the public from alleged wrongdoing. I also know from the NFA which handles the registration of forex firms that there has been an increase of registered forex dealer members who have begun to sell non-forex *Zelener*-type contracts to retail customers. Currently, seven such firms have been identified.

Protecting the public from commodity fraud and preserving the integrity of the commodity markets through swift and decisive action are critical missions of the CFTC's enforcement program. The farm bill has made that job easier in the forex area and I applaud this Subcommittee's work in that regard. The CFTC will continue to root out these fraudulent enterprises and other Ponzi schemers who prey on innocent Americans. Thank you, Chairman Boswell, and Members of the distinguished Subcommittee. I look forward to answering any questions you may have.

[The prepared statement of Mr. Obie follows:]

PREPARED STATEMENT OF MR. STEPHEN J. OBIE, ACTING DIRECTOR, DIVISION ON ENFORCEMENT, COMMODITY FUTURES TRADING COMMISSION, WASHINGTON, D.C.

Good morning, Chairman Boswell and Members of this distinguished subcommittee. Thank you for the opportunity to appear before you today to testify regarding the continuing implications of the *CFTC v. Zelener* case. I am Stephen Obie, the Acting Director of the Division of Enforcement of the United States Commodity Futures Trading Commission. My remarks today represent my views in my capacity as the Acting Director, and I am not testifying on behalf of the Commission.

As Acting Director, I oversee 120 attorneys and investigators in four offices who investigate and litigate enforcement cases in administrative forums and in federal district courts. The Division of Enforcement investigates and brings cases in a wide range of areas including trade practice violations, manipulations, and fraud. Until a few years ago, a sizeable number of the Division's matters involved retail fraud in the area of foreign currency (also called "forex"), many of them involving boiler room operations. "Boiler rooms" are operations that use high-pressure sales tactics, usually including false or misleading information, to solicit generally unsophisticated customers.

In 2003, the CFTC filed what came to be known as the *Zelener* case. The CFTC complaint alleged that over a two-year period, Michael *Zelener* operated a foreign currency boiler room that fraudulently solicited millions of dollars from over 200 unsuspecting customers in violation of the Commodity Exchange Act. Although the contracts that *Zelener* was peddling purported to require delivery of currency within

two days, in reality, the contracts were repeatedly rolled over and no delivery of currency was ever made. The CFTC contended that these contracts were, therefore, futures contracts, but the trial court ruled that the CFTC lacked jurisdiction over the contracts because *Zelener*'s "customers were not trading in futures contracts; rather they were speculating in spot contracts."[1] The trial court's ruling that the CFTC lacked jurisdiction over the "rolling spot" contracts at issue in the *Zelener* case was upheld by an appellate court in 2004.[2]

Recently, Michael *Zelener* pled guilty to criminal fraud charges based on the same facts that were alleged in the CFTC civil complaint. In his plea agreement, *Zelener* admitted that he lied when he told potential customers that they could earn 120% annual returns with almost no risk even after he knew that almost every one of his customers had lost money; he was paid a total of $ 1.4 million in mark ups and he used false account statements to conceal these mark ups; and he operated a forex boiler room for two years causing customers to suffer losses totaling $2 million. Justice will soon be served when *Zelener* is sentenced for his crimes in August.

After the appellate ruling in the *Zelener* case, the CFTC brought other cases and received similar adverse rulings from another Circuit Court of Appeals[3] and other trial courts. The case law spawned by the *Zelener* decision appeared to narrow the CFTC's reach in the area of foreign currency and created uncertainty as to the CFTC's antifraud jurisdiction over contracts in related areas where the line between futures contracts and spot contracts could be blurred. As a result of these adverse court decisions, the Division of Enforcement's case load in the area of foreign currency diminished, as we could not justify the expenditure of scarce resources to fight jurisdictional battles rather than pursuing wrongdoers in other areas where our jurisdiction was clear. But the lasting effect of the *Zelener* decision, putting this specific activity out of our jurisdictional reach, set the CFTC's Division of Enforcement forex program back a half a decade.

Fortunately, Congress clarified the CFTC's jurisdiction over the types of forex contracts sold by *Zelener* and other boiler room operators like him with the passage of the CFTC Reauthorization Act of 2008 (Title 13 of the farm bill). I applaud this subcommittee's efforts in drafting that much-needed legislation in the forex area. Since that time, the CFTC has aggressively used its clarified antifraud authority. I am proud to report to this subcommittee that the CFTC's Enforcement Division has opened 84 investigations involving foreign currency frauds, which are pending, and has already filed 9 federal court enforcement actions alleging that more than $134 million was misappropriated from customers.

The changes in the Farm Bill have been extremely helpful to the Enforcement Division in policing the forex markets. However, because the *Zelener*-fix was limited to contracts in foreign currency, swindlers have moved on to perpetuate their fraud and are marketing *Zelener*-type "rolling spot" contracts in other commodities, especially precious metals like gold, silver, and platinum, and, thus, are defrauding customers beyond the CFTC's antifraud jurisdiction. Even worse, *Zelener* and the cases that followed provided a road map to these fraudsters on how to draft their contracts to escape prosecution by the CFTC. Customer agreements appear to have been drafted specifically with the *Zelener* decision in mind and language chosen so that, under the analysis in those decisions, the contracts at issue are argued to be spot contracts outside of CFTC jurisdiction and not futures contracts covered by the Commodity Exchange Act.

From my perspective, it appears that these *Zelener*-type contracts have proliferated and more fraudsters are offering these contracts, believed to be out of the reach of the CFTC's antifraud jurisdiction. Since the enactment of the Farm Bill, the CFTC has received more than 50 complaints from the public relating to potential boiler room frauds involving commodities other than foreign currency. In addition, the National Futures Association has identified approximately 30 firms offering potentially "too-good-to-be-true" investments in purportedly spot metals and energy contracts. Unfortunately, the *Zelener* decision remains a profound impediment to the CFTC's ability to prosecute these firms and protect the public from alleged wrongdoing. Consequently, the CFTC has had to refer these matters to state law enforcement authorities and other federal agencies.

I also know from the NFA, which handles the registration of forex firms, that there has been an increase in registered forex dealer members who have begun to

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[1] *CFTC v. Zelener*, [2003-2004 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 29,621 (D. N.D. Ill. Oct. 3, 2003); No. 1:03CV04346, 2003 WL 22284295 at *5; 2003 U.S. Dist. LEXIS 17660 at *14.

[2] *CFTC v. Zelener*, 373 F.3d 861 (7th Cir. 2004).

[3] *CFTC v. Erskine*, 512 F.3d 309 (6th Cir. 2008).

sell non-forex *Zelener*-type contracts to retail customers. Currently, seven such firms have been identified.

Protecting the public from commodity fraud and preserving the integrity of the commodity markets through swift and decisive action are critical missions of the CFTC's enforcement program. The Farm Bill has made that job easier in the forex area. Should Congress see fit to expand the CFTC's authority over boiler rooms offering metal, energy, and other commodity contracts to retail customers, we will utilize that authority — as we have with the *Zelener*-fix provided by the Farm Bill for foreign currency — to shutter those boiler rooms and protect the American public. With new authority, I can assure this subcommittee that the CFTC will continue to root out these fraudulent enterprises and other Ponzi schemers who prey on innocent Americans.

Thank you Chairman Boswell and Members of this distinguished subcommittee. I look forward to answering your questions.

Mr. BOSWELL. Thank you. I would now like to recognize Mr. Roth, President and Chief Executive Officer, National Futures Association, Chicago, Illinois. Welcome.

STATEMENT OF DANIEL ROTH, PRESIDENT AND CHIEF EXECUTIVE OFFICER, NATIONAL FUTURES ASSOCIATION, CHICAGO, ILLINOIS

Mr. ROTH. Thank you, Mr. Chairman. My name is Dan Roth, and I am the President of NFA, and thanks very much for the opportunity to appear here today to talk about *Zelener* once again. Over the last year, obviously this Committee has spent an awful lot of time and energy focusing on OTC derivatives. Particularly OTC derivatives that are aimed at sophisticated institutional type customers, and that is a commendable offer and it is entirely appropriate given the systemic risk issues that those types of instruments compose. We just wanted the Committee to be aware that there is a burgeoning OTC derivatives market, completely unregulated markets, aimed at retail customers. And although these markets don't pose the sorts of systemic risk issues that credit default swaps and other OTC instruments do, it is a growing area of customer concern.

What I would like to take a minute to talk about a little bit of the history of how we got where we are, describe the nature of the problem, and describe what we think we can do about it. Back in 1974 when Congress was about to create the CFTC and expand Federal regulation of futures markets, the Treasury Department came forward and pointed out that there was a thriving interbank market involving foreign currencies and that those banks were all regulated, and that we didn't need the CFTC to insert itself into that arena. So Congress adopted the Treasury Amendment which provided in part that nothing in the Act applies to transactions in foreign currencies. Well, predictably enough, boiler rooms started popping up trying to take advantage of that loophole, and the CFTC was very successful in going to court and shutting down these retail bucket shops that were selling foreign currency products.

The CFTC argued that the Treasury Amendment was never intended to apply to transactions involving retail customers, and that worked just fine until 1996 when the Circuit Court of Appeals in the Frankel Bullion case ruled that the Treasury Amendment means what it says and that the Commodity Exchange Act doesn't apply even if the transaction involves foreign currencies. Well, that

is why Congress in 2000 with the CFMA attempted to address that issue. Congress basically stated that, yes, the Commodity Exchange Act does apply to foreign currency futures transactions with retail customers unless the counter party is an otherwise regulated entity. No sooner had we fixed that problem than another one popped up and that is the *Zelener* decision.

In the *Zelener* case, just as Steve said, the court there said we don't even have to worry about the Treasury Amendment because these things aren't futures contracts to begin with. Prior to *Zelener*, what the courts had always said was that in determining whether a contract offered to a retail customer is a futures contract, the court said what you have to do is look at the underlying purpose of the transaction and if the underlying purpose is to speculate price swings and that there is no expectation of delivery then it is a futures contract regardless of what the parties call it.

The *Zelener* court just went away from that approach completely and said no, no, no, no, what you have to look at is the written agreement between the scammer in this case and the customer. And if that written agreement calls the contractor rolling spot and if that written agreement in its fine print does not guarantee a right of offset, well, then it is not a futures contract and I don't care whether it looks like a futures contract, is sold like a futures contract, or acts like a future contract. It is not a futures contract, and the CFTC has no jurisdiction. Well, this was a huge blow. This was worse than Frankel Bullion because this affected the CFTC's ability to protect retail customers from off exchange unregulated futures contracts, not just for foreign currencies but for everything. It was a real blow.

