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Retail Investments in Precious and Industrial Metals: Mining for Proper Regulation Aimed Toward Investor Strategy

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RETAIL INVESTMENTS IN PRECIOUS AND INDUSTRIAL METALS: MINING FOR PROPER REGULATION AIMED TOWARD INVESTOR STRATEGY

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I. INTRODUCTION

In his famous words to the shareholders of his company in 2002, Warren Buffet, a man whose name resonates with many households as an extremely wealthy investment guru, condemned derivatives as "financial weapons of mass destruction."[1] Buffet made this comment in the context of Berkshire Hathaway's own institutional investment dealings in regulated areas of derivatives, such as futures and options, where he has employed top analysts from across the country to utilize these investment vehicles to hedge against risk.[2] But, if one of

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1. Sam Ro, *Berkshire Profits Plummet Thanks to Buffet's Bets on 'Financial Weapons of Mass Destruction,'* BUS. INSIDER (Nov. 5, 2011, 1:57 PM), http://www.businessinsider.com/berkshire-profits-plummet-2011-11.

2. *See id.*; *see also* Saul S. Cohen, *The Challenge of Derivatives*, 63 FORDHAM L. REV. 1993, 2007-08 (1995) ("After all, the Orange County Treasurer presumably had available to him the same computers, analytical tools and executive talent to examine and employ derivatives as do the treasurer's departments at multinational corporations like Dow Chemical, major banks and Wall Street dealers."); *id.* at 1997 ("Both swaps and options are classi-

the most notable investors in American history has such strong criticism of this investment product, what does this mean for the average "Joe Schmo" investor who does not have the sophisticated investment knowledge as, say, a fortune 500 company and is investing in derivatives not as a hedge but as a dangerous speculative investment? Even further, what does this mean for Joe when he decides to invest in an unregulated over-the-counter derivative for purposes of profiting off of volatile market movements? Does Joe need and deserve the protections of regulation? Does he want such protections?

Today, the average investor has the right and the luxury of investing in a wide range of regulated and unregulated investment vehicles in the derivatives market.[3] With the downturn in the economy, derivative investments in precious and industrial metals have piqued the interest of many Americans who believe the dollar is devalued and now buying less than it used to.[4] With this increased interest by the general public, the unregulated over-the-counter precious and industrial metals industry has also attracted individuals who build disingenuous brokerage firms for the purpose of pouncing on fast, easy money by defrauding retail customers.[5] As the fraudulent practices picked up and more and more retail investors began to lose their shirts in this high-risk investment,[6] the regulators began watching the industry keenly.[7]

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fied as derivatives, though only the latter are currently regulated."); *id.* at 2005 ("[O]ne should understand that derivatives lessen volatility by efficiently shifting risk from parties less able or willing to bear it to others with the resources to more readily absorb such risk in exchange for a potential profit.").

3. *See* SUNIL PARAMESWARAN, FUNDAMENTALS OF FINANCIAL INSTRUMENTS: AN INTRODUCTION TO STOCKS, BONDS, FOREIGN EXCHANGE, AND DERIVATIVES 16-22 (2011); Cohen, *supra* note 2, at 2000-02.

4. *See* Jon Burstein, *Gold Firm Owner Sentenced in $29.5 Million Ponzi Scheme*, SUN-SENTINEL (Nov. 18, 2011), http://articles.sun-sentinel.com/2011-11-18/news/fl-global-bullion-exchange-20111118_1_global-bullion-exchange-jamie-campany-precious-metals.

5. *See, e.g.*, *id.*; Press Release: PR6447-12, U.S. Commodity Futures Trading Comm'n, CFTC Charges Hunter Wise Commodities, Lloyds Commodities, C.D. Hopkins Financial, United States Capital Trust, Newbridge Alliance, Blackstone Metals Group, and Their Principals in Multi-Million Dollar Fraudulent Precious Metals Scheme (Dec. 5, 2012), http://www.cftc.gov/PressRoom/PressReleases/pr6447-12) [hereinafter CFTC Press Release: PR6447-12]. One such individual is fraudster and owner of the metal company Global Bullion Exchange, Jamie Campany, who defrauded more than 1400 customers throughout the nation when he marketed unregulated precious and industrial metals to unsophisticated investors using high-pressure sales tactics when, in fact, no metal interests were actually sold to customers. Burstein, *supra* note 4. Campany simply ran a Ponzi scheme worth $29.5 million with little scrutiny by regulators for a number of years. *Id.*

6. *See* Burstein, *supra* note 4. Sun-Sentinel newspaper investigators found that between 2007 and 2010, more than forty-five precious metals dealers opened up in the South Florida area alone. *Id.* Additionally, nine of these dealers in South Florida have defrauded customers of over $91 million in losses. *Id.*

7. *See CFTC Fraud Advisories—Precious Metals Fraud*, U.S. COMM. FUTURES TRADING COMM'N, http://www.cftc.gov/ConsumerProtection/FraudAwarenessPrevention/CFTCFraudAdvisories/fraudadv_preciousmetals (last visited June 22, 2014).

This Note will highlight the jurisdictional struggle between the Commodity Futures Trading Commission ("CFTC") and the precious and industrial metals industry in the CFTC's attempt to regulate the retail commodity transaction that takes place between the average retail investor and the brokerage firm soliciting the transaction, namely the "retail dealer."[8] Further, after taking a look at the past legal stance of both parties involved, this Note will analyze whether an over-the-counter investment in precious and industrial metals should be regulated and what level of regulation, if any, would be best suited for this unique investment product and its controlling industry participants. Finally, I propose a potential solution that takes all of the parties and transaction cost issues into account: a restricted regulatory approach.

II. DERIVATIVES 101

Before one can analyze whether regulation of an over-the-counter investment vehicle in precious and industrial metals is proper, it is important to know the basics of derivatives and how some derivative products are currently regulated. An explanation of the exact derivative at issue, "look-alike" precious and industrial metal futures,[9] will follow in the proceeding Parts. Starting at the beginning, a derivative is defined as "[a] security whose price is dependent upon or derived from one or more underlying assets."[10] A derivative's value is determined through underlying market factors and the movement of such factors.[11] These factors can include movements in interest rates, currency exchange rates, commodity prices, and prices of other assets.[12] Most derivatives are traded by sophisticated institutional investors, such as Mr. Buffet's company, as a hedge against the risk of the underlying product losing value at a future date of delivery.[13] Since

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8. Terms and characterization of industry participants are based off court records in the present litigation, U.S. Commodity Futures Trading Comm'n v. Hunter Wise Commodities, LLC, No. 9:12-CV-81311 (S.D. Fla. filed Dec. 5, 2012).

9. Regulation of Off-Exchange Retail Foreign Exchange Transactions and Intermediaries, 75 Fed. Reg. 55,410, 55,414-15 (Sept. 10, 2010) (to be codified at 17 C.F.R. pts. 1, 3, 4, 5, 10, 140, 145, 147, 160, & 166). The term "look-alike" is derived from the CFTC's characterization of "spot" or "cash forward" transactions in the foreign exchange industry, *id.*, a transaction proposed later by this Note to be identical to the current transaction in precious and industrial metals at issue.

10. *Definition of 'Derivative,'* INVESTOPEDIA, http://www.investopedia.com/terms/d/derivative.asp (last visited June 22, 2014); *see* PARAMESWARAN, *supra* note 3, at 16.

11. Cohen, *supra* note 2, at 2004-05; *Definition of 'Derivative,' supra* note 10.

12. Cohen, *supra* note 2, at 2004-05; *Definition of 'Derivative,' supra* note 10.

13. Cohen, *supra* note 2, at 2003-05; Christine Cuccia, *Informational Asymmetry and OTC Transactions: Understanding the Need to Regulate Derivatives*, 22 DEL. J. CORP. L. 197, 199 (1997); *see also* Frank D'Souza, Nan S. Ellis & Lisa M. Fairchild, *Illuminating the Need for Regulation in Dark Markets: Proposed Regulation of the OTC Derivatives Market*,

many investors at the retail level generally use derivatives as a speculative investment,[14] rather than as a hedge against risk, a speculating derivatives holder will enter into a contract in an attempt to profit from positive fluctuations in the market value of the investment.[15] Although the financial concepts of the many different types of derivatives are complex, basic knowledge of a derivative is enough here to obtain a legal understanding of the investment vehicle further analyzed in this writing.[16]

There are two main types of derivative contracts: over-the-counter ("OTC") derivatives and exchange-traded derivatives.[17] OTC derivatives are not traded through the use of an exchange, whereas exchange-traded derivatives are executed through specialized derivative exchanges.[18] An exchange is a centralized location where investors can trade a specific standardized investment product.[19]

The regulatory agency that provides regulation and enforcement of most derivative products and of the respective firms who sell these derivatives is the Commodity Futures Trading Commission ("CFTC").[20] The CFTC was created in 1974 as an independent agency with the mandate though the CFTC Act of 1974 to regulate commodity futures and option markets in the U.S.[21] Most products regulated by the CFTC trade on registered exchanges; although, in recent years, the CFTC has regulated some over-the-counter industries.[22] It

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12 U. PA. J. BUS. L. 473, 504 (2010) ("OTC derivatives are often created precisely because there is no standardized derivative product available for the risk management needs of the parties involved."); Ro, *supra* note 1.

14. Since derivatives are complicated instruments that, as discussed later, are difficult to understand to those even trained in portfolio management, it is assumed that many investors at the retail level also have a difficult time using derivatives as a hedge and simply invest in the derivatives market to speculate in the price movement. *See Definition of 'Derivative,' supra* note 10; *Definition of 'Speculation,'* INVESTOPEDIA, http://www.investopedia.com/terms/s/speculation.asp (last visited June 22, 2014); *see also* Cuccia, *supra* note 13, at 200 (explaining that companies, rather than individual investors, usually use the sophisticated process of hedging as a form of risk management in order to make huge profits for their company.).

15. *Definition of 'Derivative,' supra* note 10; Kristina Zucchi, *Derivatives 101*, INVESTOPEDIA (June 29, 2013), http://www.investopedia.com/articles/optioninvestor/10/derivatives-101.asp.

16. See Cohen, *supra* note 2, at 2000, where Cohen, the author and adjunct professor at Fordham University School of Law, recalls when one of his clients described derivatives as " 'any financial product that is difficult to understand.' "

17. PARAMESWARAN, *supra* note 3, at 16, 24-27.

18. *See id.* at 24-25, 27 tbl.1.3.

19. *Id.* at 24-25.

20. Regulation of Off-Exchange Retail Foreign Exchange Transactions and Intermediaries, 75 Fed. Reg. 3282, 3282-83 (proposed Jan. 20, 2010) (to be codified at 17 C.F.R. pts. 1, 3, 4, 5, 10, 140, 145, 147, 160, & 166).

21. *Id.* at 3283.

22. *Id.* at 3283-3285; Gregory Meyer, *Watchdog Closes Retail Forex Loophole*, FIN. TIMES (Jan. 12, 2010, 7:26 PM), http://www.ft.com/intl/cms/s/0/97077034-ffaf-11de-921f-

is also worth noting that the Securities and Exchange Commission and the Futures Trading Commission have also taken part in regulation of some derivative products.[23]

III. INVESTMENTS IN PHYSICAL PRECIOUS AND INDUSTRIAL METALS DERIVATIVES

Investments in physical precious and industrial metals like gold, silver, palladium, and platinum have always had downsides to their use as speculative investments due to the large transaction costs involved in storing, moving, and insuring the metals in secure depositories.[24] However, over the years, this investment has cleverly made itself available to average, unsophisticated retail customers without the need to transfer the physical product, making it a product that can be easily traded and accessible for speculation.[25]

In order to accomplish the difficult feat of reducing transaction costs enough that the average investor can engage in such an investment (but keeping in mind a court has not yet ruled on the validity of such business practices), a series of steps is taken in order to pass the investment down to the ultimate customer.[26] "Wholesalers" contract with one or more depositories in order to obtain an interest

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23. Meyer, *supra* note 22; Gregory Meyer, *US Retail FX: War Waged on Cowboy Practice*s, FIN. TIMES (Sept. 27, 2010, 5:38 PM), http://www.ft.com/cms/s/0/6d881a1a-c9c6-11df-b3d6-00144feab49a.html.

