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In the matter of

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NOTICE OF SUPPLEMENTAL AUTHORITY

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Respondents.

The Securities Division ("Division") of the Arizona Corporation Commission hereby provides notice of the current publication of two articles of legal analysis addressing the issue of state regulatory jurisdiction over the offer and sale of investments in foreign currency spot market ("FOREX") trading programs. Both articles now appear in the *Enforcement Law Reporter 1999*, published annually by the North American Securities Administrators Association, Inc., and are respectively attached hereto as Exhibits A and B. This edition of the publication was not previously available to the Division.

The purpose of this notice is to supplement the record with new authority relevant to the jurisdictional issue raised by Respondents' pending "Motion to Dismiss RE: Lack of Jurisdiction" filed in this matter on November 25, 1998.

DATED this 20th day of December, 1999.

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SECURITIES ADMINISTRATORS ASSOCIATION, INC.

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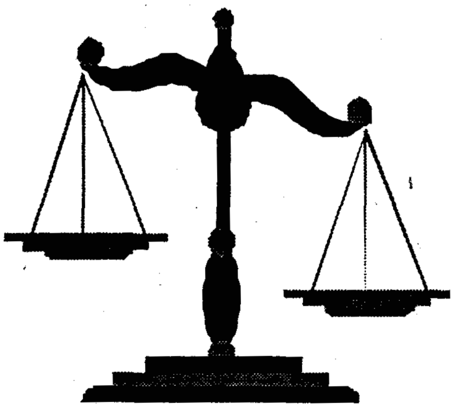

1999

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OFFERS AND SALES OF SECURITIES IN THE FORM OF FOREIGN CURRENCY INVESTMENTS: FEDERAL AND STATE JURISDICTION AND ENFORCEMENT ISSUES

By John Oses and Sonia Mayo

I. INTRODUCTION

In the past few years, securities regulators all over the United States have experienced a considerable rise in fraud involving foreign currency offerings.[1] This rise has been largely attributable to the belief by many foreign currency promoters that the cases of *Dunn v. Commodity Futures Trading Commission*[2] and *Commodity Futures Trading Commission v. Frankwell Bullion*[3] created a loophole in the regulation of foreign currency offerings. It has also been attributable to the recent economic problems in countries such as Japan and the barrage of media coverage over the volatility of foreign currency markets. Preying on the American consumer's remote awareness of financial instability abroad, foreign currency promoters have enticed investors with promises of huge profits to be obtained from exploiting movements in the foreign currency market.

As fraudulent foreign currency offerings have developed, securities regulators have observed a variety of methods for attracting investors. The first, and less common, method occurs when foreign currency promoters feed the illusion of quick profits and wealth by establishing their operations at the most extravagant offices in town and filling them with lavish decorations and large electronic monitors showing movements in the foreign currency markets. Investors are invited to visit these offices, where they are greeted by officers of the company and encouraged to personally meet with them in their individual offices. Due to their surroundings, investors believe in the legitimacy of the business. These types of operations typically do very little advertising, relying on investor referrals and perhaps a nice write-up in a local business journal to attract new investors in their town and surrounding areas.

The more common method of attracting investors is through the use of advertisements in the media promising to double a minimal five thousand dollar investment in a matter of weeks. Swept up by television, newspaper, and Internet advertisements, investors are commonly led to believe that until now they have been excluded from a profitable arena known as the "Interbank" or "off-exchange"[4] market which was previously open only to commercial banks and other sophisticated financial institutions. Investors are typically instructed to call a toll-free number and request an information packet about how they can make a quick profit by investing in the foreign currency markets. The information packet sent to investors in the mail is a fancy offering brochure designed to support the legitimacy of the operation. Behind the facade of legitimacy, there is usually a boiler-room operation where sales agents, with just enough information about foreign currency markets and terminology to sound convincing, answer the telephones, send out brochures, and make follow-up calls to close the deal.

Another method of attracting investors is the pure boiler-room offering, in which foreign currency promoters specifically seek investors who are inexperienced in the foreign currency markets as cold-call targets and engage in high-pressure sales tactics to convince them that they will only have to invest a nominal amount to make a huge profit by exploiting movements in the foreign currency markets. After an investor sends the initial investment amount, the number of telephone calls from the promoter occur more often and the tone of the conversation becomes more urgent, and the investor is often contacted by several salespeople from the same office. The investor receives assurances that the initial investment has increased in value and is persuaded to send more and more money.