So in the last reauthorization process, as Steve mentioned and as the Chairman mentioned, Congress debated how best to address *Zelener*, and we advocated what was called a broad fix so that it would affect all commodities. Congress basically decided that the current problem was foreign currency so they focused on foreign currency and adopted the narrow fix. Since then, just as Steve mentioned, we have seen this proliferation. Just in our routine day-to-day auditing or surveillance of the Internet we have become aware of dozens of these web sites, dozens of these *Zelener* type markets that are offering retail customers completely unregulated futures look-alikes. So with these contracts there is no registration requirement for anybody, so we have got people that we have booted out of the futures industry for fraud that cross the street and start selling *Zelener* contracts. We have seen familiar names. Guys that we have tossed are now selling this things because in this unregulated world there is no registration requirement, there is no capital requirement, there are no sales practice standards, there is no risk disclosure — there is no nothing.

And customers are getting hurt. We get customer complaints at NFA from people that have lost their life savings in these different types of scams. It is not right. We have to do something about it. These customers, some of them are subject to high pressure sales, some of them don't understand the nature of the transaction, they don't understand the fees that they are paying. There is no adequate disclosure. So I am almost over my time, but the point, I guess, is that I think it is time to do something with a broad

Zelener fix, and in our view that fix has to accomplish three things. Number one, it has to make sure that scammers can't sell off exchange futures contracts simply by disguising it to look like something else.

Number two, the fix should not in any way impair or interfere with the legitimate spot market. If there is actual delivery of the contract, we don't want to deal with it. If the customer is a commercial interest, he has a commercial interest in the product and might take delivery, we don't want to deal with it. We don't want to interfere with the spot market. And, number three, I think it is important to bear in mind that it is not enough just to give the CFTC anti-fraud authority over these contracts. Anti-fraud authority is no substitute for regulation. It is not good enough to come in after the fraud occurred. All the things I have talked about, the registration, the capital, the risk disclosure, the audits, all those things are designed to protect customers to prevent fraud rather than prosecute it.

Giving the CFTC simply anti-fraud authority is no substitute for the regulatory protections under the Act, and neither, by the way, is the Model State Commodity Code. If some state regulator has the authority to close one of these bucket shops, well, God bless. however, the authority to close it down after the fraud has occurred is no substitute for the regulatory protections of the Commodity Exchange Act which is why the Model Code expressly excludes transactions covered by this Act. So, Mr. Chairman, I am way over my time and I will be quiet now. But we have talked about this for a long time and we look forward to working with the Committee and the staff and look forward to this possibly being the last time I have to testify about *Zelener*, which would be nice for all of you too.

[The prepared statement of Mr. Roth follows:]

SUBMITTED STATEMENT OF MR. DANIEL ROTH, PRESIDENT AND CHIEF EXECUTIVE OFFICER, NATIONAL FUTURES ASSOCIATION, CHICAGO, ILLINOIS

My name is Daniel Roth, and I am President and Chief Executive Officer of National Futures Association. Thank you Chairman Boswell and members of the Subcommittee for this opportunity to appear here today to present our views on closing a regulatory gap that allows fraudsters to sell unregulated OTC derivatives to retail customers.

Since 1982, NFA has been the industry-wide self-regulatory organization for the U.S. futures industry, and in 2002 it extended its regulatory programs to include retail over-the-counter forex contracts. NFA is first and foremost a customer protection organization, and we take our mission very seriously.

Congress is currently expending significant time and resources to deal with systemic risk and to create greater transparency in the OTC derivatives markets. Those are important economic issues, and we support Congress' efforts to address them. Understandably, most of the debate centers around instruments offered to and traded by large, sophisticated institutions. However, there is a burgeoning OTC derivatives market aimed at unsophisticated retail customers, who are being victimized in a completely unregulated environment.

For years, retail customers that invested in futures had all of the regulatory protections of the Commodity Exchange Act. Their trades were executed on transparent exchanges and cleared by centralized clearing organizations, their brokers had to meet the fitness standards set forth in the Act, and their brokers were regulated by the CFTC and NFA. Today, for too many customers, none of those protections apply. A number of bad court decisions have created loopholes a mile wide, and retail customers are on their own in unregulated, non-transparent OTC futures-type markets.

The main problem stems from a Seventh Circuit Court of Appeals decision in a forex fraud case brought by the CFTC. In the *Zelener* case, the District court found that retail customers had, in fact, been defrauded but that the CFTC had no jurisdiction because the contracts at issue were not futures, and the Seventh Circuit affirmed that decision. The ″rolling spot″ contracts in *Zelener* were marketed to retail customers for purposes of speculation; they were sold on margin; they were routinely rolled over and over and held for long periods of time; and they were regularly offset so that delivery rarely, if ever, occurred. In *Zelener*, though, the Seventh Circuit ignored these characteristics and based its decision on the terms of the written contract between the dealer and its customers. Because the written contract in *Zelener* did not include a guaranteed right of offset, the Seventh Circuit ruled that the contracts at issue were not futures. As a result, the CFTC was unable to stop the fraud.

Zelener created the distinct possibility that, through clever draftsmanship, completely unregulated firms and individuals could sell retail customers forex contracts that looked like futures, acted like futures, and were sold like futures and could do so outside the CFTC's jurisdiction. For a short period of time, *Zelener* was just a single case addressing this issue. Since 2004, however, various Courts have continued to follow the Seventh Circuit's approach in *Zelener*, which caused the CFTC to lose enforcement cases relating to forex fraud.

A year ago, Congress closed the loophole for forex contracts. Unfortunately, the rationale of the *Zelener* decision is not limited to foreign currency products. Customers trading other commodities-such as gold and silver-are still stuck in an unregulated mine field. It's time to restore regulatory protections to all retail customers.

In testimony before this Subcommittee in 2007, I predicted that if Congress plugged the *Zelener* loophole for forex but left it open for other products, the fraudsters would simply move to *Zelener*-type contracts in other commodities. That's just what has happened. We cannot give you exact numbers, of course, because these firms are not registered. Nobody knows how widespread the fraud is, but we are aware of dozens of firms that offer *Zelener* contracts in metals or energy. Recently, we received a call from a man who had lost over $600,000, substantially all of his savings, investing with one of these firms. We have seen a sharp increase in customer complaints and mounting customer losses involving these products since Congress closed the loophole for forex.

NFA and the exchanges have previously proposed a fix that would close the *Zelener* loophole for these non-forex products. Our proposal codifies the approach the Ninth Circuit took in *CFTC v. Co-Petro*, which was the accepted and workable state of the law until *Zelener*. In particular, our approach would create a statutory presumption that leveraged or margined transactions offered to retail customers are futures contracts unless delivery is made within seven days or the retail customer has a commercial use for the commodity. This presumption is flexible and could be overcome by showing that delivery actually occurred or that the transactions were not primarily marketed to retail customers or were not marketed to those customers as a way to speculate on price movements in the underlying commodity.

This statutory presumption would not affect the interbank currency market dominated by institutional players, nor would it affect regulated instruments like securities and banking products. It would also not apply to those retail forex contracts that are already covered (or exempt) under Section 2(c). It would, however, effectively prohibit leveraged non-forex OTC contracts with retail customers when those contracts are used for price speculation and do not result in delivery.

I should note that NFA's proposal does not invalidate the 1985 interpretive letter issued by the CFTC's Office of General Counsel, which Monex International and similar entities rely on when selling gold and silver to their customers. That letter responded to a factual situation where the dealer purchased the physical metals from an unaffiliated bank for the full purchase price and left the metals in the bank's vault. The dealer then turned around and sold the gold or silver to a customer, who financed the purchase by borrowing money from the bank. Within two to seven days the dealer received the full purchase price and the customer received title to the metals. In these circumstances the metals were actually delivered within seven days, so the transactions would not be futures contracts under NFA's proposal.

In conclusion, while NFA supports Congress' efforts to deal with systemic risk and create greater transparency in the OTC markets, Congress should not lose sight of the very real threat to retail customers participating in another segment of these markets. This Subcommittee can play a leading role in protecting customers from the unregulated boiler rooms that are currently taking advantage of the *Zelener* loophole for metals and energy products. We look forward to further reviewing our

proposal with Subcommittee members and staff and working with you in this important endeavor.

Mr. BOSWELL. We are not going to require you to be quiet. We are just going to penalize you. Thank you, Mr. Roth. I appreciate your comments. And now we would like to call on Mr. Feigin, Attorney, Rothgerber Johnson & Lyons, on behalf of Monex Deposit Company, Denver, Colorado. Mr. Feigin, welcome.

STATEMENT OF PHILIP A. FEIGIN, ATTORNEY, ROTHGERBER JOHNSON & LYONS, ON BEHALF OF MONEX DEPOSIT COMPANY, DENVER, COLORADO

Mr. FEIGIN. Good morning, Mr. Chairman, and Members. My name is Philip Feigin. I am an attorney in private practice in Denver and appear today on behalf of Monex Deposit Company, the largest vendor of precious metals to retail customers in the United States. Before starting my current practice, I was Executive Director of the North American Securities Administrator's Association and before that I spent 10 years as Securities Commissioner for the State of Colorado. While commissioner, I also served as NASAA's President in 1994 and 1995 though I obviously speak today for Monex, not my former regulatory colleagues. My regulatory career is focused on enforcement and investor protection. I played an active role in drafting various investor protection statutes, including the Uniform Securities Act, and the Model State Commodity Code back in 1985, which I will discuss in my testimony today.

I believe my background puts me in an excellent position to provide the Subcommittee with perspective on whether a Federal fix is necessary for the retail spot precious metals transactions discussed. I believe the state regulation through the Model Code is the best way to address that market, a spot market that Congress has historically not placed under CFTC jurisdiction. The Model Code has been in effect in 22 states for the better part of 20 years. Monex Deposit Company operates a cash market which customers take physical delivery of gold, silver, and other precious metals. Buyers may wish to hold gold or other precious metals as a store of value, a hedge against inflation, or an avenue to generate positive investment returns. Monex is located in Newport Beach, California and has been in business more than 20 years. Monex and its affiliates has over 200 employees. On average, the company buys and sells more than 2 billion in physical precious metals with over 10,000 customers each year.