24. *See* STAFF OF S. SPEC. COMM. ON AGING, 113TH CONG., EXPLORING THE PERILS OF THE PRECIOUS METALS MARKET 4-5 (2014), *available at* http://www.aging.senate.gov/imo/media/doc/Precious%20Metals%20Market%20-%20Summary%20of%20Committee%20Staff%20Investigation.pdf; PIERO CINQUEGRANA, THE NEED FOR TRANSPARENCY IN COMMODITY AND COMMODITY DERIVATIVES MARKETS 1-2 (2008), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2005039; Cohen, *supra* note 2, at 2003-04; Cuccia, *supra* note 13.

25. STAFF OF S. SPEC. COMM. ON AGING, *supra* note 24, at 2-3.

26. The processes by which retail investors receive investments in precious and industrial metals, although not new in practice, has not been directly legally analyzed at the retail level in academic works. Most information regarding the retail processes regarding the transfer of the investment from wholesaler to retail investor can be found in current litigation documents involving players of the industry and the U.S. Government. However, as discussed later, similar transactions have taken place in the foreign exchange industry and many of the processes of this industry are the same. *See generally* Complaint for Injunctive & Equitable Relief & Penalties Under the Commodity Exchange Act, U.S. Commodity Futures Trading Comm'n v. Hunter Wise Commodities, LLC, No. 9:12-CV-81311 (S.D. Fla. filed Dec. 5, 2012) [hereinafter Hunter Wise Complaint] (The Complaint refers to company names when describing each participant in the transaction. In this situation, Hunter Wise Entities is the wholesaler, Lloyds Commodities acts as the intermediary, and CD Hopkins, Blackstone, Newbridge, and USCT conduct business as retail dealers.); CINQUEGRANA, *supra* note 24, at 10 (discussing the "downstream level" as retail and the "upstream level" as wholesale); Lydia Nadia Cabrera Pierre-Louis, *Controlling a Financial Jurassic Park: Obtaining Jurisdiction Over Derivatives by Regulating Illegal Foreign Currency Boiler Rooms*, 8 U.C. DAVIS BUS. L.J. 35 (2007) (explaining the similar issues that occurred in the foreign exchange industry).

in physical metal.[27] This interest in metal is recorded by a bookkeeping entry on the wholesaler's books, and the wholesaler keeps record of a fungible pool of inventory of which it has purchased from multiple depositories.[28] In order to decrease actual transaction costs and the risks involved, these wholesalers never actually obtain a physical inventory or move metal to their own depositories.[29]

In turn, a wholesaler then enters into a contract with one or more intermediaries, who act more or less as sales representatives and counterparties to smaller companies, or "retail dealers."[30] Retail dealers act as brokerage firms and solicit economic interest in the metals to retail investors.[31] Like the transaction between wholesaler and depository, all other steps along the way are recorded by bookkeeping the inventory with no physical metal changing hands.[32] The retail customer (synonymous with retail investor) then enters into an investment contract through his broker employed by the dealer, in order to obtain the interest in the metal of which the customer trades for speculation purposes.[33] With each step in the transaction, the transaction costs associated with the metal increase, with the ultimate retail customer paying the highest transaction cost, but this ultimate cost on the retail customer is a cost that is more economically practical than would arise if a customer had to move metal in order to trade a position.[34] Such transaction fees at this level include commission fees, interest on loans, storage fees, insurance fees, and service charges based on a percentage of the product pur-

27. *See* Defendants Hunter Wise Commodities, LLC, Hunter Wise Servs., LLC, Hunter Wise Credit, LLC, Hunter Wise Trading, LLC, Harold Edward Martin, Jr., & Fred Jager's Motion to Dismiss for Failure to State a Claim Under Fed. R. Civ. P. 12(b)(6), & Inc. Memorandum of Law in Support Thereof ¶¶ 8-9, U.S. Commodity Futures Trading Comm'n v. Hunter Wise Commodities, LLC, No. 9:12-CV-81311 (S.D. Fla. Jan. 22, 2013) [hereinafter Hunter Wise Motion to Dismiss]; Hunter Wise Complaint, *supra* note 26, ¶¶ 40-41.

28. *See* Hunter Wise Motion to Dismiss, *supra* note 27, ¶¶ 8-9; Hunter Wise Complaint, *supra* note 26, ¶¶ 61, 63, 99; *see also* CINQUEGRANA, *supra* note 24, at 10.

29. *See* Hunter Wise Complaint, *supra* note 26, ¶¶ 59-66, 99; CINQUEGRANA, *supra* note 24, at 3 & n.3. *See generally* Hunter Wise Motion to Dismiss, *supra* note 27.

30. *See* Hunter Wise Complaint, *supra* note 26, ¶¶ 40-42, 48; U.S. Commodity Futures Trading Comm'n v. 20/20 Trading Co., No. SACV11-643-JST(FMOx), 2011 WL 2221177, at *1 (C.D. Cal. June 7, 2011). An illustrative diagram of the investment flow may be helpful: Wholesaler → Intermediary/Counterparty → Retail Dealer → Ultimate Investor.

31. *See* Hunter Wise Complaint, *supra* note 26, ¶¶ 31, 35-37; *20/20 Trading Co.*, 2011 WL 2221177, at *1-2.

32. *See* Hunter Wise Motion to Dismiss, *supra* note 27, ¶ 48.

33. *See* Hunter Wise Complaint, *supra* note 26, ¶¶ 31-33.

34. *See* Hunter Wise Complaint, *supra* note 26, ¶¶ 32-33; CINQUEGRANA, *supra* note 24, at 3, 10.

chased.[35] Additionally, each intermediary along the way receives a percentage markup on the spread.[36]

It is important to note that investors at the retail level are simply entering into the contract with the dealer in order to trade in one or more physical metal products.[37] That is, these investors are ultimately betting on market movements that affect the price of the metal thereby receiving the negative or positive difference on the spread of the price of the metal.[38] Although many investors have the option in these transactions to take physical delivery of metals, investors choose not to, as their main goal is simply to speculate in the metals market rather than hold a vault containing their own metal in their basement.[39]

Another aspect of these transactions involves the use of financing or leverage.[40] Although the difference between the term "finance" and "leverage" has been an issue in court, the ultimate end to the process involves the investor receiving additional funds on loan in order to buy more metal than his own dollar would afford him.[41] Consistent with most other types of derivative contracts, many investors choose to finance or leverage their positions of metal in order to obtain a larger purchasing power and thereby acquire a larger profit if the volatile metal markets move in the investor's favor.[42] For example, a retail customer will typically put down twenty to twenty-five percent of the total metal value as a "down payment," and then the dealer, through use of funds made available to him by the wholesaler, will finance the remaining product of the metals.[43] This loan process leaves the retail customer indebted to the dealer, and the retail

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35. Hunter Wise Complaint, *supra* note 26, ¶ 33.

36. *See* Hunter Wise Complaint, *supra* note 26, ¶¶ 3, 33, 41-42.

37. *See* Hunter Wise Complaint, *supra* note 26, ¶¶ 3, 31-37; Defendants', Newbridge Alliance, Inc. and John King, Motion to Dismiss Complaint and Incorporated Memorandum of Law ¶¶ 10-12, U.S. Commodity Futures Trading Comm'n v. Hunter Wise Commodities, LLC, No. 9:12-CV-81311 (S.D. Fla. Jan. 22, 2013) [hereinafter Newbridge Motion to Dismiss].

38. *See* Hunter Wise Complaint, *supra* note 26, ¶¶ 31-34; CINQUEGRANA, *supra* note 24, at 4.

39. *See* Hunter Wise Complaint, *supra* note 26, ¶¶ 3, 31-34.

40. *See* Hunter Wise Motion to Dismiss, *supra* note 27, pt. III, ¶¶ 28-33, Hunter Wise Complaint, *supra* note 26, ¶ 31; U.S. Commodity Futures Trading Comm'n v. 20/20 Trading Co., No. SACV11-643-JST(FMOx), 2011 WL 2221177, at *1, *5-6 (C.D. Cal. June 7, 2011) (discussing the definitions and legal implications of a leveraged transaction under CFTC regulations); *see also* STAFF OF S. SPEC. COMM. ON AGING, *supra* note 24, at 2, 6-9.

41. *See* Hunter Wise Motion to Dismiss, *supra* note 27, pt. III, ¶¶ 28-33; Hunter Wise Complaint, *supra* note 26, ¶ 31; *see also 20/20 Trading Co.*, 2011 WL 2221177, at *1, *5-6.

42. *See* Hunter Wise Complaint, *supra* note 26, ¶¶ 32-34; Hunter Wise Motion to Dismiss, *supra* note 26, ¶¶ 66-71; *20/20 Trading Co.*, 2011 WL 2221177, at *1.

43. *See* Hunter Wise Complaint, *supra* note 26, ¶¶ 31-32; *20/20 Trading Co.*, 2011 WL 2221177, at *1.

customer pays interest charges on the loan at a specified rate.[44] It is ultimately the investor's choice to participate in a financed transaction as the investor has the option to purchase one-hundred percent of the metal outright and to choose whether to have the metal delivered or not.[45]

Since the inception of this product, such investments have never traded on an exchange or board of trade.[46] Furthermore, this investment product and industry has found a loophole in the regulation, as it mimics many aspects of a futures contract but has never been regulated by any regulator, including the CFTC.[47] Not only has the product itself never been regulated, but the brokerage firms who solicit these investments from the public have also escaped any kind of disclosure, reporting, or recordkeeping requirements.[48]

A. What Is the Problem?

Of course, with any "hole" in a regulation, intentional or not, there are bad actors that emerge to take advantage of the regulatory gap.[49] Even further, as in this situation, bad actors of the industry have an easier way to commit fraud than they would have otherwise, as there is no watchdog keeping track of the firms' practices. Unmonitored brokers commit fraud by taking on a salesperson role and going right after the unsophisticated investor, saying whatever needs to be said to close the deal.[50] In many cases, these customers believe what they are told, do not investigate the investment further, and do not realize the immense risk involved in not only trading in a volatile market

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44. *See* Hunter Wise Complaint, *supra* note 26, ¶¶ 31-34, 77; *20/20 Trading Co.*, 2011 WL 2221177, at *1.

45. *See* Hunter Wise Complaint, *supra* note 26, ¶¶ 31-32; *20/20 Trading Co.*, 2011 WL 2221177, at *1.

46. Hunter Wise Complaint, *supra* note 26, ¶¶ 1-6 (The government alleges that defendants have unlawfully engaged in investment in futures contracts of precious metals outside of an exchange); *see also 20/20 Trading Co.*, 2011 WL 2221177, at *1-4.