Regardless of the method chosen to attract investors, foreign currency promoters have raised hundreds of millions of dollars over the last few years, always with promises of huge profits in a very short time and claims of low risk due to self-proclaimed promoter expertise in foreign currency trading.

As securities regulators have increased the number of enforcement actions brought to respond to the heavy losses suffered by investors in the off-exchange market, promoters have attempted to argue that off-exchange foreign currency transactions are entirely exempt from regulation. As this article will discuss, this argument is primarily based on a misinterpretation of *Dunn* and *Frankwell,* which interpreted the meaning of the Treasury Amendment in § 2(ii) of the Commodity Exchange Act (CEA)[5] and discussed the issue of jurisdiction over off-exchange transactions in the foreign currency markets by the Commodity Futures Trading Commission (CFTC). The application of federal and state securities laws to the investment relationship between the investors and the promoters in foreign currency offerings, which is the relationship securities regulators oversee, was not discussed or prohibited by the Treasury Amendment or these decisions.

Promoters have also argued that the exclusivity provision contained in § 2(i) of the CEA grants exclusive jurisdiction to the CFTC and preempts the application of federal and state securities laws to commodity-related investments. As will be discussed in more detail in Section IV of this article, this section does grant exclusive jurisdiction to the CFTC over certain commodity[6] investments, but it contains several limitations to that jurisdiction.[7] Foreign currency promoters are currently taking advantage of the fact that many securities regulators have not had the occasion to study the legislative history of the CEA, the CEA itself, and the cases interpreting the CEA. This article is designed to provide a road map to these areas so that a better understanding can be gained about the role of securities regulators over commodity investments in foreign currency and the application of securities laws to foreign currency offerings.

Since the Treasury Amendment and the exclusivity provision do not prohibit or preempt regulation over foreign currency transactions on the off-exchange market, securities regulators have and should continue to apply securities laws to fraudulent, off-exchange foreign currency offerings which may be defined as a security. The most common approach used by securities regulators to bring foreign currency offerings within the definition of a security is the investment contract theory developed by the states and first articulated by the Supreme Court in the landmark case of *SEC v. W.J. Howey Co.*[8] With its broad application to a variety of investment schemes, the investment contract theory is the best mechanism to bring fraudulent foreign currency offerings within the jurisdiction of securities laws and provide a recourse for individual, unsophisticated investors who have been caught in the frenzy created by foreign currency promoters.

This article, while discussing the common characteristics of fraudulent foreign currency offerings throughout, will first provide the reader with an overview of how the foreign currency market operates. Then the article will seek to clarify the holdings of *Dunn* and *Frankwell* and minimize the confusion regarding CFTC jurisdiction as it relates to federal and state securities regulators. Finally, it will discuss the application of the investment contract analysis to foreign currency offerings.

II. OVERVIEW OF FOREIGN CURRENCY MARKETS

Although this article will focus on the fraudulent offerings of investment programs involving foreign currency, a working knowledge of the foreign currency markets is necessary when investigating any investment offering involving foreign currency.[9] The foreign currency markets consist of both regulated national exchanges, such as the Philadelphia Stock Exchange and the Chicago Board of Trade, and the Over-the-Counter ("OTC") market, also known as the Interbank or off-exchange market (hereinafter "Interbank" or "off-exchange"). National regulated exchanges offer instruments such as options or futures which are often standardized with regard to contract size, strike or exercise price, premium, and exercise date.[10] The Interbank market is a twenty-four hour market conducted through privately negotiated transactions, off any formal exchange, and primarily consisting of commercial and investment banks, multi-national corporations and sophisticated investors.[11] All manner of foreign currency instruments, including spot transactions, options, futures, and forward contracts are traded on the Interbank market.[12]

The foreign currency markets allow institutional investors and corporations to limit their risk against adverse currency fluctuations, lock in maximum costs or minimum revenues related to international transactions, or to hedge foreign stock and bond holdings.[13] The dominant types of foreign currency instruments which are used for these purposes consist of spot transactions (also known as cash transactions), options, and futures.