When a customer purchases gold from Monex, the full amount of the gold purchased is delivered either to the customer itself or a depository. Under the Model Code delivery must occur in no more than 28 days. The customers either pay cash or finance their purchase through a Monex affiliate with at least a 20 percent down payment. About 20 percent of Monex's customers use this financing. Like any business dealing with the retail public, Monex has received some complaints over the years. Most are resolved with an explanation or simple logistical solution. Of the more than 100,000 customers that Monex has dealt with over the past 20 years only 82 brought claims against Monex in court or arbitration and of those Monex has lost only one case for a total award of $270.

My written testimony provides a short history of the development of the Model State Commodity Code that also reflects my experiences in enforcing investor protection laws at the state level. In 1975, as Mr. Roth discussed, a significant increase in commodities trading was accompanied by a rise in bucket shops and other abusive companies. The newly created CFTC was understaffed and overwhelmed and the states were frustrated in going after many of these scam operators because they were pre-empted by Federal law. Eventually Congress changed the law to allow states a greater enforcement role. However, this did not mean the states had the law on their books to take advantage of the new authority. The need for a model statute was apparent, and we state regulators spent 2 years working with the CFTC and the NFA studying the problems and drafting what eventually became the Model Code in 1985.

This is the statute under which Monex operates under the supervision of the California Department of Corporations, and it has been enacted by 21 other states. The code has many provisions, but among the most important is its concept of a commodity contract, an arrangement that cannot be sold unless it meets standards set out in the code. One of those, which I mentioned earlier, is the requirement that the purchaser receive the physical delivery of his purchase within 28 days of payment of any part of the purchase price. The code was designed as a modern bucket shop law. It allows regulators and prosecutors, and I want to emphasize this, to analyze a contract or transaction quickly to determine if it is lawful. They avoid the often complicated and uncertain task of attempting to establish the presence of futures contract under current law.

In my written statement, I quoted the NFA's and the CFTC's testimony in support of the code. I have also cited several examples of the code's use against scam artists in which states such as Missouri, Maine, and Colorado used it very well. The code is an efficient and effective law enforcement tool. In order to operate lawfully under the code, the purchaser or his recognized depository must receive delivery of his commodities within 28 days of the payment of any part of the purchase price. This is a significant deterrent and it is at the heart of the code. There is a case to be made for additional Federal regulation at both on exchange futures markets and off exchange slot markets where we have seen exaggerated commodity price movement and where over the counter trading may have contributed to systemic risk in the world economy.

This committee passed H.R. 977 to deal with these issues but no one to my knowledge has argued that the retail metals trading poses a systemic financial risk or distorts market prices. Customer protection is the focus of the proposed *Zelener* fix, but we suggest the Model Code has served that purpose for precious metals investors for well over 20 years. If it is the decision of the Congress that Federal action is necessary, we are more than willing to participate on the development of the approach and share our experience in dealing with both the underlying premises and applications of our approach to policing the off exchange spot market transactions. Thanks for the opportunity to testify. I will be happy to respond to any questions.

[The prepared statement of Mr. Feigin follows:]

PREPARED STATEMENT OF MR. PHILIP A. FEIGIN, ATTORNEY, ROTHGERBER JOHNSON & LYONS, ON BEHALF OF MONEX DEPOSIT COMPANY, DENVER, COLORADO

Good morning, Mr. Chairman and committee Members. My name is Philip A. Feigin. I am an attorney in private practice with the law firm of Rothgerber Johnson & Lyons in Denver, Colorado. Prior to joining the firm, I served as Executive Director of the North American Securities Administrators Association ("NASAA") in 1998 and 1999. NASAA represents the state and provincial securities agencies of the 50 states, the District of Columbia, Puerto Rico, the U.S. Virgin Islands, the provinces and territories of Canada, and the Republic of Mexico. It is the oldest international organization devoted to investor protection. Prior to my time in Washington, I served as the Securities Commissioner for the State of Colorado for 10 years, Deputy Commissioner for seven and Chief Enforcement Attorney for the Wisconsin Securities Commissioner for almost four years before that. While Colorado Securities Commissioner, I served as the President of NASAA in 1994-95, and as a member of NASAA's board of directors for seven years. I also served as Chair of NASAA's Enforcement Section and its Commodities Committee for several years.

My regulatory career was focused on enforcement and investor protection. I chaired or participated in multistate enforcement efforts involving Lloyds of London, securities day trading abuses, the Moser case at Salomon Brothers, precious metals boiler rooms in South Florida and Orange County and penny stock swindlers in Denver. I pioneered the development of NASAA's coordination of multistate enforcement projects. I also spearheaded the creation and funding of a permanent Securities Fraud Prosecution Unit at the Colorado Attorney General's office.I was active in crafting a new regulatory regime for Colorado. I participated in the drafting and led enactment of the Colorado's Securities Act, Commodity Code, Municipal Bond Supervision Act, local government investment pool trust fund regulation, and provisions under which the state's investment advisers and investment adviser representatives are regulated. I was also actively involved in the drafting of the national Uniform Securities Act (2002) as a model for all state securities regulation.

I was privileged to serve for several years on the Commodity Futures Trading Commission's ("CFTC") Advisory Committee on Federal-State Cooperation. I have testified on numerous occasions before committees of both the U.S. House of Representatives and the Senate on securities, banking, commodities regulation and investor protection issues as well as various committees of the Colorado General Assembly and other state legislatures. I have also served as an expert witness for the U.S. Attorney, the Securities and Exchange Commission ("SEC"), states attorneys general and district attorneys in several states in many federal and state criminal investment fraud cases.

I have gone through my background in detail in an effort to establish my credentials as one who has spent virtually his entire career in investment law enforcement and investor protection. I am here today to speak on behalf of Monex Deposit Company, specifically with regard to the issues presented by the holding in *CFTC v. Zelener* and whether a federal "fix" is needed with regard to the sort of retail spot precious metals transactions in which Monex engages. I submit to you that current regulatory standards provide all necessary customer protections. I also suggest that Congress has historically chosen not to regulate spot commodity markets for good reasons, and that no case has been made that spot metals trading poses the type of systemic risk that might justify the application of a broad new regulatory scheme.

MONEX

Monex Deposit Company is the largest vendor of precious metals to retail customers in the United States. Purchasers may wish to hold gold or other metals as a store of value or hedge against inflation or against changes in the value of the dollar or other assets that may have negative correlation with precious metals. They may also wish to trade the value of precious metals in hopes of attaining positive returns.

Monex Deposit Company is located in Newport Beach, California, and, together with several affiliated companies, has over 200 employees. Monex routinely buys and sells in excess of $2 billion in physical precious metals with over 10,000 customers annually. Customers may pay in full and take personal delivery or store their goods through Monex in an independent depository. They may also finance their purchases through Monex's affiliate, Monex Credit Company, with a minimum down payment of 20%. The maximum loan is 80% of the purchase price. The precious metals owned by the customer is the collateral for the loan. Historically, the average loan is about 50% of the collateral value.

In all transactions, title to the full amount of the metals purchased passes to the customer and delivery is made, either to the customer or his designated depository, within 28 days, or such shorter period as may otherwise be required by law, upon receipt of full or partial payment of the purchase price, as applicable. Monex Credit Company also lends precious metals to customers who wish to take a short position in the market. All transactions with the Monex companies are self-directed by the customer. There are no managed accounts. Approximately 20% of Monex customers finance their purchases.

Monex Deposit Company and Monex Credit Company have been in business for over 20 years and conduct their business in compliance with the requirements of the Model State Commodity Code, as adopted in 22 states, including California, where the Monex companies are located. The companies' principals have been in the retail precious metals investment business since 1967.

Monex Deposit Company and Monex Credit Company are registered with the California Department of Corporations, respectively, as a telephonic seller and finance lender. The risk disclosures included in the Monex account agreements are the most extensive available to retail commodity investors.

The number of customer complaints received by Monex is very low, generally no more than two or three per month, compared to the thousands of customers and transactions that we handle annually. Most complaints are of a minor nature and are resolved by an explanation or a logistical solution. Serious complaints result in reimbursement or are settled if they appear meritorious. In the last 20 years, Monex has been involved in 82 customer litigation and arbitration matters. Ten are still pending. Of those resolved, Monex has lost only one case, which resulted in an award of $270.

BRIEF HISTORY

In 1974, Congress enacted the Commodity Futures Trading Commission Act. In so doing, Congress created the CFTC. In addition to instituting the first meaningful federal comprehensive regulatory scheme for the commodity futures industry, Congress preempted the states (primarily state securities regulators) from applying their laws to persons and transactions within the jurisdiction of the Commodity Exchange Act (CEA).

The creation of the CFTC coincided with an enormous increase in commodities trading as the Vietnam era inflationary cycle, the oil crunch and many other factors caused upheavals in the economy. In addition, the early 1970s marked the first time since World War I that Americans could own gold bullion. As is all too often the case, expansion of legitimate markets was accompanied by expansion of illegal activity as well.

Commodity-theme boiler rooms proliferated around the country, mostly in Boston, New York and South Florida, purportedly selling contracts involving everything from gasoline stored in tankers moored in Maracaibo Bay, to gold and silver, to aluminum stored in caverns beneath the Isle of Jersey and coal in the hills of Tennessee. The CFTC was grossly understaffed to deal with off-exchange commodities fraud. The entire Enforcement Division had less than 125 people. The CEA was crafted to regulate the established exchange-based commodity futures market, but was extremely complicated and ill-suited to deal with off-exchange problems. Hundreds of millions of dollars were lost by unsuspecting victims. The states were virtually powerless to attack the scams. Even if a state had the resources and evidence to proceed, the CEA preempted state intervention. In fact, in one infamous case arising in Arkansas, the Arkansas Securities Commissioner took action against a commodities boiler room under the Arkansas Securities Act in defiance of the preemption. The CFTC actually intervened on behalf of the boiler room to assert the position that Arkansas was preempted from acting, but took no action of its own against the fraudster. This was the low point in relations between the states and the CFTC.