47. *See* Jon Burstein, *Little Regulation, Lots of Risk Can Leave Gold Investors on Shaky Ground*, SUN-SENTINEL (Mar. 19, 2011), http://articles.sun-sentinel.com/2011-03-19/news/fl-leveraged-gold-industry-20110303_1_precious-metals-owner-jamie-campany-gold-investors; *see also* Hunter Wise Motion to Dismiss, *supra* note 27, ¶¶ 66-80; Hunter Wise Complaint, *supra* note 26, ¶¶ 1-3 (Although the CFTC argues it has been able to regulate this type of transaction and industry since the Dodd-Frank Wall Street Reform and Protection Act of 2010 became effective on July 16, 2011, industry participants dispute otherwise. However, it is clear that prior to the effective date of Dodd-Frank, this industry was unregulated by the CFTC or any other regulator.); *20/20 Trading Co.*, 2011 WL 2221177, at *5-8.

48. *See* Burstein, *supra* note 47; *see also* Hunter Wise Complaint, *supra* note 26, ¶¶ 1-3; *20/20 Trading Co.*, 2011 WL 2221177, at *5-8.

49. *See* Burstein, *supra* note 4; Burstein, *supra* note 47.

50. *See* Hunter Wise Complaint, *supra* note 26, ¶¶ 2-3, 11; *20/20 Trading Co.*, 2011 WL 2221177, at *1, Pierre-Louis, *supra* note 26, at 36-37.

such as metals, but also in buying such product on margin.[51] The more of these investors who that get scammed and the richer these fraudulent dealers become, the more enticing the metals marketplace becomes to future fraudulent dealers.[52] For this reason, the CFTC has taken a stand in regulating this currently unregulated industry in the name of consumer protection.[53]

B. Current Events

As of April 2014 there is a pending litigation between the CFTC and many current actors in the physical precious and industrial metals industry, each side having their own arguments on what this investment entails.[54] Amongst those being sued by the CFTC are wholesalers, intermediaries, and dealers who all sell such investments at different levels in the marketplace.[55]

The main issues in this litigation revolve around whether: 1) the CFTC has the jurisdiction to regulate this type of transaction as a financed commodity transaction with retail customers; and 2) the transaction is an illegal, and thereby fraudulent, off-exchange financed commodity transaction with retail customers.[56]

The CFTC argues that Section 742 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank Act") broadened the scope of CFTC jurisdiction under the Commodity and Exchange Act ("CEA") to include this specific type of transaction under CEA Section 2(c)(2)(D).[57] Furthermore, since the CFTC believes

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51. *See* Hunter Wise Complaint, *supra* note 26, ¶¶ 2-3, 78-85; *20/20 Trading Co.*, 2011 WL 2221177, at *1; Pierre-Louis, *supra* note 26, at 36-38; Burstein, *supra* note 4 (alleging that the firm targeted the elderly, as "[t]he majority of the firm's 20 largest clients were senior citizens"); Richard Y. Roberts, Commissioner, Sec. Exch. Comm'n, Current SEC Issues of Interest (Jan. 19, 1995), *available at* http://www.sec.gov/news/speech/speecharchive/1995/spch026.txt ("Derivatives are not inherently bad or good—they're just volatile.").

52. *See, e.g.*, Burstein, *supra* note 4 ("Global Bullion Exchange was part of an explosion of precious metals firms that set up shop in Broward and Palm Beach counties, operating in what has been a largely unregulated niche of the precious metals industry. More than 45 firms opened locally between 2007 and [2010], most offering gold, silver and palladium via heavily financed transactions. A Sun-Sentinel investigation in March found that convicted felons and people with checkered regulatory histories were able to operate such businesses with little—if any—scrutiny.").

53. *See generally* Hunter Wise Complaint, *supra* note 26; CFTC Press Release: PR6447-12, *supra* note 5.

54. *See* U.S. Commodity Futures Trading Comm'n v. Hunter Wise Commodities, LLC, No. 9:12-CV-81311 (S.D. Fla. filed Dec. 5, 2012).

55. Hunter Wise Complaint, *supra* note 26, ¶¶ 10-11.

56. *See* Hunter Wise Complaint, *supra* note 26, ¶¶ 1-6; Hunter Wise Motion to Dismiss, *supra* note 26, ¶¶ 28-40, 64-65, 82-83, 100-01.

57. Hunter Wise Complaint, *supra* note 26, ¶¶ 1-2, 27-28; *see* Interpretation of Retail Commodity Transactions Under Commodity Exchange Act, 78 Fed. Reg. 52,426, 52,426

that these transactions come under its jurisdiction, it further contends that these retail commodity transactions are required to be executed on an exchange.[58]

Section 2(c)(2)(D) of the CEA is entitled "Retail Commodity Transactions" and states as follows:

> [T]his subparagraph shall apply to any agreement, contract, or transaction in any commodity that is—(I) entered into with, or offered to (even if not entered into with), a person that is not an eligible contract participant or eligible commercial entity; and (II) entered into, or offered (even if not entered into), on a leveraged or margined basis, or financed by the offeror, the counterparty, or a person acting in concert with the offeror or counterparty on a similar basis.[59]

Further, the CFTC contends that the wholesaler "does not actually buy, sell, loan, store, or transfer physical metals in connection with" their transactions, but rather it "records and tracks customer orders and trading positions."[60] Instead, the CFTC equates these transactions with those of futures contracts.[61]

The precious and industrial metal industry participants, as individual defendants involved in different levels of the transaction in this case, argue that the CFTC fails to show that they have jurisdiction over their industry because the CFTC "has inappropriately attempted to unilaterally expand its Congressional grant of authority by characterizing a physical spot transaction as a contract for sale of a commodity for future delivery."[62] These industry participants state that the Dodd-Frank Act did not intend to include financed products as evidenced by the fact that Congress followed the word "financed" in Section 2(c)(2)(D) with "on a similar basis," thereby indicating that Congress is referring only to transactions that are leveraged or margined.[63] The industry defendants refute that these transactions are

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(Aug. 23, 2013) (to be codified at 17 C.F.R. pt. 1) (discussing the addition of Section 2(c)(2)(D) to the CEA).

58. Hunter Wise Complaint, *supra* note 26, ¶¶ 1-2, 29-30.

59. 7 U.S.C. § 2(c)(2)(D) (2012).

60. Hunter Wise Complaint, *supra* note 26, ¶ 46.

61. *Id.* ¶¶ 46, 103, 107-10, 195-98. The CFTC has previously made similar arguments regarding futures contracts. *See* Commodity Futures Trading Comm'n v. Co Petro Mktg. Grp., Inc., 680 F.2d 573 (9th Cir. 1982).

62. Hunter Wise Motion to Dismiss, *supra* note 27, ¶ 25. Similarly, at least one court has determined that the CFTC did not have the authority, based on its ability to regulate futures contracts, to regulate certain contracts for the speculative sale or purchase of foreign currency. Commodity Futures Trading Comm'n v. Zelener, 373 F.3d 861 (7th Cir. 2004).

63. Hunter Wise Motion to Dismiss, *supra* note 27, ¶ 29; Newbridge Motion to Dismiss, *supra* note 37, ¶¶ 31-46; Motion to Dismiss and Incorporated Memorandum of Law of Defendants Lloyds Commodities, LLC, Lloyds Commodities Credit Company, LLC, Lloyds Services, LLC, James Burbage and Frank Guardino, U.S. Commodity Futures Trading

leveraged, margined, or financed on a similar basis as the duration of the transaction does not exceed ten years, a mandatory requirement of a contract that is leveraged or margined.[64]

The wholesaler, in particular, also refutes the CFTC's position that it engages in futures contracts; rather, it states that it conducts business with an array of banks and institutions "from whom it purchases and to whom it sells inventory" in order to fulfill the various orders of its clients in physical precious and industrial metals.[65] Instead of futures contracts, the wholesaler says that it purchases and sells " '[c]ash forward' or 'spot' contracts [that] are not subject to regulation because the underlying commodity in the transaction holds an 'inherent value' to the transacting parties, and actually involve[s] the sale of the underlying commodity."[66]

An important aspect of cash forward or spot contracts is that they do not have terms that are standardized, whereas futures contracts are fungible contracts and have standard terms.[67] The wholesaler contends that these transactions are not standardized because the customers buy metals of varying price, quantity, settlement dates, delivery, and financing immediately rather than at a future date.[68]

On February 26, 2013, the court issued an order granting the preliminary injunction requested by the CFTC and against the defendant parties of the metals industry.[69] In the order, Judge Donald M. Middlebrooks made the finding that the CFTC has jurisdiction over

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Comm'n v. Hunter Wise Commodities, LLC, No. 9:12-CV-81311 (S.D. Fla. Jan. 22, 2013) (explicitly incorporating by reference all arguments from the Hunter Wise Motion to Dismiss).

64. Hunter Wise Motion to Dismiss, *supra* note 26, ¶¶ 30-40; *see also* U.S. Commodity Futures Trading Comm'n v. 20/20 Trading Co., No. SAVC11-643-JST(FMOx), 2011 WL 2221177, at *5-8 (C.D. Cal. 2011) (holding that precious and industrial metals contracts allowing investors to speculate in the metals market can only be classified in two ways: futures or leveraged contracts, and a contract that does not satisfy the ten year durational requirement cannot be a leveraged contract).

65. Hunter Wise Motion to Dismiss, *supra* note 27, ¶ 8; *see also Zelener*, 373 F.3d 861, at 865 (finding that in futures contracts, terms are standardized "mak[ing] it possible to close a position by buying an offsetting contract," and finding in contrast that "forward or spot contracts, are not purchased identically and each is unique in the amount and timing").

66. Hunter Wise Motion to Dismiss, *supra* note 27, ¶ 67 (internal citation omitted). *See generally Zelener*, 373 F.3d 861, at 867 (concluding that spot or forward transactions are not traded "in the contract" but rather "in the commodity.").

67. Hunter Wise Motion to Dismiss, *supra* note 27, ¶¶ 68-71; *see also* PARAMESWARAN, *supra* note 3, at 16-17; D'Souza, Ellis & Fairchild, *supra* note 13, at 504; Elizabeth D. Lauzon, Annotation, *What are "Contracts of Sale of a Commodity for Future Delivery" Within Meaning of Commodity Exchange Act*, 182 A.L.R. Fed. 559 (2002).

68. Hunter Wise Motion to Dismiss, *supra* note 27, ¶¶ 76-77; *see also* D'Souza, Ellis & Fairchild, *supra* note 13, at 504; Lauzon, *supra* note 67.

69. U.S. Commodity Futures Trading Comm'n v. Hunter Wise Commodities, LLC, No. 12-81311-CIV, 2013 WL 718503, at *1 (S.D. Fla. Feb. 26, 2013) (order granting preliminary injunction).

the matter at bar under the Dodd-Frank Act, Section 2(c)(2)(D), and the transaction is financed as contemplated by the statute.[70]

Since this order was handed down by Judge Middlebrooks, a number of changes have occurred in the lawsuit. First, the court entered summary judgment against the Defendants as to many disputed issues in the litigation thus far, most importantly finding that the CEA's requirement that those engaged in commodities transactions to purchase and sell those commodities on a regulated board of trade, exchange, or contract was not facially vague, or vague as applied to the dealers.[71] The court also reiterated that Section 742 of Dodd-Frank expanded the scope of the CFTC's jurisdiction to encompass this type of transaction.[72] Additionally, many of the retail dealer defendants and even the intermediary involved in this case have since opted to settle with the CFTC rather than litigate the suit and consent decrees ordering permanent injunctions and damages have been issued against them.[73] Therefore, the final order will deal primarily with the allegations against the wholesaler.

Unsurprisingly, many of these issues have been previously litigated regarding other similar investment products. Not only has the court had trouble defining such "modified" derivative products that seem to veer slightly from conventional derivatives in the given area, but the CFTC has also continued to struggle with jurisdiction issues regarding other OTC derivatives.