A. Spot Currency Transactions

Some of the largest and most aggressive foreign currency schemes involve the offering of investments in the spot currency market.[14] Spot currency trading takes place on the Interbank market and it is the most popular foreign currency instrument in the world, accounting for 48% of all foreign currency activity.[15] The spot Interbank market is often referred to as the "cash market" or Forex market.[16] The Forex market is an "off-exchange" network of large banks, financial institutions and traders who enter into agreements to deliver a certain amount of different currencies to each other, at an agreed upon exchange rate, within two business days of the date into which the agreement was entered.[17] There are two distinct purposes for entering into spot transactions: for accepting delivery of currency and for speculative or investment purposes where delivery of the currency is never contemplated.

First, many corporations and financial institutions need access to large amounts of foreign currency for purchasing or selling services or goods in international markets. When a company purchases services or goods from foreign countries, it must pay for those items in the currency of that foreign country.[18]

In addition, goods and services sold to a foreign country may necessitate the conversion of the foreign currency received into the currency of the seller's home country in order for the profits generated to be repatriated.[19] These types of transactions contemplate the actual delivery of the foreign currency between the parties involved and is an essential element of international trade.

The second purpose for entering into spot foreign currency transactions is for speculative investment where actual delivery of the foreign currency does not occur. Many financial institutions, corporations, investment firms, and large sophisticated investors enter into spot market transactions for pure speculative purposes.[20] These investors hope to reap large returns from small fluctuations in the foreign currency exchange rates. Positions in foreign currency are closed out, typically on the same day, by entering into an opposing position rather than accepting delivery of the currency.[21] Positions can be maintained for longer periods either by having the positions "rolled over," which is accomplished by selling an existing position and immediately purchasing a new position, or by maintaining the existing position by paying a "storage" or "margin" fee in order to keep the position overnight.[22]

This second type of spot market transaction is the type used by many promoters to entice investors into investing large sums of money in the foreign currency markets. Investors are commonly told that they can control a large amount of foreign currency in the Forex market with a relatively small investment by purchasing currency on margin, which is often as low as 10%, meaning that an investor can control up to $10,000 of a foreign currency with an initial investment of only $1,000. Promoters claim that their expertise in the Forex market, along with the large amount of leverage created by the small margin requirements, will allow them to create huge returns for investors in a very short period of time. Promoters often claim that institutional investors and wealthy individuals have long invested in the foreign currency markets and have reaped large returns while risking only a small amount of capital. They often also claim that, until recently, these foreign currency markets were not available to the small individual investor, but through their program, these once exclusive markets are now available to them. These representations are often used to entice small, unsophisticated investors into investing in these foreign currency programs.

B. Options on Foreign Currency

Options on foreign currency are traded on both national exchanges and on the Interbank market.[23] Many promoters offer investments based on options on foreign currency due to the limited risks associated with options. The price paid for the option, also known as the premium price, is the most amount of money that the purchaser of an option can lose. This quality entices many investors who believe that their risk is limited to the amount of their initial investment. The purchase of an option does have limited risk in that if the cost of executing the option is greater than the premium paid for the option, the buyer will not execute the option and the total amount lost is the premium price plus any costs or commissions associated with the purchase of the option. Selling or writing an option, however, does entail substantial risks to the investor because in return for the premium received, the writer must be ready to sell the predetermined amount of currency at the predetermined strike price if and when the buyer of the option exercises the right.[24] The maximum amount of return for the seller is set at the premium price received for the option but the risk is unlimited as the currency price could change greatly during the exercise period.[25]

C. Futures and Forward Contracts on Foreign Currency

A futures contract calls for the delivery of a specific quantity of a commodity or financial instrument at some specific date in the future.[26] Unlike options which confer the right, but not the obligation to exercise, a futures contract must be executed or settled by the parties who entered into the futures contract.[27] This obligation is most likely the reason that promoters have not seemed to offer any investments involving the purchase of futures.

Promoters are unable to represent that investor risks are limited to the purchase price of the futures contract as they can with options, thus making the investment seem much riskier to the unsophisticated investor.

A forward transaction is an agreement between two parties to deliver a set amount of currencies to each other, at an agreed exchange rate, at least two business days after the agreement date.[28] Forward transactions are generally entered into with the expectation of delivery of the currency and thus have seen little, if any, use as a speculative investment instrument.