By 1978, it was clear that something was very wrong. Millions of dollars had been lost to scammers. The CFTC proved out-gunned in its efforts to address the problem. Congress determined that the states should be allowed into the enforcement effort, and enacted Section 6d of the CEA providing the states with the authority to enforce state laws "of general criminal application" (not securities laws) against violators, and allowing states to enforce the CEA in federal court themselves. Although a move in the right direction, Section 6d was not particularly well received by the states or successful in achieving the desired goal. States were unfamiliar with the CEA and the federal forum, not many cases were brought in cooperation with the CFTC and none were brought by states acting alone.

Matters came to a head in 1983. An outfit in Fort Lauderdale called International Gold Bullion Exchange had been advertising in the Wall Street Journal for over a

year, offering to sell gold at below the spot price if purchasers would agree to store the metal at IGBE for a year. The company would pay them 5% interest a year. Over 425,000 investors across the country, including many in Colorado, sent IGBE a total of more than $140 million to buy gold. When authorities entered the vault in 1983, they found 50 pieces of wood painted gold. The money was all gone and there was no gold.[1]

Just as IGBE's fraudulent operations neared their peak, in 1982, Congress enacted the so-called ″open season″ provision of the CEA, Section 12(e). Under this new provision, the states were authorized to enforce any applicable law against any person who had to be registered with the CFTC to engage in particular conduct but failed to do so, and any transaction that had to be effected on a contract market or exchange under the CEA but was not.

Enactment of the "open season" provision did not mean that states had applicable laws on their books providing jurisdiction to take advantage of it. This led to the initiation of a multi-jurisdictional project to draft a model statute that states could enact to utilize against off-exchange commodity-theme frauds. State securities regulators, the CFTC and the National Futures Association ("NFA") joined forces to create the Model State Commodity Code ("Model Code" or "Code"). It took two years of drafting, including public releases, comment periods, review of responses, meetings with industry and a public hearing before the New York Commodities Bar. In testimony presented to the Washington State legislature in support of its Code legislation in 1985, CFTC Commissioner Fowler C. West described the working group's efforts.

> Two drafts were circulated for public comment. The working group received and assessed a great number of comments on these drafts and held meetings with representatives of the commodities industry in order to assure that the Code did not unnecessarily curb legitimate business interests. Those efforts culminated in a final version of the Model Code, finalized in April 1985. . .[2]

With Monex's support and assistance, the Model Code was adopted in California and Colorado. It has also been enacted in Georgia, Idaho, Indiana, Iowa, Kansas, Maine, Mississippi, Missouri, Nebraska, Nevada, New Mexico, North Carolina, North Dakota, Oklahoma, Oregon, South Carolina and Washington, and its substantive provisions were incorporated into the state securities laws of Arizona, Montana, and Utah. Florida enacted provisions dealing with the problem using a different but effective approach.

WHAT THE CODE DOES

The preamble to the Model Code begins by stating that the Code is a "modern bucket shop law." It is essential to understand that the Code is not meant to regulate commerce; it is an enforcement statute.

In its deliberations, the Code's drafters examined existing state laws to determine if any other law provided the jurisdiction necessary to take action against the schemes and frauds being perpetrated under the generic commodities theme. Traditional securities laws were deemed to be inadequate; it proved very difficult to establish that the agreements were ″investment contract″ securities, as would be required under those statutes. In order to make such a case, we needed vast amounts of documentary evidence and analysis, and the firms were most often located in another jurisdiction beyond the reach of state administrative subpoenas. Even if we could acquire such data, by the time a case was prepared, the boiler room was long gone.

There were two fundamental fraudulent patterns of conduct that showed up most frequently: (i) consumers were being sold commodities on a down-payment basis for speculative purposes-delivery was not required for many months (there were no commodities and the company vanished with the money that the customer had paid); and (ii) consumers were buying precious metals from out-of-state companies promising to store the metal for them, but the companies never bought the metal and squandered the cash. Proving jurisdiction under the CEA in off-exchange cases often was (and remains) less a legal enforcement action and more all but metaphysical exercise in quantum economics and semantics, requiring reams of evidence, expert testimony from economists, and even then a measure of luck. Back then and to this day, enforcement authorities charged with protecting customers from fraud need a quick recognition, simple litmus test to give them the basis to take prompt

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[1] *Coloradans Caught in Gold Scandal*, Bruce Wilkinson, Denver Post, August 18, 1983

[2] Testimony of The Honorable Fowler C. West, Commissioner, U.S. Commodity Futures Trading Commission, In Support of Senate Bill 4527 Before the Senate Financial Institutions Committee, The Honorable Ray Moore, Chairman, February 4, 1986, at p. 3.

action in response to a newspaper ad or an infomercial. Months, even years later is far too late. We needed a new approach.

Under the Code, we prohibited both of those fraud themes, on sight. We created a new concept, the ″commodity contract,″ defined as a contract for the purchase or sale of commodities, primarily for speculative or investment purposes, and not for use or consumption by the offeree or purchaser. We crafted a presumption that, in the absence of evidence to the contrary, such contracts are for speculative or investment purposes. Under the Code, the offer or sale of such ″commodity contracts″ is strictly prohibited. Excluded from this prohibition-and therefore unaffected by the Code-are contracts or transactions:

- under which is required, and where the purchaser actually receives, within 28 days [or other period determined by a state] of the payment in good funds of any portion of the purchase price, physical delivery of the total amount of each commodity purchased;
- offered, sold or purchased by CFTC, SEC or state registrants, and financial institutions;
- within the exclusive jurisdiction of the CFTC; or
- involving the purchase of precious metals, under which it is required and where the purchaser or his/her designated and authorized depository receives, within 28 days of payment by the purchaser in good funds of any portion of the purchase price, physical delivery of the precious metals purchased-and the depository (or another approved depository) delivers a document to the purchaser confirming that the metals are being held by the depository on the purchaser's behalf.

Given this new formulation, we could examine a contract or transaction and determine *quickly* whether it was lawful under the Code. That was the key element. If delivery was not required or did not actually occur within 28 days of any payment, it was illegal and we had the grounds to proceed immediately under the Code, with cease and desist orders, injunctions or even referrals for criminal action. No experts, no reams of documentation, no six months to work up the case while our citizens were defrauded. All we needed was a look at the ad or contract and a calendar.

In 1989 written testimony on the Model Code presented to the Colorado General Assembly, the NFA stated:

> There should be no question as to NFA's support of the Model State Commodity Code now--or in the future.
>
> The thrust of the Model Commodity Code is really to act as a modern bucket shop law, and goes straight to the heart of this regulatory problem--it will prohibit the very type of transactions which have been fraught with customer abuses. These are contracts which fall into a regulatory abyss. Commodity futures contracts traded on exchanges by registered professionals are already regulated. Commodity option contracts, as allowed to be traded pursuant to the Acts and Regulations promulgated thereunder, are not the problem. Leverage contracts traded pursuant to CFTC regulations are not the type of problem you are being asked to address. Regulatory mechanisms exist which can deal with those aspects of the industry. The real problems are the lookalikes, the tagalongs--contracts which should be designated by the CFTC but are not; contracts which should be regulated but are not; contracts which are non-futures, non-options, non-leverage; commodity contracts in which the dealer says he's got it (maybe in a warehouse in Mozambique) but is usually gone when the customer wants to get it. If states, such as Colorado, outlaw this type of activity, that activity which requires registration but is not registered, swift, effective enforcement action can be taken at the State level much more efficiently than has been done in the past.[3]

The Code has worked very well in the many states where it has been adopted. The jurisdictional hurdles confronting state regulatory authorities attempting to classify commodity-theme frauds as selling securities are no longer of concern in Code states. They can react quickly and effectively to protect their citizens. For example, Missouri used the Code in a criminal case involving a multi-million dollar platinum fraud that might have been difficult to pursue under traditional securities theories. In a commodities boiler room raided by New Jersey officials, warnings

[3] Statement of National Futures Association In Support of Pending Legislation H.B. 1130 Colorado Commodity Code, In the State of Colorado, at p. 8, January 20, 1989

were discovered that salespeople should not call into Maine (presumably because Maine has the Code). Colorado had a similar experience in another case.

The Code approach works. I would be remiss if I did not add that, given my understanding of the facts in *Zelener*, the rolling Forex contracts were illegal "commodity contracts" under the Code. Although the contracts called for delivery within 28 days, in this case, 48 hours, actual delivery of the currency was not made to the investors. Purchases and sales were netted out. The Code was also strongly endorsed by the Futures Industry Association. Real commerce between real merchants, investments offered and sold by regulated entities and transactions lawful under the CEA are in no way prohibited under the Code.

Again, in its Colorado testimony, the NFA stated:

> The Model Commodity Code will not outlaw legitimate commodity activity, it will not outlaw or impede in any way transactions between commercial interests nor will it outlaw or in any way inhibit cash sales transactions. If delivery is made within the specified period, FINE! But this will proscribe the activity wherein your citizens have purportedly purchased such things as gold bullion for delivery in 9 months from an unregistered firm, only to find out 6 months later that their "gold bullion" was merely a vault full of two-by-fours painted gold.[4]

Further, in Commissioner West's Washington testimony, he went on as follows:

> Let me briefly state what the Model Code does and does not do. While the Code bans [the] types of transactions that have been fraught with abuse, the Code does not interfere with legitimate business.[5]

Since 1985, the CFTC has scrutinized Monex's products on at least two occasions, determining in each instance that no futures, commodity options or leverage transactions were involved and took no enforcement action of any kind against the Monex companies. Monex Deposit Company and Monex Credit Company have never been the subject of any governmental sanction relating to their business dealings with customers.

THE ISSUE TODAY

There is a long history of not regulating spot markets under the CEA. To subject spot metals markets to CFTC oversight would set a precedent for also regulating other spot markets. Such an expansion of the CFTC's role would prove impracticable and would have undesirable market impacts. The CEA has always been intended to apply to futures contracts and related instruments. It does not and never has controlled cash market transactions unrelated to futures activities. In 1985, the CFTC acknowledged its lack of jurisdiction over retail precious metals transactions in which delivery is effected to purchasers by the prompt transfer of title to metals stored in a depository (*See* Interpretive Letter 85-2, CFTC Office of General Counsel, ['84-'86 Binder] CCH Comm. Fut. L. Rep. ¶ 22,673 (August 6, 1985). The Code was drafted to complement the Federal commodities laws and permit public investment in legitimate off-exchange commodity transactions, most specifically in cash market precious metals.