C. Jurisdictional Disputes with the Metals Industry

The CFTC has had jurisdictional issues in regulating types of derivatives contracts similar to these over-the-counter precious and industrial metals transactions spanning back to the 1970s.[74] To clear up this confusion, Congress has passed additional laws and the CFTC has published further interpretations regarding retail com-

70. *Id.* at *7-9.

71. U.S. Commodity Futures Trading Comm'n v. Hunter Wise Commodities, LLC, No. 12-81311, 2014 WL 652888, at *10-11 (S.D. Fla. Feb. 19, 2014) (order granting summary judgment against Defendants on certain claims and issues).

72. *Id.* at *1.

73. *See* Consent Order for Permanent Injunction, Civil Monetary Penalty, and Other Equitable Relief Against United States Capital Trust, LLC and David A. Moore, No. 9:12-CV-81311 (S.D. Fla. Feb. 26, 2014) (example of settlement agreement with one of the many groupings of dealer Defendants who settled); Consent Order for Permanent Injunction, Civil Monetary Penalty and Other Equitable Relief Against Lloyds Commodities, LLC, Lloyds Commodities Credit Company, LLC, Lloyds Services, LLC, James Burbage and Frank Gaudino, U.S. Commodity Futures Trading Comm'n v. Hunter Wise Commodities, LLC, No. 9:12-CV-81311 (S.D. Fla. Feb. 5, 2014) (settlement agreement with intermediary firm Lloyds Commodities, LLC).

74. *See* Commodity Futures Trading Comm'n v. Co Petro Mktg. Grp., Inc., 680 F.2d 573, 576-81 (9th Cir. 1982); *see also* Commodity Futures Trading Comm'n v. Am. Precious Metals, LLC, 845 F. Supp. 2d 1279, 1282-87 (S.D. Fla. 2011).

modity transactions in an attempt to clarify the CFTC's jurisdiction.[75] Each past enactment, however, seemed to provide less and less clarity on the issue and produce further issues in the courts.[76]

Prior to the implementation of the Dodd-Frank Act, the CFTC sued a dealer firm selling physical precious metals to retail investors through telephone solicitation,[77] a similar transaction as the one currently in litigation. In the 2011 case *Commodity Futures Trading Commission v. American Precious Metals, LLC*, the CFTC alleged that the defendants committed fraud in violation of Section 19 of the CEA and CFTC Rule 31.3.[78] The defendants contended that the CFTC lacked regulatory jurisdiction under Section 19 because the contracts at issue lasted for less than ten years, and "any contract lasting fewer than ten years was . . . not a leverage contract" as defined by CFTC Rule 31.4(w).[79] The court sided with the defendant dealer, finding that since the CFTC had previously interpreted its own regulation narrowly multiple times, the CFTC's regulatory jurisdiction only extended to leverage contracts as defined by Rule 31.4(w).[80] The CTFC's case was therefore dismissed.[81]

The CFTC experienced a huge defeat when the court ordered that the agency lacked jurisdiction over these physical metal transactions. However, after this case was decided, Dodd-Frank took effect and added the term "financed" to the CEA.[82] The true meaning of this addition has not been fully litigated.[83]

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75. *Am. Precious Metals, LLC*, 845 F. Supp. 2d at 1282-87; Interpretation of Retail Commodity Transactions Under Commodity Exchange Act, 76 Fed. Reg. 77,670, 77,670-72 (Dec. 14, 2011) (to be codified at 17 C.F.R. pt. 1) (explaining the prior enactment of laws regarding retail commodity transactions that led to the necessity of implementing further law by Congress in Dodd-Frank).

76. *See Am. Precious Metals, LLC*, 845 F. Supp. 2d at 1282-87; Interpretation of Retail Commodity Transactions Under Commodity Exchange Act, 76 Fed. Reg. at 77,670-72.

77. *Am. Precious Metals, LLC*, 845 F. Supp. 2d at 1281-82.

78. *Id.* at 1281.

79. *Id.* at 1284.

80. *Id.* at 1285-87.

81. *Id.* at 1287-88. Similar reasoning was used in *U.S. Commodity Futures Trading Comm'n v. 20/20 Trading Co.*, where the court held that the CFTC did not have jurisdiction over similar types of metals transactions as the contracts did not meet the definition of leveraged contracts. No. SACV11-643-JST(FMOx), 2011 WL 2221177 (C.D. Cal. 2011).

82. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 742(a)(2), 124 Stat. 1376, 1732-33 (2010) (to be codified at 7 U.S.C. § 2(c)(2)(D)).

83. *See generally* Hunter Wise Motion to Dismiss, *supra* note 27. *But see* U.S. Commodity Futures Trading Comm'n v. Hunter Wise Commodities, LLC, No. 12-81311-CIV, 2013 WL 718503, at *8, *11 (S.D. Fla. Feb. 26, 2013). The court held in the order granting a preliminary injunction that the retail precious and industrial metal transactions were now considered to be financed products as contemplated by the addition of the word "financed" by the Dodd-Frank Act. However, a permanent injunction has not yet been issued on the matter. *See* U.S. Commodity Futures Trading Comm'n v. Hunter Wise Commodities, LLC, No. 12-81311-CIV, 2014 WL 652888, at *5 (S.D. Fla. Feb. 19, 2014) (finding that the commodities transactions involved were financed through loans and "the financed precious

As the situation between the CFTC and the precious and industrial metals industry progresses, it is becoming quite obvious that the CFTC has encountered a similar situation in its past. Like the current issue, it took the CFTC years to establish regulatory jurisdiction and impose regulation upon the foreign exchange industry, an industry proposed here as one very similar to that of precious and industrial metals. One might wonder why the CFTC has not learned from the grueling jurisdictional and congressional battles that it has already once experienced.

IV. COMPARISON ISSUE: RETAIL FOREX TRANSACTIONS

For the past forty years, the CFTC has been actively regulating the retail foreign exchange ("Forex") industry, which entails a transaction in the over-the-counter market very similar to the precious and industrial metals transaction at the heart of this Note.[84] In fact, not only has the CFTC published investor warnings about heavy fraud in the industry dating back to the early 1990s, but Gary Gensler, Chairman of the CFTC, once described foreign exchange as " 'the largest area of retail fraud that the CFTC oversees.' "[85]

A. *Regulation History of Foreign Exchange Transactions*

Until the 2000s, trading in Forex markets by public investors was effectively unregulated.[86] Although there are many types of Forex transactions, the facts described in *Zelener* are typical of a particular species that involves a speculative transaction in foreign currency where a public investor opens up an account with a brokerage firm.[87] After opening an account, a customer could purchase a desired quantity with the contract calling for a settlement forty-eight hours after purchase, but no customer took delivery of the currency.[88] The transactions continued to be rolled forward after each settlement, which

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metal transactions at issue here were supposed to have been conducted on a regulated exchange").

84. *See* Izabella Kaminska, *New Regulations: Once-Disadvantaged Retail Sector Expands Quickly*, FIN. TIMES (Sept. 26, 2011, 3:18 PM), http://www.ft.com/cms/s/0/042aea96-e385-11e0-8f47-00144feabdc0.html; *see also* Regulation of Off-Exchange Retail Foreign Exchange Transactions and Intermediaries, 75 Fed. Reg. 3281, 3283 (proposed Jan. 20, 2010) (to be codified at 17 C.F.R. pts. 1, 3, 4, 5, 10, 140, 145, 147, 160, & 166).

85. Meyer, *supra* note 23. The article puts current fraud resonating from the Forex industry in perspective. Although "forex brokers make up less than 1 per cent of the members of the National Futures Association, a self-regulatory body, they were the target of 43 per cent of the complaints from its business conduct committee in the year end[ing] June 30[, 2010]." *Id.*

86. *See id.*

87. *See, e.g.*, Commodity Futures Trading Comm'n v. Zelener, 373 F.3d 861, 862-63 (7th Cir. 2004).

88. *See, e.g.*, *id.* at 863.

kept the customer's position open.[89] If the value of the currency went up, the customer could close the position and obtain benefits from a positive market movement by selling the amount of currency back to the firm.[90] The Forex market, like the precious and industrial metals market, is characterized as a highly volatile market, which provides higher expected returns than most other conventional asset classes.[91]

Similar to the jurisdictional dispute between the CFTC and the precious and industrial metals industry, the CFTC once too had a jurisdictional dispute between itself and the Forex industry.[92] Originally, the bill creating the CFTC granted it "jurisdiction over on-exchange trading in futures and options contracts on forex" as well as over off-exchange foreign currency transactions.[93] The Department of the Treasury was concerned about the effect of the bill's passage "on the off-exchange foreign currency . . . market that existed at the time between large, institutional customers" and sent a letter to the Senate Committee "contain[ing] proposed language for the bill which would have maintained the *status quo* for institutional off-exchange forex trading."[94] In response to this concern, the bill was amended to include this language, which became known as the "Treasury Amendment."[95] The Treasury Amendment was challenged in court time and time again to determine whether the CFTC had jurisdiction over off-exchange retail Forex transactions.[96] In *Salomon Forex v. Tauber*, the court held that trading in off-exchange futures and options was excluded from the CFTC's regulatory jurisdiction, along with spot and forward transactions that involved "sophisticated, large-scale foreign currency traders."[97] "Under the Treasury Amendment, retail forex transactions were excluded from the Commission's jurisdiction unless they were conducted on a 'board of trade.' "[98]

Realizing the troubles in interpreting the Treasury Amendment in regards to the CFTC's jurisdiction over retail Forex transactions with the general public, Congress enacted the Commodity Futures Modernization Act of 2000, which then expressly permitted off-exchange

89. *See, e.g.*, *id.*

90. *See, e.g.*, *id.*

91. Kaminska, *supra* note 84; *see* Elaine Moore, *Private Investors: Traders Gain from Access to Information*, FIN. TIMES (Apr. 4, 2012, 3:21 PM), http://www.ft.com/intl/cms/s/0/85887cf4-688a-11e1-b803-00144feabdc0.html#axzz2P2K73nvb.

92. *See generally* Pierre-Louis, *supra* note 26.

93. Regulation of Off-Exchange Retail Foreign Exchange Transactions and Intermediaries, 75 Fed. Reg. 3282, 3283 (proposed Jan. 20, 2010) (to be codified at 17 C.F.R. pts. 1, 3, 4, 5, 10, 140, 145, 147, 160, & 166).

94. *Id.*

95. *Id.*

96. *Id.*

97. *Id.* (quoting Salomon Forex v. Tauber, 8 F.3d 966, 978 (4th Cir. 1993)).

98. *Id.* at 3284.

futures contracts as long as the counterparty was one of those enumerated in the Act.[99] Yet, jurisdiction issues continued as firms began to offer CFTC-described "look-alike" or "rolling spot" contracts that were similar to futures contracts but were (cleverly) labeled "spot" transactions.[100]

When the CFTC brought a case against a Forex firm contracting with unsophisticated public investors to sell "look-alike" futures Forex contracts, the Seventh Circuit in *Zelener* held the transactions to be "spot" contracts and not subject to CFTC regulation, as the transaction involved trading in the commodity directly rather than trading in the contract itself.[101] Furthermore, these transactions did not trade on a registered exchange.[102] The court discussed that futures contracts are fungible because they contain "[s]tandard terms and an absence of counterparty-specific risk."[103] The court explained further that each futures contract calls for delivery of the same product at the same place at the same time.[104] But, in forward and spot contracts, like the current metals transactions that occurred between these firms and their customers, the sale is in the actual commodity, the contracts are not fungible, and the terms are negotiated.[105] As such, the court denied CFTC jurisdiction over these products.[106]

Although the court has recognized that off-exchange retail Forex transactions labeled as "forward" or "spot" transactions are not subject to CFTC regulation in some circuits, other circuits have found similar non-Forex and Forex transactions to be futures contracts rather than forward or spot transactions.[107] For instance, the Ninth Circuit in *Commodity Futures Trading Commission v. Co Petro Marketing Group, Inc.*, held earlier that similar non-Forex transactions to those in *Zelener* were futures contracts that fell under CFTC jurisdic-

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99. *Id.*

100. *Id. See generally* Commodity Futures Trading Comm'n v. Zelener, 373 F.3d 861 (7th Cir. 2004); Cuccia, *supra* note 13, at 205 ("In the quest for more lucrative deals, financial institutions created increasingly sophisticated products. The financial institutions could impress their clients with the complexity of the new instruments, and investment banks saw a way to make large profits from the growing industry. . . . With new derivative instruments created almost every day, the sellers are challenging the ability of buyers to stay on top of what they are offered." (footnotes omitted)); *id.* at 206 n.67 (" 'The largely unregulated $5 trillion derivatives market may be growing and evolving too fast for even diligent regulators to get a harness on it.' " (citation omitted)).

