TESTIMONY OF PHILIP A. FEIGIN

ON BEHALF OF MONEX DEPOSIT COMPANY

BEFORE THE U.S. HOUSE OF REPRESENTATIVES

COMMITTEE ON AGRICULTURE

SUBCOMMITTEE
ON GENERAL FARM COMMODITIES
AND RISK MANAGEMENT

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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

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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.

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 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.
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> 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 tag-alongs--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 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

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[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

> 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

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

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

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 unreported 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.