One reason that Congress is considering additional regulation of financial markets and instruments is the systemic economic and financial risk posed by some products and market structures that became prevalent over the past two decades. In retrospect, it has become clear that even if transactions are limited to large, well-capitalized counterparties, they can-and did-create unanticipated risks that threaten all American citizens. No one has alleged that to be the case here: it has not been charged or demonstrated that off-exchange spot precious metals transactions pose a systemic risk. Retail metals trading involves individual investors, not large institutions whose failure could create systemic financial risk. Moreover, prices of metals are largely determined by the much-larger exchange futures markets, so any potential for price manipulation in retail markets is minimal.

Concerns have also been raised about the use of leverage, but the mere fact that a seller extends credit to a buyer does not automatically mean that the transaction should be regulated under the CEA. By this logic, any product purchased with a down payment and the use of credit would be considered "leveraged" and ripe for CFTC regulation.

In H.R. 977, passed earlier this year by the Committee on Agriculture, Congress is in the process of giving CFTC major new responsibilities to establish agricultural and energy speculative position limits; re-visit earlier hedging exemptions in many commodities; collect and interpret large volumes of previously undisclosed and unre-

[4] NFA Testimony, *id*. at p. 9.
[5] West Testimony, *id*. at p. 3.

ported information about the swaps market; and establish and enforce a new regulatory regime for clearing swaps. The Committee has ably made the case for these new responsibilities, but I would suggest that this is not the time to add even more tasks to an already-overburdened agency in the absence of a clear and compelling case for the need to do so. Nor should major market participants on futures exchanges and in the off-exchange swap markets be allowed to divert attention from last year's huge commodity bubble and the damage it did to our economy by trying to divert Congress's focus to a few retail metals dealers.

CONCLUSION

Congress' focus should remain fixed on last year's huge commodity bubble and the damage done to our economy by major market participants on futures exchanges and in the off-exchange swap markets. The retail metals market is in fine shape.

The Model State Commodity Code was born of the need for an effective state investor protection tool in the absence of federal oversight. It has served its purpose well, nationwide, as a stand-alone statute. There have been no unintended consequences. If problems arise in states that have not yet adopted the Code, one must presume they will address them under some other statutory approach or adopt the Code as have their sister states. As it is, the presence of the Code in 22 states suppresses fraud in all. There has been no resurgence of precious metals fraud since the adoption of the Code, even with the recent run-up in the price of gold. To attempt to contort the CEA to provide jurisdiction to any already overtaxed CFTC would risk unintended consequences of futures-style regulation of spot market commerce. I believe this approach is ill-conceived and unwarranted. Thank you.

Mr. BOSWELL. Well, thank you. We will start the questions. I will just be very brief. But since this narrow *Zelener* fix in the 2008 Farm Bill, should this be extended to other commodities besides foreign currency? I think you have addressed that a little bit, but I will let you respond first, Mr. Feigin, then the rest of you may make a comment. Mr. Feigin.

Mr. FEIGIN. I harken back to the late 1980's after the states had become very active in attacking precious metals frauds. As soon as gold and silver went out of favor, the scammers turned to strategic metals. Some metals I had never heard of harkening back to high school chemistry. They were selling chromium because it was being used in catalytic converters. And there were also scams that I am sure my colleagues remember regarding coal, aluminum, all sorts of things, and the scammers will go to the path of least resistance, so this has to be a broad-based remedy that is not a rifle shot, but more a shotgun approach.

Mr. BOSWELL. Mr. Roth or Mr. Obie, either one.

Mr. ROTH. I do think further action is required, Mr. Chairman, for the reasons that I outlined, and to just repeat them briefly. We have seen the migration of abusive practices away from the foreign currency trade to the unregulated, right now it is precious metals, tomorrow it might be something else. But we have seen these web sites, 30 of them, that have this unregulated; futures market even though they call it something else. So the point that I made earlier was that anti-fraud authority is not enough. The whole point of the Commodity Exchange Act is that retail customers need regulatory protection when they are trading futures contracts, and that goes beyond anti-fraud authority. We are trying to prevent the fraud, not just prosecute it.

And that is why under the Act when a retail customer is doing a futures contract it has to be on a transparent, open and regulated exchange. The customer has to have a risk disclosure. There are regular audits of the member to make sure that they have the financial capital to meet their obligations. None of those protections apply in the current, unregulated environment. Like I said, it is

distressing to work hard to throw a guy out of the futures industry and then get a customer complaint 2 weeks later from someone who says the same guy is now selling *Zelener* gold. The customer doesn't say *Zelener* gold but that is what it is. So if the question is do we need further action to address *Zelener* my answer is most certainly, yes, because the migration that we feared would happen has happened. We have got retail customers in an unregulated futures market, and the fact that the scammer calls it something else shouldn't be enough to defeat CFTC jurisdiction.

Mr. BOSWELL. Mr. Obie.

Mr. OBIE. And equally frustrating, Chairman, is to bring actions in the foreign currency area and then see folks think that they can sell the same exact contracts and gold, precious metals, and other commodities, and so, you know, from the CFTC standpoint customers who have been harmed here in these *Zelener* futures look-alikes and other commodities reach out to us to complain, and we know that we are not able to help them. We are not able to bring actions. We are not able to use the enforcement powers that we have in this area, and so I think it is important for the Committee to know that we are seeing an increase in this area and that this is an opportunity to really nip this fraud in the bud.

Mr. BOSWELL. Thank you. Mr. Moran.

Mr. MORAN. Mr. Chairman, thank you. Mr. Roth, what Mr. Feigin is saying, you disagree with, and is the disagreement what you just described in that it is only anti-fraud provisions that are covered by the state statutes so we are responding after the fact under the Uniform Act? Is that the distinction between what is not happening today and what you would like to see happen? Mr. Feigin's argument is this ought to be taken care of, as I understand your argument, it should be taken care of at the state level. We have a Uniform Model Act in place. Twenty-two states have that. But your concern is that it is after the fact?

Mr. ROTH. Right. The Model Commodity Code specifically excludes from this coverage anything that is covered by the Commodity Exchange Act. It doesn't cover futures contracts, which is what these are. And my point is that the Model State Commodity Code or CFTC anti-fraud authority is not a substitute for the network of regulatory protections that the Commodity Exchange Act has historically provided to retail customers trading futures.

Mr. BOSWELL. Mr. Feigin, your response?

Mr. FEIGIN. Pointing to the *Zelener* case, the court with respect said that they were not futures contracts, so I think a different fix is required, and the Model Code poses an easily identifiable tool to allow the regulators and law enforcement to shut these things down on site. We found that they were inherently fraudulent, that there was no retail participation in the spot market. Some people wanted to buy gold, yes, and we provided for that and protected them by setting a 28-day physical actual delivery requirement, but in other ways we found there was no retail, honest retail, participation in the spot markets, and, therefore, we didn't want to regulate it. We wanted to stop it. We wanted to find an easy way to simply shut it off. If they are futures contracts certainly they ought to be regulated under the Commodity Exchange Act. But if they try to escape, try to sell off exchange the Model Code mechanism provides

a way for law enforcement to simply close them down on site, not requiring further analysis.

Mr. MORAN. What would be the consequences to Monex's business if Congress adopted the suggestion of a broad *Zelener* fix?

Mr. FEIGIN. Well, obviously it would depend what it is but Monex has been working under and operating under the Model Code precepts for 20 years. And I want to make clear we are not in dispute with the NFA, and I don't think the NFA is seeking here to shut Monex down. I think we have a common ground in that we both want to see these off exchange scams shut down as fast as possible.

Mr. MORAN. Mr. Roth, let me ask you a question before my time expires, and then you can respond to Mr. Feigin. But we have been through this a long time. We have had a long conversation and discussion in Congress about a broad *Zelener* fix. A conclusion was reached in the 2008 Farm Bill for a narrow fix. Describe to me why that was the conclusion. What are the forces at work out here that prevented what I think many of us thought was an important direction to go.

Mr. ROTH. I can tell you what I think was going on, and that before when *Zelener* always came up, it always came up in the context of reauthorization, and when you are talking about reauthorization, you are talking about roughly 2,000 other issues that come up. And there is necessary compromise. You need to move the legislation forward. We need to get the CFTC reauthorized. I feel silly telling you about the political process but compromises are reached, and we were always frustrated that we couldn't prevail in our position but we understood the necessity of moving the legislation. So from my perspective, it was largely a political sort of process and the President's working group and Mr. Greenspan felt that we should really focus on the problem at hand and that was foreign currency.

Mr. MORAN. Did you have something you wanted to respond to other than my question?

Mr. ROTH. Mr. Feigin's point that the *Zelener* court ruled that these weren't futures contracts, well, that is the problem. That is the point. That in reaching that decision this court decided to exalt form over substance and say we are going to look at the four corners of the written agreement and if that customer got trapped by clever draftsmanship, well, that is just too bad. And I recognize that the Model Code gives the states a vehicle to approach and attack that type of problem, and that is great. But, as I said, it is no substitute for the regulatory protections designed to prevent fraud, and that is what we are looking for.

Mr. MORAN. Mr. Obie.

Mr. OBIE. Looking forward giving the markets and the state that they are in at this moment, I think gold, silver and other precious metal frauds are attractive at this time. Previously, I think foreign currency was the fraud de jeur, and now given the state of the economy and the state of the markets, I think you are seeing this increase in gold and precious metals for a reason. But not just in those commodities. We are also seeing it in energy commodities, and I am aware of at least a couple orange juice potential fraud boiler rooms.

Mr. MORAN. Thank you very much. Thank you, Mr. Chairman.

Mr. ROTH. Mr. Chairman, if I could add one more thing with respect to Mr. Moran's question about how our approach would effect——

Mr. BOSWELL. We will get to that in just a minute.

Mr. ROTH. Thank you, sir.

Mr. BOSWELL. Mr. Marshall.

Mr. MARSHALL. Thank you, Mr. Chairman. Just continuing this line of discussion here, the Model Commodity Act, is that what it is called?

Mr. FEIGIN. The Model State Commodity Code.

Mr. MARSHALL. Model State Commodity Code is in 22 states now?

Mr. FEIGIN. Yes, sir.

Mr. MARSHALL. So does that mean that somebody can locate in another state that doesn't have the code and effectively proceed to engage—because a bucket shop can be anywhere. It is just a telephone and the Internet communication. And effectively proceed to conduct the scam operation and be fairly safe from anybody coming after them?