101. *Zelener*, 373 F.3d at 867-69.

102. *See id.* at 862-63.

103. *Id.* at 865.

104. *Id.*

105. *Id.* at 865-66.

106. *Id.* at 869.

107. *See* Regulation of Off-Exchange Retail Foreign Exchange Transactions and Intermediaries, 75 Fed. Reg. 3281, 3285 (proposed Jan. 20, 2010) (to be codified at 17 C.F.R. pts. 1, 3, 4, 5, 10, 140, 145, 147, 160, & 166).

tion.[108] In holding this way, the court utilized a multifactor test to determine whether the contract was a futures contract.[109] Later in *Commodity Futures Trading Commission v. International Financial Services, Inc.*, the Southern District of New York analyzed a Forex transaction using a similar test.[110] In looking to the true purpose of the transactions, the court found the Forex transactions to be futures contracts rather than spot or forward contracts.[111]

In a further effort to combat Forex fraud activities through increased enforcement and public awareness and in an attempt to mend the years of jurisdiction issues, Congress passed The CFTC Reauthorization Act of 2008.[112] This Act modified the CEA by granting the CFTC the authority to promulgate and enforce fraud regulations in connection with off-exchange retail foreign currency futures, options, and options on futures, as well as leveraged off-exchange Forex contracts "offered to or entered into with retail customers."[113] The CFTC was granted jurisdiction to combat fraud in Forex transactions even if the transactions could not be considered futures or options.[114] "Thus, the CRA charges the [CFTC] with regulating speculative forms of retail forex trading, but excludes from the [CFTC]'s purview true spot transactions that have a legitimate business purpose or that result in actual delivery."[115]

B. Dodd-Frank's Control Over Retail Forex Transactions

The Dodd-Frank Act further modified the CEA by requiring that all off-exchange retail Forex transactions be conducted under the rules of the CFTC.[116] This gave the CFTC the ability to promulgate recordkeeping, capital and margin, and disclosure rules on Forex transactions.[117] Congress's attempt in enacting sections re-

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108. 680 F.2d 573, 580-82 (9th Cir. 1982).

109. Regulation of Off-Exchange Retail Foreign Exchange Transactions and Intermediaries, 75 Fed. Reg. 3282, 3284-85 (proposed Jan. 20, 2010) (to be codified at 17 C.F.R. pts. 1, 3, 4, 5, 10, 140, 145, 147, 160, 166); *see also Co Petro Marketing Group*, 680 F.2d at 576-81; Pierre-Louis, *supra* note 26, at 57-59.

110. 323 F. Supp. 2d 482, 494 (S.D.N.Y. 2004).

111. *Id.* at 494-98.

112. Regulation of Off-Exchange Retail Foreign Exchange Transactions and Intermediaries, 75 Fed. Reg. at 3285.

113. *Id.* at 3282, 3285.

114. *Id.* at 3285.

115. *Id.*

116. 7 U.S.C. § 2(c)(2)(B) (2012).

117. U.S. COMMODITY FUTURES TRADING COMM'N, Q & A – FINAL RETAIL FOREIGN EXCHANGE RULES 1-2 (2010), *available at* http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/forexfinalrule_qa.pdf [hereinafter FOREX Q&A]; *see* Kaminska, *supra* note 84 (stating that the CFTC introduced stricter rules related to a minimum capital buffer).

lating to Forex transactions in the Dodd-Frank Act was to further close loopholes by giving regulatory jurisdiction to a number of different regulators.[118]

The rules promulgated by the CFTC (effective October 18, 2010) in regulating the Forex industry included registration of various parties, distribution of disclosure documents to customers regarding risk and potential conflicts of interest, making and keeping of various records, maintenance of prescribed minimum amounts of capital, and trading and operational standards.[119] The disclosure document rules require Forex firms to disclose the percentage of accounts that actually turn a profit,[120] as the vast majority of accounts rarely ever do.[121] Additionally, the recordkeeping requirement mandates firms to maintain records of customer complaints.[122]

Most significantly, the CFTC has set leverage parameters as a requirement of those serving as counterparties of retail customers, with the parameters being a "2 percent security deposit in the case of major currencies and 5 percent of the notional value of the transaction for all other currencies."[123] However, despite the large amount of regulations that have now been promulgated to combat fraud in off-exchange retail Forex transactions, spanning almost forty years of debate, they remain over-the-counter transactions.[124]

C. *Effects of Regulation in Forex*

Although some associated with the Forex industry see the CFTC's jurisdiction and regulation over Forex transactions and the industry as a positive, it seems that many other industry participants believe the industry has taken a severe hit due to the new regulations.[125] Despite this disdain toward the regulations, there is some agreement among commentators that the CFTC has met its purpose for enacting

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118. *See* Regulation of Off-Exchange Retail Foreign Exchange Transactions and Intermediaries, 75 Fed. Reg. 55,410, 55,410 (Sept. 10, 2010) (to be codified at 17 C.F.R. pts. 1, 3, 4, 5, 10, 140, 145, 147, 160, & 166); FOREX Q&A, *supra* note 117, at 1; Meyer, *supra* note 23.

119. *See* FOREX Q&A, *supra* note 117; Foley & Lardner, *supra* note 116; Kaminska, *supra* note 84.

120. Meyer, *supra* note 23.

121. Stephen L. Bernard, *Is Currency Trading Worth the Risk?*, WALL ST. J. (July 8, 2011), http://online.wsj.com/news/articles/SB10001424052702304665904576384111852016334 ("Only about 30% of all retail forex trades are profitable.").

122. *Id.*

123. FOREX Q&A, *supra* note 117, at 3.

124. *See* PARAMESWARAN, *supra* note 3, at 15-16.

125. *See, e.g.*, Kaminska, *supra* note 84; Adam Kritzer, *New CFTC Forex Regulations Unpopular, but Worthwhile*, FOREX BLOG (Jan. 22, 2010), http://www.forexblog.org/2010/01/new-cftc-forex-regulations-unpopular-but-worthwhile.html.

the regulation.[126] The CFTC effectively cleaned up the Forex "streets" and combated much of the fraud in the industry, likely by sending fraud merchants out of business.[127] Glenn Stevens, chief executive of Gain Capital, a U.S. based company that hosts an online Forex trading website, said, "[The CFTC] is getting the rules down on paper, because they've realised, 'If we don't delineate the rules, they get bent.' "[128]

However, does the regulation provide too much oversight? After all, the Forex industry is a $3700 billion-a-day market with the retail public making up $125 billion of that market.[129] It is a small chunk of the overall financial market, about ten percent,[130] but pessimists believe that percentage that is falling rapidly.[131] The ambiguities in the law and legal battles that ensued between the Forex industry and the CFTC increased the costs for those involved in the Forex market.[132] As a result, when the relevant regulations became active in 2010, the number of registered foreign exchange dealers dropped significantly.[133]

Furthermore, the new leverage buffer has also reduced the number of Forex transactions executed by brokers, as retail clients desired the high leverage that previously unregulated Forex brokers could provide them.[134] Evidencing this investor outrage, the CFTC received a record number of comment letters from Forex investors in response to their proposed rules—9100 letters to be exact.[135] Investors complained about one specific proposal, the now-imposed cap on leverage.[136]

Industry brokerage firms believe the harsh and rapid influx of regulation on the Forex industry caused negative impacts on its

126. *See* Kaminska, *supra* note 84; Meyer, *supra* note 23.

127. *See* Kaminska, *supra* note 84.

128. Meyer, *supra* note 22.

129. *Id.*

130. Kaminska, *supra* note 84.

131. Wanfeng Zhou, *Retail Investors in U.S. Retreat from Currency Trading*, REUTERS (Jan. 22, 2013), http://www.reuters.com/article/2013/01/22/markets-forex-retailfx-idUSL1N0AR9F220130122.

132. *See* discussion *supra* Part IV.A.

133. *See* Meyer, *supra* note 23 (noting that when the National Futures Association imposed minimum capital requirements on Forex firms already registered with the self-regulatory organization in 2010, the NFA saw a sharp drop in registered Forex firms from forty-one firms to seventeen); Paul Murphy, *Time for Regulator to Move on Retail FX Trading*, FIN. TIMES (July 13, 2012), http://www.ft.com/intl/cms/s/0/93a462f2-cd03-11e1-b78b-00144feabdc0.html?siteedition=intl#axzz2yEK8WABF (explaining that after the CFTC imposed regulations on Forex firms, several firms moved to London, where Forex trading is "largely unregulated").

134. *See* Kaminska, *supra* note 84.

135. Meyer, *supra* note 23.

136. *Id.*

growth.[137] For example, chief executive Drew Niv of FXCM, a retail Forex dealer, stated in September 2011:

> 'The foreign exchange dealer category has become the most heavily encumbered type of financial market firm today, from a regulatory perspective . . . . That's why you've seen a huge shrinkage in the industry. There are now dozens of names, instead of hundreds. . . . It's been a regulatory earthquake, and in the next year you will see more aftershocks and more firms going out of business . . . .'[138]

Since the regulations have imposed so many added costs to the OTC market, much of the business has fled overseas where regulation over this market is less prevalent,[139] a fear of the CFTC during proposal of the regulations.[140] A United States public investor may now prefer to open a Forex account overseas and transact with foreign businesses, thus "circumventing the new regulations, in particular the leverage restrictions."[141] The downside: more American business being shipped overseas and less American jobs.[142]

However, some other long-term positives that the Forex industry has noticed from the regulation of the industry are an eventual increased market share, a stable group of customers, a wider customer base, less detriment to previous high-leverage customers, more knowledgeable participants, competitive prices to the wider market, increased technological tools to the market such as retail platforms, automatic trading between customer and vendors, institutional investors becoming brokers, large banks now selling to the retail sector, and increased investor protection.[143]

V. Regulating the Precious and Industrial Metals Industry

Many theorists have proposed approaches to efficient regulation of the securities market. Specifically, some theorists believe that markets are efficient within themselves and regulation is not needed in order for the market to function appropriately.[144] Others have suggested various alternative schemes in place of the current method of

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137. *See, e.g.*, Kaminska, *supra* note 84.

138. *Id.*

139. *See* Murphy, *supra* note 133.

140. Kritzer, *supra* note 125; Meyer, *supra* note 23.

141. *See* Kristina Zucchi, *The Pros and Cons of Trading Forex in an Overseas Account*, INVESTOPEDIA (May 27, 2011), http://www.investopedia.com/articles/forex/11/trading-forex-overseas-account.asp.

142. *See* Murphy, *supra* note 133.