Mr. FEIGIN. Certainly a boiler room could locate, for instance, in Pennsylvania, and sell into Idaho or Montana. Of course, they have the code so they would have to pick another state, South Dakota, perhaps. But, more importantly, bucket shops have tended to locate in southern California, south Florida, Scottsdale, Arizona, and some in New York.

Mr. MARSHALL. Is that because those are places where people are instinctively fraudulent kind of characters?

Mr. FEIGIN. If you are making a million dollars a month, I guess it is more fun to be in South Beach than Bismarck with all due respect to North Dakota. But I think that has been the reason, and so that seemed to be very effective when those states took action. It seemed to stem the tide of the problem back in the 1980's.

Mr. MARSHALL. Mr. Roth, Monex representatives and I had a discussion yesterday about their operation, and they sound like they are pretty straightforward and that you wouldn't have a problem with what they do, is that correct?

Mr. ROTH. Well, the fix that we have been proposing would not affect any contracts in which there is actual delivery. We are not trying to regulate the spot market. We are just trying to prevent people from disguising futures contracts by calling them spot contracts, so I don't think we would have any—from our point of view, the proposal that we have been advocating would not affect Monex.

Mr. MARSHALL. Let us say we stay with just the state regulatory scheme, you say that that is no substitute for the Federal scheme, the way the CFTC and NFA goes about protecting people from these kinds of scams. Could you elaborate a little bit about that or, Mr. Obie, could you elaborate how do you all—after the fact, closing down a Ponzi operation scheme after the fact really doesn't help a whole lot of people out because typically they don't have any money. It may be that you go back and try and collect from individuals who benefited from the scheme and then trying to distribute money, but that is very difficult to do. And largely there is no remedy at that point except the satisfaction of seeing somebody go to jail.

Mr. ROTH. Closing down a Ponzi scheme has a positive benefit if you close it early because you close it before all the other people get taken in. Your ability to close a Ponzi scheme early is greatly enhanced if you have the authority to conduct regular on-site examination of the person conducting the Ponzi scheme. If they are on your radar screen——

Mr. MARSHALL. So the basic idea here is we expand the class of transactions that are covered by the CFTC's authority and individuals selling those kinds of products have to register and consequently they are subject to regular oversight, review, et cetera, so that their little Ponzi operation can't grow to a large——

Mr. ROTH. Correct. And the only quibble I would have with you would be that in my view we are not expanding the CFTC's authority or jurisdiction. We are restoring it.

Mr. MARSHALL. We are correcting an aberration, what you would say is an improper reading of what congressional intent was in the statute. Mr. Feigin, your response? How is it that Mr. Roth and Mr. Obie suggest to us that a lot of people will be protected from Ponzi schemes if this authority is given and Monex won't be hurt at all, so why not go ahead and permit it so that we fill this gap and protect these folks and you all aren't harmed?

Mr. FEIGIN. We have not quibbled with the idea that futures contracts and futures trading ought to be regulated and——

Mr. MARSHALL. What we are talking about here though is expanding the—well, correcting would be the argument the *Zelener* interpretation of what a futures contract is. If in substance it is a futures contract, it is going to be regulated. It doesn't matter how clever your draftsmanship is. That is all they are saying.

Mr. FEIGIN. But we don't believe these off exchange futures contracts have any validity at all. We think they ought to be banned, and, therefore, we found not regulated, banned.

Mr. MARSHALL. Well, but they are not at the moment and isn't that just a decision that the CFTC and NFA should make themselves?

Mr. FEIGIN. So at that point if a Federal fix is warranted, we heartily recommend a quick trigger mechanism to shut them down, not to regulate them and allow them to continue to operate and develop. We think they should be shut down immediately.

Mr. MARSHALL. I am out of time, but you want to respond, Mr. Roth.

Mr. ROTH. That mechanism already exists in the act. The act prohibits off exchange futures contracts for retail customers, so when you make the determination that these things are futures contracts, they are per se illegal.

Mr. FEIGIN. That is the problem. It is almost a Talmudic decision as to whether something is a futures contract as is seen in *Zelener*. You often need an economist to try to testify that something is a futures contract. To prove something is a commodity contract and therefore banned under the Model Code——

Mr. MARSHALL. If we simply say it is to be delivered and then the pattern is that there is delivery, doesn't that take care of your worries? Would it matter what the writing said?

Mr. FEIGIN. All you need is the contract and a calendar and then the evidence whether the commodity was delivered in 28 days or

not. If the contract didn't call for delivery, require it, and delivery wasn't in fact made within 28 days, it is simply illegal.

Mr. BOSWELL. I am letting you have a little extra time here, Mr. Marshall, because this, I think, pertains to what we are talking about. So, Mr. Roth, I will give you one last moment here.

Mr. ROTH. With respect to the decision about whether—I think it was referred to as a Talmudic decision as to whether something is or isn't a futures contract. Well, from 1974 to the *Zelener* case it wasn't a problem. Courts dealt with this just fine by looking at the underlying purpose of the transaction when it was a retail customer. It wasn't until 2004 that the *Zelener* court said that we should just look at the four corners of the written agreement, so I know it is at times a complex issue but really things worked just fine from 1974 to 2004, and all we are trying to do is sort of restore that rule of law.

Mr. BOSWELL. Mr. Feigin, last remark on Mr. Marshall's point.

Mr. FEIGIN. I think it is a question of an enforcement tool. I think the Model State Commodity Code and I think the three of us work together to formulate this response it is much easier to determine something is an illegal commodity contract under the code than it is, and I submit, there were other very complex decisions and analyses of whether something is or isn't a futures contract. And it is a lot easier to prove something under the code than it is under the Commodity Exchange Act.

Mr. MARSHALL. If we adopted a definition, which essentially broadened, you know, got rid of the *Zelener* decision and sort of went back to the pre-*Zelener* era where the CFTC and NFA could step in there and try and stop these Ponzi schemes that are operated on a retail level and admittedly all three of you acknowledge hurting the hell out of people who just are suckers and they get caught up in this, and we simply said if your operation is one that is designed to comply with the Commodity Code and delivery does occur, two things, in fact, delivery is occurring in your operation, and that is accepted, would that work? Wouldn't that fill the gap right there, and you would be able to—CFTC, NFA would be able to go after the Ponzi schemes that are now popping up all over the place in these different commodities and Monex and others who are operating underneath and actually delivering would be okay and they wouldn't have to fool with you guys.

Mr. ROTH. I think that is right, Congressman. We are looking to effect leverage contracts offered to retail customers where there is no expectation of delivery, and that is what we are trying to reach and that restores the law to, I think, its pre-*Zelener* state.

Mr. MARSHALL. It sort of sounds to me like the three of you could get together and come up with something that would guide us that would protect the legitimate commodity traders at the retail level who do deliver their spot contracts, they do deliver, and at the same time expand the jurisdiction so we get rid of these Ponzi schemes.

Mr. BOSWELL. This has been a good discussion. Thank you. I only gave you double time there, Mr. Marshall, but it was a good discussion, and Mr. Moran and I agreed on that. So Mr. Luetkemeyer.

Mr. LUETKEMEYER. Thank you, Mr. Chairman. I certainly appreciate you allowing Mr. Marshall to continue there. That was an in-

teresting discussion and quite educational for me. Mr. Feigin, you made a statement a while ago and made a comment about a bucket shop. Can you explain or define what that is for me?

Mr. FEIGIN. Bucketing is the idea of selling something to a speculator and then taking an offsetting transaction in that alleged good but you never have it so it is naked speculation.

Mr. LUETKEMEYER. That is an empty bucket, isn't it?

Mr. FEIGIN. That is the idea. And they evolved along with telephones and the like where you could just bet with somebody although they didn't know they were betting. They could own something for a while, sell it, but you never owned it. So the term evolved as bucketing, and there were a lot of anti-bucketing laws in the 1960's, but they were very limited.

Mr. LUETKEMEYER. Okay. Thank you. Mr. Roth, you made a couple comments with regards to the development of some of the rules and laws. I was very interested in the exchange with Mr. Marshall. I think you made a comment one time about something about not just enforcement but we also need to do something prior so that we define what a contract is and set up some rules as to how it be framed, and you said something about the four corners of an agreement. Can you explain what that is for me, please?

Mr. ROTH. The *Zelener* court basically said that in determining whether a contract with a retail customer is a futures contract, you have to look at the four corners of the document and only the four corners of the document.

Mr. LUETKEMEYER. What are the four corners, I guess is the question.

Mr. ROTH. The written document itself, just the written page.

Mr. LUETKEMEYER. Okay.

Mr. ROTH. And that if certain language was included notwithstanding the substance of the transaction it would be considered not a futures contract and therefore beyond the Commodity Exchange Act.

Mr. LUETKEMEYER. Okay. So when you say four corners, it is not four tenets of a contract that you have to have in order to be able to be judged a futures contract. It is just the definition of a written contract.

Mr. ROTH. It is the written contract itself.

Mr. LUETKEMEYER. Okay. Very good. Thank you. Mr. Obie, you made a comment also about enforcement. What are the tools that you need to be able to do your job? I know we talked about a number of things here. What other things do you see that you need to be able to broaden your scope to be able to prevent some of these things from happening?

Mr. OBIE. Obviously, we have to get over this jurisdictional hurdle. We have the ability to move quickly to freeze funds. We work very closely with criminal authorities. We have trading bans. We got registration bans. And we put these folks down and we try to help the American public.

Mr. LUETKEMEYER. You don't have the ability to do those things right now?

Mr. OBIE. Not in this area.

Mr. LUETKEMEYER. Not in this area. Okay. Very good. Thank you. Mr. Chairman, I yield back the balance of my time. Thank you.

Mr. BOSWELL. Thank you. Mr. Walz.

Mr. WALZ. Thank you, Mr. Chairman, and thank you all for being here today and help us understand this issue. I am going to ask you be somewhat subjective here. Did the Seventh Circuit rule wrong on *Zelener*, can I ask each of you in your opinion?

Mr. ROTH. Dead bang.

Mr. FEIGIN. Absolutely.

Mr. OBIE. And we obviously are litigating that. We were telling the court how to rule and it ruled against us.

Mr. WALZ. Is that the proper fix then to go back and appeal that decision that way or is the proper—it is done, so there is nothing else that can be done that way, that is why you come this way?

Mr. OBIE. That is right. And other circuit courts look towards *Zelener* in reaching decisions, so we have lost a line of progeny there.

Mr. WALZ. Okay. Did we make the right fix, albeit narrow, in the Farm Bill fix on that?

Mr. OBIE. In bringing the nine cases that we brought so far, we have not seen jurisdictional obstacles, and so in foreign currency we believe we have the tools to aggressively prosecute these bucket shops and Ponzi schemes.

Mr. ROTH. With respect to foreign currencies, the farm bill extended the commission's anti-fraud authority to these type contracts for foreign currencies. What I stated before is that anti-fraud authority is no substitute for regulatory protections. At the same time, I recognize, and this is why I went into it in my testimony, foreign currencies have been treated differently since 1974, so I understand why Congress may have taken this act in the farm bill and just extended the anti-fraud authority with respect to foreign currencies. I would hate to see that carried further into other commodities where it was only anti-fraud authority because I don't think that is a substitute for regulatory protections.

Mr. FEIGIN. Unless I am wrong, I think that the idea that forex had to be traded through an SCM creates a fairly quick trigger identification mechanism so that if you see somebody trading in forex instruments, and they are not registered as an SCM that provides a quick trigger. As to whether they are doing it lawfully after being registered as an SCM, that is another question. I want to point to this distinction, this anomaly that was created with the Treasury Amendment. There should not be any off exchange futures trading. It just should not be. It should be banned. And to the extent that jurisdictional anomalies have allowed it to proceed in one way or another, we have to accommodate. But we should not give rise or accommodate the development of off exchange futures trading, so what we are offering, what we are suggesting, is that this quick fix gives everybody a chance to just shut it down, not to develop. That is why I make the distinction between this should not be regulated. This should be shut down.

Mr. WALZ. And I would ask, and Mr. Feigin had brought it up to the next question on this that I am interested in but I know I may not have the right people here. Maybe, Mr. Obie, you are the

best to engage this. What has happened on legitimate forex trading? I know you said there has been 84 investigations or whatever. Can you speak to anything what happened in that regard?

Mr. OBIE. It is very hard to say legitimate forex trading because historically off exchange futures contracts were illegal. We have this special animal that retail forex contracts have been allowed through off exchange model but we have tried to—Congress has tried to come with a new regime by having registered forex dealer members, but historically these leveraged contracts which harm the economy were never allowed to be marketed to the retail public, and so that is where we have seen the greatest fraud. And in the exchange area, we see much fewer complaints in the forex area or anything else, so if I had to compare we have many more frauds off exchange, very few frauds on exchange.

Mr. WALZ. Okay. Thank you, and I yield back, Mr. Chairman.

Mr. BOSWELL. Thank you. We will recognize Mr. Schrader.

Mr. SCHRADER. Thank you, Mr. Chairman. I am again still trying to get clarity on the differences of opinion if there are any here, Mr. Feigin, I guess the bottom line is at this point your contention is that the metals trades that are referred to by Mr. Roth and Mr. Obie are not really futures contracts, would that be correct?

Mr. FEIGIN. They may be, they may not be. I think that the identification of a futures contract has proven to be a more problematic issue in court than has the more physical identification mechanism that has been used under the Model Code. So I don't think we disagree. I think Mr. Obie would be thrilled if there was an easier way to identify these and eliminate legal issues to be able to shut the off exchange things down. They may be futures contracts, but they may not, but they are certainly off exchange and in the fact that they are off exchange they ought to be shut down unless they end all forex and a few precious metals dealers who deliver.

Mr. SCHRADER. Mr. Roth, I assume you believe they are futures contracts? Mr. Feigin is not sure.

Mr. ROTH. I certainly believe that the contracts that were at issue in the *Zelener* case were futures contracts. I believe that the 30 or so web sites that are offering these contracts to retail customers for precious metals are futures contracts. I think most of the problematic issues that have come up in defining a futures contract involve where there is a commercial user or an institutional user and not as much in the retail sector. And Steve can speak to this better than I, but I think from 1974 until the *Zelener* decision the commission seldom lost on jurisdictional grounds when fighting retail bucket shops.

Mr. OBIE. And Mr. Roth is absolutely right in that regard, and we don't see an issue where delivery is occurring. Our middle name is futures. What we are saying is that these 2 day rolling spot contracts and other crafty arguments that are used to defeat the futures jurisdiction has impeded our ability to stop fraudsters and Ponzi schemers.

Mr. SCHRADER. And I assume, Mr. Feigin, you would rather have the states deal with these issues under the Model Code that you have referenced?

Mr. FEIGIN. Yes, sir.

Mr. SCHRADER. Is it a fair statement, Mr. Feigin, that you believe that it is better to deal with these as fraud issues rather than prevention regulation issues as asked for by Mr. Roth?

Mr. FEIGIN. I believe all three organizations back in the 1980's made the determination that there was no lawful or legitimate reason for these contracts to be permitted nor was there any useful purpose, that they were inherently fraudulent and ought to be prohibited, and then we looked very carefully and determined whether we were stepping on any legitimate toes and carved out those few issues where there were legitimate companies operating. We made sure there were consumer protections there. So we were very careful, and I think it is important not to try to create a new market. If they are futures contracts, they ought to be shut down because they are off exchange.

Mr. SCHRADER. But if we are not sure they are futures contracts, you are not sure, then we ban them?

Mr. FEIGIN. Then, in essence, as we are all agreeing, the requirement for delivery, for actual delivery of the commodity that you are purchasing within a brief period of time is the trigger mechanism. The bucket shops don't have the stuff to deliver nor do they actually deliver it, so delivery is the key and was the key in the operation of the——

Mr. SCHRADER. So in your testimony, you have talked about the 28 deliveries that currently exist, and I think it was Mr. Roth in his testimony referenced that is a little too long in the rolling contracts, and perhaps a 7 day period would be better. And I assume you object to that and I would like Mr. Roth to respond too.

Mr. FEIGIN. The Model Code started with the 7 day delivery period and after some testimony from an outfit that I don't think is around anymore called the Industry Council for Tangible Assets the NASAA people were convinced to extend it to 28 days for various circumstances. That number, it is in there. That is less of a problem than the concept in itself.

Mr. ROTH. Congressman, we have no problem with 28 days. We picked 7 days. If it was 28 days, I think it would achieve the same effect what we are trying to achieve. If I could just draw one distinction. I think why I say anti-fraud is no substitute for regulatory protection, and then we get into the distinction that should we ban off exchange futures or regulate them. There is no real disagreement here. My point is that if it is an off exchange futures contract, it is banned, and if they are going to offer futures contracts, they have to become a contract market, and once they are a contract market then they are fully regulated and we have all the regulatory protections. So I certainly don't mean to suggest that we should regular off exchange futures contracts for things other than foreign currency. They should all be on exchange. I agree with that.

Mr. SCHRADER. So trying to get a handle, which I have not yet, is that apparently the bottom line difference would be defining what a futures contract is. Obviously, some misunderstanding, disagreement, whatever, on what a futures contract is because if you could do that then we would just all agree happily that we should ban those.

Mr. ROTH. And I think the uncertainly that we are talking about in the definition of futures contract was injected and created by the

Zelener decision, and so the legislation that we are trying to craft that we are drafting is hopefully to restore the law to its pre-*Zelener* state.

Mr. SCHRADER. Mr. Feigin, last comment.

Mr. FEIGIN. The pre-*Zelener* state dealt with issues of whether it was for speculative or investment purposes. I think that goes to the mental state of the parties as opposed to whether or not you have to deliver in 28 days. Like I said, all you need is the contract and a calendar as opposed to delving into the mental state of the parties or the intent. That is subjective. Twenty-eight days is not——

Mr. SCHRADER. Thank you. Thank you, Mr. Chairman.

Mr. BOSWELL. Thank you. Mr. Kissell.

Mr. KISSELL. Thank you, Mr. Chairman. I would like to yield time to begin with to Mr. Walz for a question.

Mr. WALZ. I thank the gentleman, and this is, Mr. Obie, I am still trying to get a handle on this. Can you tell me from CFTC's perspective—I could have had my legal scholar, Mr. Marshall, help me. He was gone here in just a minute. What happened in the appeal to the Supreme Court on this because it is a palatable feeling here that this was a bad, bad decision? Can you tell me the history from CFTC what happened there just for my background? And I thank the gentleman for yielding me a minute.

Mr. OBIE. We consulted with the solicitor general and there was no appeal to the Supreme Court from the *Zelener* decision.

Mr. WALZ. Do you have any idea why that was?

Mr. OBIE. I do not. I can get you that information.

Mr. WALZ. That is fine. We can do the research too. But, thank you. Thank you, Mr. Kissell.

Mr. KISSELL. And that is kind of a question I had too. Mr. Obie, if things worked well from 1974 to 2004, and all of a sudden the courts say within the four corners it is no longer going to work, what do we need to change within those four corners to make it work because it seems like to me that if we try to do it with regulations these guys are always going to figure out a way to get ahead of us and look for the loopholes. So what within those four corners needs to be changed?

Mr. OBIE. I think this committee has already done that with regard to foreign currency. We know that these rolling spot contracts are look-alike futures contracts, and what has happened is foreign currency is just not as attractive to have a fraud in, so those contracts that were right on the web site have just been picked up and foreign currency has been changed, and now you see orange juice, you see precious metals, and you see other commodities entered in, and those are arguably outside our jurisdiction. The *Zelener* fix gives us the roadmap to extending that to other commodities.

Mr. KISSELL. So we could follow this same premise of the narrow fix and broaden it and you feel like that would take care of it?

Mr. OBIE. And once you do that what happens is that there are other provisions under the Commodity Exchange Act that would apply and say that off exchange futures contracts are illegal, so that we wouldn't have an off exchange market in orange juice dealing with futures contracts. We wouldn't have off exchange orange juice. It would be up to the commission in that regard, but the op-

erative effect of the law would be that, and I think we are all in agreement, that we wouldn't have off exchange futures as a result.

Mr. KISSELL. Thank you, sir. Mr. Roth, you mentioned something about 30 Internet sites that advertise this type of transaction. Of those 30, how many do you think are not legitimate in terms of fraudulence that may exist?