143. Kaminska, *supra* note 84.

144. *See* Paul G. Mahoney, *The Exchange as Regulator*, 83 VA. L. REV. 1453, 1454 (1997).

regulation, especially in the area of unregulated OTC derivatives.[145] This Note will first establish that regulation through an exchange is infeasible in this industry. Nevertheless, this Note will argue that, like in Forex, CFTC jurisdiction is essential and some direct government regulation of precious and industrial metals is needed in order to protect consumers. Specifically, this Note will propose and analyze support for regulation, such as the inability of the retail consumer to protect himself, the lack of incentive for dealers to self-regulate, and the failure of a proposed exchange as a regulator. However, although some regulation is needed due to the level of unsophistication in the retail investors, too much regulation will have the negative effect of overregulation of the industry.

A. *The Failure of an Exchange as a Regulator*

The CFTC suggests that the industry has violated the law because the product has never been executed on an exchange, but the CFTC fails to state what exchange exists that would adequately provide proper housing for this product.[146] As discussed, this transaction is over-the-counter, meaning it is not executed on an exchange nor has it ever been. The CFTC alludes to a "board of trade" and states that the metals industry has failed to conduct its transaction "subject to the rules of a board of trade that has been designated or registered by the Commission as a contract market."[147] In making this reference to a board of trade, the CFTC is ultimately suggesting that this transaction was required to trade in the same manner as a futures contract, as all standardized futures are conducted on a board of trade.

Under an exchange, "intermediaries trade securities pursuant to a common set of rules."[148] Some debate that securities that are executed on exchange are thereby regulated to the point that further intervention by the government is not needed.[149] For example, an exchange, by itself, creates liquidity, competition, disclosure, uniform format for the presentation of information, and incentive to adopt rules in the market.[150]

145. *See generally* Cohen, *supra* note 2 (discussing three different regulatory proposals for derivatives); Cuccia, *supra* note 13 (proposing derivative regulation at the institutional level including various disclosures to protect dealers, end-users, and shareholders); D'Souza, Ellis & Fairchild, *supra* note 13 (proposing a regulatory system that would include the enforcement by the CFTC and the SEC).

146. Hunter Wise Complaint, *supra* note 26, ¶ 1; Hunter Wise Motion to Dismiss, *supra* note 27, ¶ 7 n.3.

147. *Id.* ¶¶ 29, 109.

148. Mahoney, *supra* note 144, at 1457.

149. *See id.* at 1455-57.

150. *See id.* at 1457-59.

Although the dispute regarding whether this product is a futures contract has not been fully decided on by the courts, it is likely that even a "look-alike" futures ruling granting the CFTC jurisdiction over these transactions would eliminate them because inherent characteristics of the transactions arguably preclude them from being executed on a board of trade. Execution of this product on an exchange is not feasible because the product is not standardized, as is true of all OTC derivatives.[151] The customers contract for varying price, quantity, settlement dates, delivery, and financing.[152] Therefore, an exchange would not effectively regulate this industry, as an exchange requires that each contract be standardized in order for it to function appropriately. Regulating this investment product by placing it on an exchange is impracticable and unfeasible. However, as evidenced by the Forex industry, the precious and industrial metals transaction can still be regulated in other ways while remaining an OTC transaction.

B. The Inability of the Consumer to Protect Himself

Although it is argued that regulation is unnecessary for rational investors with good information, the industry here enters into transactions with average persons, deemed retail investors, which is the key difference between this proposal and others that have denounced regulation of OTC derivatives generally.[153] As has been previously recognized, even institutional investors lack the necessary information when entering into derivative OTC transactions with brokering banks; as such, the informational asymmetry that occurs between the industry participants and the everyday retail investor transpires at a much larger scale and to the detriment of the retail investor, regardless of the investor's rationality.[154]

1. The Nature of the Retail Dealer as Salesman

First, the dealer is a sales-based business and thereby earns profit based off of the volume of trades made by clients and executed by brokers of the firm. In fact, the salesmanship aspect behind this transaction might not be much different than OTC derivative transactions that occur between large institutional investors and investment banks.[155] If Fortune 500 companies, with abundant resources

151. Cuccia, *supra* note 13, at 201-02.

152. *See, e.g.*, Hunter Wise Motion to Dismiss, *supra* note 27, ¶¶ 75-77.

153. *See generally* Cohen, *supra* note 2; Mahoney, *supra* note 144.

154. *See generally* Cuccia, *supra* note 13 (explaining that informational asymmetry occurs when one contracting party has more information than the other).

155. *See id.* at 205 ("However, the huge sums of money the Wall Street banks would make—as well as the contracts' less obvious, but nevertheless devastating, risks—were omitted from the investment banks' sales pitch.").

available to them, cannot protect themselves from salesmen, how can one expect an unsophisticated retail investor to have enough information to steer clear of high-pressure sales tactics? Dealers induce clients to invest by portraying the investment as "high-return" with little to no risk.[156] However, due in part to some of the qualities of the investment, such as high volatility or the use of leverage, the vast majority of clients lose money relatively quickly when investing in precious and industrial metals.[157] Unfortunately, due to the excellent salesmanship of those employed and trained by the dealers, retail investors all too often lunge at a deal that is too good to be true; a deal too good to be true only because the investor knows no better.

2. The Moral Hazard Problem Associated with Retail Dealers and Brokers

Further, due to the fact that the industry lacks any regulation or enforcement regarding broker actions in soliciting such investments, investors are unknowingly struck by the moral hazard problem when brokers fraudulently induce a trade with the mere incentive of raising commission funds for self-profit.[158] Although some brokers may believe that they are making informed and skillful decisions for the client, the reality is that even brokers who have a reasonable basis in making trading decisions often fail to give the client all of the information necessary in order for the client to make a knowledgeable decision to enter into the transaction. Instead, an investor naively fails to realize the repercussions of listening to his agent broker, and the risk and costs of an investment are shifted from the broker to the retail investor when disclosure is not required as a precursor to the retail investor authorizing trades. After selling the investment, brokers and dealers bear little of the risk if the retail investor loses all of his invested capital. But, had there been regulatory oversight in the form of mandated disclosure to the investor, the broker and dealer would have behaved differently, as they would have exposed themselves to the risks of entering into a transaction without providing proper notification to the client. Additionally, the client too will bear some of the

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156. *See id.* at 208-09. This is assuming that high-pressure sales tactics are the worst that can happen, which is in fact untrue. However, even institutional investors are intentionally deceived. *Id.* One bank salesman selling an OTC derivative investment to Proctor and Gamble admitted that he set the company up. *Id.* at 209. Another said: " 'Funny business, you know? Lure people into that calm and then just totally f— 'em.' " *Id.*

157. *See, e.g.*, Hunter Wise Complaint, *supra* note 26, ¶¶ 81-84.

158. *See* Definition *of 'Moral Hazard,'* INVESTOPEDIA, http://www.investopedia.com/terms/m/moralhazard.asp (last visited June 22, 2014) (defining "moral hazard" as "[t]he risk that a party to a transaction has not entered into the contract in good faith, has provided misleading information about its assets, liabilities or credit capacity, or has an incentive to take unusual risks in a desperate attempt to earn a profit before the contract settles").

risk, if properly disclosed, as the client will have made the trade knowingly and likely without fraudulent inducement when the contract portrays clear standards for the trade.[159]

3. The Unsophistication of the Retail Investor and Adverse Selection

The type of investors targeted for these types of transaction are unsophisticated investors who lack conception of just how complex and risky derivatives can be. As derivatives historically were only used by institutional investors as a hedge against risk,[160] most average investors are unfamiliar with the various types of derivatives and how the markets operate. Scarily, even brokers working at the top of the chain selling investments to institutional investors have trouble understanding the sophisticated derivative product.[161] Those with knowledge in derivatives are unlikely to invest in these types of OTC derivatives without attesting to the fact that such an investment is a mere gamble in the markets, especially when they are not afforded any credible information regarding the investment. Truthful and credible information is impossible to discern from untruthful, unreliable information, creating a source of information asymmetry before the parties' contract, when there is no regulatory body monitoring what is portrayed to retail investors by these, frequently, mere salesmen.[162] With that being said, brokerage firms and especially fraud merchants selling interests in metals find their most likely customers in the most unsophisticated types of investors—often times, the elderly and all-around novice investors.[163]

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159. *See, e.g.*, Taylor Woodrow Homes Fla., Inc. v. 4/46-A Corp., 850 So. 2d 536, 542-43 (Fla. 5th DCA 2003) (stating that "the courts have held that a party may not recover in fraud for an alleged false statement when proper disclosure of the truth is subsequently revealed in a written agreement between the parties"); Advanced Mktg. Sys. Corp. v. ZK Yacht Sales, 830 So. 2d 924, 928 (Fla. 4th DCA 2002) (determining that promissory estoppel was inappropriate because the parties had a written contract, which covered the commissions).

160. *See* Cuccia, *supra* note 13, at 199.

161. *Id.* at 206 (" '[S]ome of the most sophisticated asset managers in the nation don't properly understand derivatives which is why there've been such huge and unexpected losses.' If someone selling the derivatives does not fully comprehend them, one wonders how a buyer can adequately assess the complexity and risks of these instruments." (citation omitted)).

162. *See id.* at 198 ("It may be that potential investors are irrational, or that they 'are systematically given misleading and biased information and have no ability to evaluate its inaccuracies.' "). *See generally* George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q.J. ECON. 488, 489-90 (1970).

163. Burstein, *supra* note 4.

4. The Inadequacy of State Law Causes of Action

Retail investors wronged by fraud merchants lack the ability to take their claims to federal court when there is an absence of federal statutory authority or regulation over the industry. However, those that invest in a wide variety of other regulated instruments have many anti-fraud provisions and regulations under which the investor can sue for relief. It is true that investors have state remedy claims such as breach of fiduciary duty, fraud, negligent misrepresentation, lack of authority, and breach of contract available to them, but at least one commentator has rejected the adequacy of bringing claims under the common law.[164] The drawbacks from resolving disputes under state common law, or state statutes derived from the common law, include a lack of precedent in the area, difficult facts to ascertain and describe accurately, and muddled opinions from confused, untutored judges regarding the complex transaction.[165] As state law claims do not provide suitable avenues by investors against fraud merchants in this industry, some federal regulation is necessary to at least protect aggrieved investors from getting taken by those that target the unsophisticated. Additionally, it is likely that when an investor has the federal judicial avenue available to him, many fraud merchants will cease to exist because such industry participants will be unable to use the law as a shield to avoid wronged investors. For the reasons mentioned, retail investors are not able to protect themselves in this transaction, and the precious and industrial metals industry necessitates regulatory oversight.

C. Current Lack of Industry Disclosure and the Non-Existent Incentive for Dealers to Self-Disclose

As an unregulated market targeting unsophisticated investors, the industry lacks meaningful disclosure in all aspects of its business model and product.[166] Further, any optional disclosure a dealer firm does make to its investors can be untruthful or misleading. One thing is true—in the end, every party has more information about the product than the retail investor,[167] and regulation is needed to alter that status quo.

As to other regulated securities markets, it is argued that regulated disclosure is not necessary because disclosure works on a copycat,

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164. Frank Partnoy, *The Shifting Contours of Global Derivatives Regulation*, 22 U. PA. J. INT'L. ECON. L. 421, 447-78 (2001).