Mr. ROTH. I can tell you that virtually none of them are registered with the CFTC. Some of them, when you look at them and you can look at the web site and see some misleading information, but one of the things that happens with these electronic trading platforms is sometimes you can only see the fraud by looking at the actual trading on the trading platform and see how the trading platform can be manipulated by the owner of the platform to put customers at a huge disadvantage. And you can't see that without getting in to do an audit and an examination, and because these firms aren't registered and they are not members they are escaping that sort of scrutiny. So just looking at the web site, certainly some of them are very troubling as far as their sales practices, but where the real heart of the fraud might be is something you would only get into and know the full extent of it after you do an examination. And right now we can't do that examination because we don't have jurisdiction.

Mr. KISSELL. And, Mr. Obie, that brings me back to another, just curiosity. The people that the fraudulence is being imposed upon, is there a generality as to how these people get in touch with them? What makes them subject themselves to fraudulence? Is there a commonality there that, gee, I should know better. What is the pattern there? What are the people that are getting caught up in this like?

Mr. OBIE. I have seen it in several instances. One category is affinity fraud, and that is where you know someone who tells you, hey, I have an investment and it has been doing really well, and you usually find that from a fraudster who either has the same ethnic background or is a member of your church, or recently we had someone who was a school board member and was well respected in the community and was operating a Ponzi scheme of many millions of dollars in Philadelphia. We also see it though with regard to folks who know with the stock market collapsing that they need to save for retirement, and so they are looking for other alternative investments. And the Ponzi schemers just prey on these folks. They are average Americans, many of whom are blue collar who are just looking to find an investment that will enable them to retire and have a comfortable living.

The poor folks that we have to deal with, I can tell you about the Agape case that was up in Long Island. It had thousands of victims and involved hundreds of millions of dollars that were defrauded. And the folks there were average Americans who lost substantially all of their investment.

Mr. KISSELL. Thank you, Mr. Chairman.

Mr. BOSWELL. Thank you. I see Mr. Pomeroy has joined us. Mr. Pomeroy, I hate to bother you at this crucial moment here. Did you have a question or should we come back to you in just a moment?

Mr. POMEROY. If there is someone else to inquire, I will be happy to defer to them.

Mr. MARSHALL. This is not your time, Mr. Pomeroy. The Chair is going to yield——

Mr. BOSWELL. No, I will make that decision.

Mr. MARSHALL. We might infer that this be your time. The fix that we initially proposed in 2005 and then stuck into the 2008 act, we are not necessarily wed to that as the concept for moving forward, it seems to me. And it also seems to me based on the conversation that we had here today as I mentioned earlier that you all should be able to get together and give us some guidance how to move forward in a way that will close the gaps in regulation so that these folks, you know, as soon as they pop up on your web site you are able to call them up and say, hey, what are you doing? By the way, either one, you can't do it at all or, two, you are going to have to do an exchange, or, three, I don't know what the three is, frankly, because the way it works right now you are either doing it on exchange as retail or you don't do it at all.

And so I think that satisfies your need, Mr. Feigin, and at the same time we ought to be able to figure out some way to not have you burdened, your operations burdened by excessive regulations. Certainly, the regulation would be pretty minimal in your case. So I am hoping that you can come up with something, and I am just suggesting that we are not necessarily wed to what we have done in 2008. If there is a better way to describe this to accomplish the objective, we are all ears. And I could yield back. I could keep on and then you would just have less and less time.

Mr. BOSWELL. Mr. Pomeroy.

Mr. POMEROY. Thank you, Mr. Chairman. I have never seen Brother Marshall run out of words before so quickly so this has been a stunning development. I apologize for missing this hearing, which I looked forward to, but I do have—the question I wanted to bring to this hearing involves the issue of, I guess, functional versus identify a specifically identified item for regulation. And it looks to me like some of the discussion between Mr. Feigin and Mr. Obie involves this issue. Specifically, what I mean is it has been suggested that a State securities regulatory type approach that would identify a particular practice, prohibit it very clearly, very clean, but it would allow just some other instrument, some other product to be gamed in a way that wouldn't be addressed by the State prohibition. Mr. Feigin, can you explain how your approach would be sufficiently encompassing so that we wouldn't have to chase the scam with new rules every time?

Mr. FEIGIN. Sure. I am going to start by saying that I believe the *Zelener*—I wasn't involved in it obviously, but I believe the *Zelener* contract violated the Model Code, and would have been illegal on site. The Model Code applies to anything in commerce. It could be sweaters. It could be bars of gold. It could be rolls of aluminum. It could be anything. If you sell it, it is presumed to be for investment purposes and if the contract doesn't require delivery, and if, in fact, delivery is not made within 28 days it is illegal. And so it would apply to all commodities, and I strenuously urge, I think, with my fellow panel members that whatever you do this fix not be limited to precious metals. If you proceed with it, that has no meaning. They will just go do something else.

So the Model Code applies to everything just as the Commodity Exchange Act applies to any commerce except onions. I am waiting for the next onion scam to come up, but at least for both statutes its coverage is universal.

Mr. POMEROY. An onion scam brings tears to my eyes. Mr. Roth, would you care to comment?

Mr. ROTH. The point that we made earlier was that what we are looking for is a fix which—the Model State Commodity Code doesn't apply to futures contracts that are regulated under the Commodity Exchange Act. We are concerned that people under the *Zelener* decision, people can simply cosmetically disguise futures contracts as something else to try to evade the jurisdiction of the CFTC. The fact that the Model Code may allow a state's securities regulator to close the firm down in our view is not a substitute for preventing the fraud in the first place by requiring these entities to be on exchange. I would note that of the 30 web sites that we cited in our Internet surveillance, we have made referrals on all 30 of them to the appropriate states, and not a single case has been brought, and the states have plenty to do. And historically it has been a tough sell.

Maybe Steve can discuss this further, but make more referrals to states and getting states to take an affirmative prosecutorial stand in these cases hasn't been the easiest thing in the world to do, and these futures contracts typically lie within the expertise of the futures regulators, and that is where I think they ought to be dealt with.

Mr. OBIE. We do have expertise in this area, and we have lent our assistance wherever we are needed, but clearly this is a complex area, and that is where the Division of Enforcement has the expertise and we have been able to prosecute the foreign currency scammers that we have seen. We have 84 active investigations. We have already brought nine cases. That is 25 percent of our current litigation so far this year with that perspective. We have already filed approximately 36 cases this year. All of fiscal year 2008, we filed a total of 40. So we are on pace to use the clarified authority that you have given us.

Mr. POMEROY. So is it your position if something for delivery within 28 days, physical delivery, is some kind of loophole if that is regulated under——

Mr. OBIE. No. The proposals, I think we are in agreement. We are hearing as a panel that is in agreement here that regulating the spot market is not something we are interested in. We are looking at the look-alike paper contracts. These have been crafty contracts that were drafted by high-powered lawyers to evade jurisdiction. We are not looking at where tangible products are delivered.

Mr. POMEROY. Thank you. My question is probably a little out of left field given my missing the testimony in the first place, but thank you very much. It has been clarified somewhat for me. Thank you, Mr. Chairman.

Mr. BOSWELL. Thank you very much. Mr. Moran.

Mr. MORAN. Mr. Chairman, thank you. What seems to be developing, and, in fact, we have talked here among ourselves that if we put the three of you in a room we would have a broader *Zelener* fix. My question goes back to one I raised with Mr. Roth earlier.

We had this opportunity for a broader *Zelener* fix in the Farm Bill and previous to that. We have debated fixing *Zelener* for a long time. Who are we missing a the table this morning that if we put them in the room with you would cause the deal to fall apart? What is the argument against this broader fix other than, I guess, Mr. Roth was telling us the Treasury Department said that we don't need to focus on it at the moment. But within the industry there is not unanimity of agreement that seems like something is missing here in this morning's discussion?

Mr. ROTH. Well, if you want to know who objects to what we are proposing besides the people we are trying to reach, the concern I always heard from certain aspects of the regulated industry was a concern that anything that appeared to give the CFTC jurisdiction over anything that is called an OTC instrument caused tremors and made people nervous, and it was the old camel's nose type of an argument that my God, anything that gets into OTC is bad. And our counter was but these are futures contracts aimed at retail customers, but I think there was just such concern about CFTC jurisdiction extending to OTC instruments that people got very, very nervous.

Mr. MORAN. Let me make sure, Mr. Roth, you said there is no real disagreement between 7 and 28 days.

Mr. ROTH. Yes.

Mr. MORAN. Okay. We also did the fix as it related to foreign currency exchange, and you all, particularly you, Mr. Roth, in your history have described the uniqueness of the regulatory framework toward foreign currency. It reminded me of the history of that. Why is it treated uniquely, and is there something unique about it that again suggests that we ought to have a narrow fix?

Mr. ROTH. And the reason foreign currencies are treated differently under the Act, foreign currency and onions, I guess, but focusing on foreign currencies, again I think it stems from the fact that just as the CFTC was being created the Treasury Department was concerned that if this interbank foreign currency market that they were involved in the regulation of, that they didn't want the CFTC interfering with that interbank market. And that is why the Treasury Amendment was created in 1974, and where it becomes difficult is when you start having foreign currency transactions involving not the interbank market but retail customers.

Mr. MORAN. Thank you for the reminder. I remember you saying that now, and so there is no fundamental difference other than bank regulation, the treasury regulation of commercial banks, for example, in comparison to metals. The consequence to the consumer, to the participant in the market is the same.

Mr. ROTH. Exactly.

Mr. MORAN. Okay. Thank you, Mr. Chairman.

Mr. BOSWELL. I think that brings us to a point unless somebody has something they want to ask. You know, Mr. Moran and I have been talking about it, and Mr. Marshall as well, I think the three of you, if you had the time to do it and would do it could sit down and work out something that would be workable. I am going to ask you to consider that, and I am going to instruct Mr. Ogilvie, to contact you and see if there is a time you could come together and sit down and give us a draft that we could take a serious look at. I

appreciate what you have done this morning. I don't think there is any point in us dragging this out any further. Do you have any closing remarks you want to make?

Mr. MORAN. I do not, Mr. Chairman. Thank you for allowing me a second round of questions.

Mr. BOSWELL. You are welcome. I think we have learned something here this morning. I think you have made a contribution. We appreciate it. I also think there is a solution, and I think I am looking at the people who can put it together if you will sit together and give and take a little bit and let Clark with you. We can either decide to do something or leave it alone. That is where we are going to stop at that point right there unless somebody else has anything else they want to say. I thank you very much for your participation today, and the usual applies, and this hearing has come to a close. Thank you.

[Whereupon, at 11:20 a.m., the Subcommittee was adjourned.]

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