165. *Id.*

166. Cuccia, *supra* note 13, at 206.

167. *Id.* at 207.

unraveling method.[168] Each firm ultimately chooses to disclose unrequired information as a method to combat competition.[169] Such firms will ultimately disclose necessary information in an effort to gain increased market share, with each firm following in the other's footsteps.[170] However, this argument is not plausible when it comes to a completely unregulated industry riddled with fraud, as the fraud merchants have the same goal as one another and ultimately lack the survival impulse of a legitimate firm. The competition, ultimately, regards who can defraud or "sell" their customers better by looking as attractive as possible without incurring costs. As for those firms attempting to run a legitimate business, they fall into a competition war with the fraud merchants and neglect to disclose as well, as there is no incentive for these firms to increase their transaction costs when such costs fail to produce value. In other words, legitimate merchants are forced to keep their costs competitive with fraud merchants in order to keep up in the industry and thereby disclose information up to the point that a fraud merchant would disclose, which is often negligible in comparison to the risk involved in the investment. Investors cannot easily discern whether any further disclosure regarding the transaction by fraud merchants is beneficially truthful information or if the disclosure is simply fraudulent lies.

Because the goals of increased sales and low transaction costs are forcefully aligned between industry participants, not only do fraud merchants lack the need and justification to send forged credible signals of their "trustworthiness" to investors, thereby provoking the unraveling effect of disclosure, but any credible signal attempted to be displayed to investors by rightful firms often lacks any relevance. Retail investors, not realizing the difference between a fraud merchant and a legitimate dealer, are simply sold on the sales technique of the firm, rather than the amount or sufficiency of the disclosure that the firm produces.[171] Further, even if an investor feels as if one firm has provided him with better disclosure information than another, many times the investor is unable to decipher a truthful disclosure rather than a fraudulent statement from a smooth-talking broker.[172]

For example, one of the biggest areas lacking disclosure is in regards to the processes of the transaction itself. In almost all instances, retail investors believe that they are dealing with the dealer di-

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168. *See generally* Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669 (1984) (discussing firm incentives for firms to disclose information themselves rather than as required by regulation).

169. *Id.*

170. *Id.*

171. Akerlof, *supra* note 162, at 495-96.

172. *Id.*

rectly as the sole intermediary between the retail investor and the depository where their metal is ultimately held.[173] Many times, the dealers portray to investors that they will store the investor's metal in a depository, potentially misleading the unsophisticated investor that their investment is safe in a depository owned or run by the retail dealer itself.[174] However, little does the investor know that the firm has failed to disclose or has even misrepresented the fact that there can be as many as two or three other intermediaries, or counterparties, between the retail investor and the source of metal, each charging incremental fees along the way.[175] This lack of information—due to the absence of disclosure regulation requiring otherwise—creates a detrimental informational asymmetry to the retail investor, where he lacks the necessary information to make an informed decision on whether the investment meets his personal goals.[176] Knowing this information, some investors may forego this type of investment because the potential increased returns are not worth the risk or they feel that the fees charged along the way are too high given the services provided. Had the retail investor known that his product had been marked up to prices much higher than an institutional investor would be paying, he might have opted to take his funds to a different market with a product that charges less fees, incurs less risk, and provides a reduced rate of return. Furthermore, this information is never disclosed by fraud merchants or even firms with honest business practices because the investment is solicited profitably despite the lack of disclosure, transaction costs are kept lower without the forced regulation, firms compete through the use of sales tactics rather than through credibility, and unsophisticated investors continue to fall for the investment without objection due to their inability to determine just disclosures from fraud. Such misinformation communicated between the principal and agent in this transaction leads one to the solution that an informational asymmetry problem between the parties could be cured by disclosure methods as a source of regulation in this industry.[177]

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173. *See, e.g.*, Hunter Wise Complaint, *supra* note 26, ¶ 32.

174. *Commission Advisory: Beware of Promises of Easy Profits From Buying Precious Metals and Other Commodities*, COMMODITY FUTURES TRADING COMM'N, http://www.cftc.gov/enf/00orders/enfposting5-metals.htm (last visited June 22, 2014) [hereinafter *CFTC Metals Advisory*].

175. *See* Hunter Wise Complaint, *supra* note 26, ¶¶ 33-34 (detailing the different fees each intermediary charges on the transaction before the investment reaches the retail dealer).

176. *See* Cuccia, *supra* note 13, at 207 ("In an OTC contract, the dealer has more information than the end-user . . . .").

177. *Id.* at 215 ("It is no secret that requiring mandatory disclosure aids in correcting the problems caused by informational asymmetry.").

Dealers and wholesalers in the precious and industrial metals industry lack the incentive to self-regulate for a number of reasons, but at the forefront of discussion is the problem of collective action when the industry as a whole fails to self-disclose by providing disclosure voluntarily. First, as previously discussed, the income obtained by the broker from its clients is strictly commission-based thereby incentivizing brokers, as sole communicators with the customers, to "seal the deal" despite what informal limits may have been placed on them by the dealer.[178] Unfortunately, and unsurprisingly, principals of the dealer firms and trainers of their brokers coach their sales personnel to use sales tactics to sign up customers quickly and provide customers with generic disclosures, if any, which are replicated by each dealer in the tight knit industry.[179]

While there may be some incentive for some dealer firms to self-disclose in order to create a better reputation for the negatively viewed industry amongst sophisticated investors and other financial industry providers, there is even less incentive for a wholesaler in the industry to provide disclosure as wholesalers' sole marketing is to retail dealers rather than to investors.[180] As discussed earlier, investors rarely know about the wholesaler's relationship to their investment. For that reason, wholesalers simply have to look credible enough to the retail dealers in order to be successful. Many times, self-regulatory measures such as disclosure to retail dealers are unnecessary as a wholesaler's appearance to dealers is one of high-sophistication due to the technological and accounting practices utilized by wholesalers to keep track of inventory amongst their various dealer clients.[181] Dealers, for the most part, lack most of the modern technology utilized by today's regulated industries, such as real time pricing, online portals, and complex spreadsheet and accounting analysis and rely on wholesalers to provide the like.[182] Oftentimes, it is likely that such bells and whistles of the wholesaler are enough for dealers to sign-up without questioning the details behind the metal

178. *See* discussion *supra* Part V.B.1.

179. *CFTC Metals Advisory*, *supra* note 174.

180. *E.g.*, U.S. Commodity Futures Trading Comm'n v. Hunter Wise Commodities, LLC, No. 12-81311-CIV, 2013 WL 718503, at *4-5 (S.D. Fla. Feb. 26, 2013) ("Hunter Wise is the conductor of this orchestra, with the other Defendants playing instruments at Hunter Wise's direction. Hunter Wise recruits and engages intermediaries and sales firms, such as the Lloyds Defendants (an intermediary) and the Dealer Defendants (sales firms), to solicit retail customers to purchase physical metals on a financed basis." (footnotes omitted)).

181. *See id.* at *5-6.

182. *See id.* Although the dealer could potentially provide itself with additional technology or revert to providing its own technology to clients, a dealer provided with resources by the wholesaler is unlikely to duplicate any assets provided to it as the costs of doing so will likely exceed the benefit—especially due to the fact that wholesalers are receiving some of the proceeds of the transaction in order to provide such services.

transactions on the wholesaler's end since a substantial portion of the start-up costs of the company are taken care of by the wholesaler.[183]

As most actors in the industry forego self-regulation, the few dealers that do try to implement some components of self-regulation, such as disclosure, are left in the dust by the rest of the industry when transaction costs of self-regulation increase to the point that the profit to the firms and its clients diminish.[184] Those who may optionally choose to self-regulate are forced to limit any self-regulation in order to stay competitive in the marketplace. Additionally, without the use of self-regulation, dealers are still able to obtain a profitable level of business by the utilization of high-pressure sales techniques on the public. If disclosure were indeed profitable for the dealer, the firm would provide for it, but it does not.[185] The time, effort, and money required to self-regulate therefore fails to gather the momentum necessary to make disclosure a priority to the entire industry. Hence, the answer is simple: when it comes to self-regulation, retail dealers in precious and industrial metals take the "why bother?" attitude due to the collective action problem amongst the industry participants. As one dealer remains profitable without the added costs, the others notice and follow along in the "why bother?" attitude.

D. Just Enough Regulation: Disclosure Only Regulation

Proposed here is a solution rooted in a public interest theory[186] approach to regulation that meets the goal of the CFTC in eradicating fraudulent practices, the objectives of the retail investor in choosing an investment in precious and industrial metals, and the safeguards necessary to provide investors with tools for informed decision-making. The solution takes into account the newly heavily regulated Forex industry and proposes that some regulation is appropriate for an investment in precious and industrial metals at the retail level, but that other regulation should not be imposed as to denature the investment from its categorization as an OTC contract.

Retail investors who find themselves investing in this product, whether fraudulently induced or not, do so for one reason: the potential for a high rate of return on their investment. Investors who are investing for other reasons would invest and use a more risk-averse strategy by placing their funds in other securities, such as bonds or

183. *See id.*

184. *See* Easterbrook & Fischel, *supra* note 168, at 673-74.

185. *See id.* at 683.

186. J. Harold Mulherin, *Measuring the Costs and Benefits of Regulation: Conceptual Issues in Securities Markets*, 13 J. CORP. FIN. 421, 422 (2007) ("The public interest theory is the traditional statement that regulation responds to market failure as an attempt to improve social welfare.").

mutual funds.[187] Given these types of investors, it is likely that the full range of regulation over this investment vehicle will adversely affect investor goals in placing their money with precious and industrial metals firms, as evidenced by the recent regulation of the Forex industry.[188] Increased transaction costs associated with a heavily regulated security will likely thwart the efforts of these investors as some, if not all, of the costs associated with the increased regulation would pass down to the retail investors in the spread of the investment.[189] Some investors would likely be discouraged from investing in this hypothetically highly-regulated product because coupled with the extreme volatility of the product, lower rates of returns would not be worth the severe risk such investments pose. Therefore, the transaction costs involved in fully regulating this industry will likely foreclose much of the investor base currently investing in precious and industrial metals.

To the extent that more regulation is promulgated and implemented, enforcement costs for investigative, prosecutorial, and judicial staffs increase.[190] As the CFTC has previously regulated the Forex industry containing a product and problems much similar to those in the metals industry, it is important that the CFTC learn from the regulation instituted in the Forex industry.[191] It is asserted that the CFTC, combined with efforts of the National Futures Association,[192] has over-regulated the Forex industry to the detriment of the retail public investors, the taxpayers, the brokerage firms, and the United States economy.[193] The CFTC must better balance the benefits of eliminating fraud with the foregoing detriment to participants of the industry, and in doing so, it must first avoid sending reputable business out of the country. Some regulation is enough to combat fraud merchants from continuing business as the cost of implementing regulation and registration alone would disinterest these business owners from continuing in this industry nationally rather than moving on.[194] Investors are forced to take their funds overseas in Forex transactions because investors will only accept the increased cost of regulation up to the point that the cost begins to exceed the

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187. *See* Easterbrook & Fischel, *supra* note 168, at 676-77.

188. *See* FOREX Q&A, *supra* note 117 (detailing the full range of Forex regulation).

189. *See* Meyer, *supra* note 23.

190. Easterbrook & Fischel, *supra* note 168, at 678.

191. Kaminska, *supra* note 84; Meyer, *supra* note 22.

192. NATIONAL FUTURES ASSOCIATION, http://www.nfa.futures.org (last visited June 22, 2014) ("National Futures Association (NFA) is the industrywide, self-regulatory organization for the U.S. futures industry. NFA strives every day to safeguard market integrity, protect investors and help our Members meet their regulatory responsibilities.").

193. *See* discussion *supra* Part IV.C.

194. *See, e.g.*, Kaminska, *supra* note 84.

need for protection.[195] As represented in the case of Forex, many dealers and investors found that the more attractive option post-regulation was to bring their business overseas as these participants likely felt the costs of business exceeded their need for protection.[196] Hence, regulation should be limited to the point where transaction costs allow for efficient operation of business within the borders of the United States but remain high enough to keep fraud merchants from entering the business.

In this intermediate proposal of regulation, the main focus should be on giving public retail investors the necessary information to make value-maximizing decisions on their own behalf. In doing so, I propose that the only set of regulations required to keep the industry viable, yet do so within operation of equitable principles, is through the use of disclosure regulations.[197] It is acknowledged that finding just the right amount of regulation is a difficult feat,[198] so in this proposal, the minimum amount of regulation is suggested with the caveat that an analysis should be undertaken in due time after the implementation of the regulation to determine the regulation's effectiveness on industry-wide fraud. Further implementation of regulations is always available if the proposal has not reduced the level of fraud to a common level found in other areas of regulated securities. With that said, the reader should acknowledge that complete eradication of bad actors is an impossible achievement in any industry, but disclosure regulation will most likely provide a tolerable level of industry fraud, thereby protecting the vast majority of consumers investing at the retail level. The following paragraphs propose the areas of these transactions that require disclosure regulation by the CFTC when, rather than if, jurisdiction is granted to the CFTC over these transactions by the court. The CFTC, having the most expertise in the derivatives market, is an adequate regulatory agency to handle such a task and should be the entity to delegate action to other regulatory parties as it sees fit.

The regulatory focus should be on disclosure at the retail dealer level due to the high-risk, high-volatility, and high-leverage associated with the transaction. By proposing the regulation of firms at the bottom, wholesalers and institutions will be required to provide sufficient information to dealers without the use of mandatory disclosure in order to be able to viably solicit such dealers. Simple disclosure

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195. *See* Easterbrook & Fischel, *supra* note 168, at 696; Zucchi, *supra* note 141.

196. *See* Kritzer, *supra* note 125; Zucchi, *supra* note 141.

197. Easterbrook & Fischel, *supra* note 168, at 669 (explaining that the securities laws have "two basic components: a prohibition against fraud, and requirements of disclosure when securities are issued and periodically thereafter").

198. *Id.* ("The notorious complexities of securities practice arise from defining the details of disclosure.").

regulations at the retail level would cure many of the mismatches between dealer and retail investor previously discussed, such as the detrimental informational asymmetry problem to retail investors, the moral hazard problem produced by brokers, and adverse selection issues associated with the industry participants.[199] Furthermore, as evidenced by the vast disclosure regulations in other securities industries, a consensus throughout the nation seems to be that consumers deserve and desire to know exactly what they are allocating valuable resources toward, despite the added costs.[200] Due to collective action problems amongst industry participants at different levels and the failure of the unraveling method, retail dealers have no intention to disclose truthful and complete information to their retail customers on their own accord; thus, the only feasible way to provide thorough information to consumers is through mandatory disclosure requirements.[201]

Although it may be argued that disclosure regulations are some of the most costly to implement by the firm and the monitoring by the regulatory agency also provides increased taxpayer costs, it must be acknowledged that limiting regulation to simply disclosure regulations cuts costs greatly to both parties if viewed in comparison to the full wide-range of regulations that were implemented in the Forex industry.[202] Strictly limiting regulation to mandatory disclosure requirements means that the costs of regulations regarding minimum capitalization requirements, leverage ratios, registration, and excessive monitoring will limit costs to taxpayers, consumers, and industry participants. Additionally, the standardization of mandatory disclosure will reduce, in due time, transaction costs associated with the initial shock to the industry that regulation often delivers.[203] Furthermore, I propose that the costs that pass down to the consumer through disclosure would be subsumed by the retail investor as a cost of doing business in the area because the investor is able to make more informed decisions regarding investments in precious and industrial metals.

Some of the most important types of disclosures that should be mandatorily distributed to retail investors prior to opening an ac-

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199. *See id.* at 680 ("A mandatory disclosure system substantially limits firms' ability to remain silent."); *see also* discussion *supra* Part V.B–C.

200. Paul G. Mahoney, *Mandatory Disclosure as a Solution to Agency Problems*, 62 U. CHI. L. REV. 1047, 1047-48 (1995).

201. *Id.* at 1048 ("Disclosure can contribute to informational efficiency (and ultimately to social welfare) by enabling traders to gather information, and thereby reflect new information in prices, at a reduced cost compared to a world without disclosure.").

202. FOREX Q&A, *supra* note 117.

203. *Cf.* Easterbrook & Fischel, *supra* note 168, at 687 ("Mandatory disclosure rules promulgated by the government are one means to achieve standardization, but it does not follow that mandatory disclosure is necessary.").

count with a retail dealer are risk disclosures.[204] These investments pose a variety of risks at the institutional level, which are passed down to retail investors.[205] Disclosures regarding the high level of risk involved in OTC derivative contracts, as well as the volatility often found in the market, are imperative to investors in making informed decisions and limiting the dealer salesmen's ability to downplay such risks involved. The risk disclosures should be standardized across the industry and developed through the CFTC to limit dealers from downplaying investor risk using sales tactics.

A big part of the increased risk in these investments is the dealer's push for retail investors to buy a metal position using leverage. Not only do some of these investors fail to understand the vast repercussions associated with increasing their purchasing power, as the thought of an even greater return using the grandiose sounding term "purchasing power" seems superb at the time, but many investors do not realize the further increased risk associated with the use as leverage.[206] Not only could a retail investor lose his invested capital, but he could end up owing additional funds to cover the loan and fees. Included in the risk disclosures should be detailed statements about the process of leverage, including real time examples and hypothetical scenarios regarding the effects leverage can have positively and negatively on an investor.[207] By educating investors on the use of leverage associated with their transactions, regulation instituting leverage caps becomes repetitive and unnecessary when investors are informed adequately about the repercussions. Furthermore, as many investors optionally choose to invest in derivatives and precious and industrial metals for the potential benefits of high leverage associated with these transactions, providing any further regulation limiting leverage devoices investors of their aspirations by inhibiting an investor's autonomy in making educated decisions regarding the use of his personal funds.

Additionally, the industry should disclose operational standards informing investors of the processes of the business, how metal could

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204. To discuss derivatives' risks does not mean they are bad. "Indeed, because derivatives present risks and benefits, they have been compared to electricity—'dangerous if mishandled but bearing the potential to do tremendous good.' " Cuccia, *supra* note 13, at 201.

205. *See generally* Cohen, *supra* note 2, at 2006-13 (discussing the various risks associated with derivatives).

206. *See* STAFF OF S. SPEC. COMM. ON AGING, *supra* note 24, at 2, 6-8.

207. *See, e.g.*, Cuccia, *supra* note 13, at 216. As an example, at the institutional level, the Federal Reserve Board has previously entered into an agreement with a bank requiring that the bank "shall conduct its leveraged derivatives transactions business in a manner which seeks to reasonably ensure that each leverage derivatives transaction customer has the capability to understand the nature and material terms, conditions and risks of any leveraged derivatives transaction entered into with the customer." *Id.* (citation and quotation marks omitted).

be stored at any number of multiple depositories, and how their metals are performing in the market using a system displaying real-time quotes. Included in these operational disclosures should be fee disclosures listing the mark-up percentage from each intermediary associated with the transactions.[208] By providing fee disclosures to investors, not only are investors able to make more rational decisions regarding the transactions, but it will also help limit the extreme inflation of mark-up fees that oftentimes occurs between the spot price of the metal, keeping the actors competitive all the while.[209]

Furthermore, disclosure regarding trustworthiness of brokers hired by retail dealers should be implemented. Negative history regarding financial industry violations should be revealed to retail investors who are relying on the word of a "salesman" entrusted with large sums of investor funds. Including this disclosure would also aid in correcting the moral hazard problem that occurs between broker and investor as brokers will be held accountable for their actions with the retail dealer by, in the interest of competition, limiting the number of "scam artists" used to solicit investments. Such a disclosure would also alleviate most of the need for registration by brokers, as a goal of registration is often to determine the adequacy of the broker in order to protect consumers.

Finally, with all this required disclosure, someone is needed to make sure it meets standards of accuracy. The CFTC is in the best position to either monitor dealer disclosures on their own or to essentially contract the duty out to another agency, such as the Federal Trade Commission, or a self-regulatory body, such as the National Futures Association. Monitoring of disclosures should take place at the inception of a precious and industrial metals firm and then annually, as long as the firm does not change the materials sent to customers. Additionally, the agency in charge of monitoring should continuously conduct routine and random policing investigations to ensure that disclosure materials submitted are the same as those that make their way to consumer investors, bringing anti-fraud actions where necessary. Such policing actions would alleviate the need to require more frequent disclosures, thereby limiting costs to taxpayers.

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208. *See, e.g.*, *id.* at 217. In an agreement between the Federal Reserve Board and an institutional banker selling derivatives, the bank agreed to "adopt practices which ensure 'reasonable transparency of pricing and valuation' so that customers can track the daily values of the complex instruments. *Id.* (citation omitted).

209. *See* U.S. Commodity Futures Trading Comm'n v. Hunter Wise Commodities, LLC, No. 12-81311-CIV, 2013 WL 718503, at *6 n.22 (S.D. Fla. Feb. 26, 2013). At the institutional level, "[d]ealers on Wall Street have responded to the growing market by creating more complex instruments to impress end-users and earn huge fees through sales." Cuccia, *supra* note 13, at 219; *see also* STAFF OF S. SPEC. COMM. ON AGING, *supra* note 24, at 2-3, 5-10.

Limited regulation in the form of disclosure-only requirements is necessary. Further requirements should not be imposed upon the precious and metals industry. If proper disclosure is made, further regulatory requirements would be repetitive, provide additional cost barriers, and devoice investors of their wishes. As discussed earlier, investors interested in this industry desire the risk and the high rates of return associated with the business. More regulation would impose more transaction costs associated with the investment, thereby impeding this investment's intended use to retail investors who have legitimate aspirations to involve themselves in high-risk, high-return investment strategies. By inhibiting an investor's choice to use his money in ways he deems best given his goals, the regulatory body is obstructing personal autonomy and thus overstepping its regulatory purpose of consumer protection.[210]

VI. CONCLUSION

The precious and industrial metals industry is deserving of some regulation as the retail public is in need of consumer protection vehicles. By simply adequately informing the consumer through the use of disclosure-only regulation, the consumer maintains his own liberty in choosing his investment and is also provided the needed information to make value-maximizing decisions. In promulgating some regulatory disclosure provisions, the industry is benefited rather than inhibited by transaction costs associated with regulation. As participants in the industry adapt to the regulation, the cost absorbed by the dealers will decrease with time as markets and their participants sophisticate. Just enough regulation increases investor confidence in the precious metals market, later leading to growth of the industry in our own backyard rather than overseas.[211]

In conclusion, the most equitable approach the CFTC should take in order to reduce costs of the agency and taxpayers, but still fulfill the agency's purpose, would first be to establish clear regulatory jurisdiction over the retail precious and industrial metals industry. Delay in establishing clear regulatory jurisdiction, after the CFTC has already once experienced a similar situation in retail Forex, is unnecessary and adds costs to all parties involved, even sending some important players in the industry out of business in an attempt to defend their business in court. Secondly, instead of instituting enforcement actions against those currently operating in the industry,

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210. *See* Meyer, *supra* note 23. In regards to the proposed Forex regulation, one commentator said that " '[p]utting a cap [on leverage] is interference with the free-market system and capitalism . . . . You are telling the investor how to invest their money. The first steps toward communism.' " *Id.*

211. "As [regulators] seek to impose oversight on spot foreign exchange transactions, they risk repelling investors from a fledging marketplace." *Id.*

the CFTC should attempt to engage in negotiation with the industry in an effort to facilitate cooperation between the parties. With the CFTC and the metals industry in coordination, the CFTC should then promulgate the proposed regulation, with regulatory focus only on disclosure, to the extent beneficial to all parties involved.