D. Conclusion

As can be seen above, there are various foreign currency instruments that are traded on both regulated exchanges and in the off-exchange or OTC markets. While the vast majority of foreign currency transactions conducted in the off-exchange market are entered into for legitimate hedging or speculation and generally occur between large, sophisticated parties, fraudulent promoters do offer off-exchange foreign currency investments to unsophisticated investors. The majority of the fraudulent offerings appear to involve the offer and sale of investments utilizing spot transactions and options on foreign currencies, whereas few, if any, offer investments involving futures and forward contracts.

III. INTERPRETING THE REACH OF THE TREASURY AMENDMENT OVER THE INTERBANK MARKET

To support the argument that off-exchange foreign currency transactions are exempt from federal and state securities regulation, foreign currency promoters rely on two key arguments. First, promoters argue that the Treasury Amendment[29] to the CEA does not permit regulation of off-exchange foreign currency transactions by any regulatory agency. This argument is premised upon a misstatement and misapplication of the holdings in *Dunn*[30] and *Frankwell,*[31] which did not address the issue of securities regulation and dealt solely with the issue of CFTC jurisdiction over certain types of off-exchange transactions in foreign currency. This topic will be the focus of this section of the article. Second, foreign currency promoters argue that the exclusivity provision contained in § 2 of the CEA preempts federal and state securities regulators from bringing actions against promoters engaged in off-exchange foreign currency transactions. This topic will be developed further in Section IV of the article.

This article will address those claims and argue that the holdings in *Dunn* and *Frankwell,* and the CEA's exclusive jurisdiction clause contained in § 2(i) do not preempt or divest federal and state securities regulators from bringing actions under their respective acts, and further, that the original jurisdictional savings clause of § 2(i) and the "open season" provision of § 16(e) limit the exclusive jurisdiction granted to the CFTC.

A. Misinterpretation of the Holdings in *Dunn v. CFTC* and *Frankwell Bullion, Ltd. v. CFTC:* Construing the Meaning of the Terms "Transactions in Foreign Currency" and "Board of Trade" within the Treasury Amendment

The Treasury Amendment, which is contained in Section 2(ii) of the CEA, provides, "[n]othing in this chapter shall be deemed to govern or in any way be applicable to transactions in foreign currency . . . unless such transactions involve the sale thereof for future delivery conducted on a board of trade."[32] The Treasury Amendment was enacted as part of the 1974 amendments to the CEA, which replaced the authority of the Secretary of Agriculture with the newly-created CFTC and entrusted it with authority to implement the CEA. The CFTC was granted exclusive jurisdiction over commodity futures, contracts and various other commodity-related activities, including options trading.

While the 1974 amendments were being considered, the Department of Treasury became concerned that the CEA's grant of authority to the CFTC could subject the sophisticated foreign currency market to new and unnecessary regulation. In response to its concerns, the Treasury Department wrote a letter to the Senate Committee considering the 1974 amendments, which will be discussed in further detail below in Section IV of this article. In essence, the letter expressed concern that the new regulatory requirements would adversely affect the usefulness and efficiency of the foreign currency markets. To address these concerns, the Treasury Department suggested an amendment to the 1974 Act which would exclude the Interbank market from CFTC jurisdiction. Congress responded by incorporating almost all of the Treasury's proposed amendment in what is now commonly known as the Treasury Amendment.[33]

In the years following the 1974 Act, the Interbank market began to evolve. Concerned by these developments, the CFTC issued interpretive letters in 1977 and 1985, in which it expressed its position that the Treasury Amendment could not be interpreted to exclude from CFTC jurisdiction the marketing to the general public of off-exchange foreign currency transactions. The CFTC believed that the Treasury Amendment was meant to encompass only transactions among banks and other sophisticated, informed institutions. Meanwhile, the Treasury Department and various financial institutions argued that the term "transactions in foreign currency" plainly excluded off-exchange transactions in foreign currency from CFTC jurisdiction. As the Supreme Court ultimately determined in *Dunn*, the Treasury Department's view of the term "transactions in foreign currency" was correct.[34] While the Supreme Court resolved the meaning of the term "transactions in foreign currency," it has not yet had the opportunity to determine the meaning of the term "board of trade." This issue has only made it as far as the Ninth Circuit, which discussed the meaning of the term in the *Frankwell* decision.

Promoters have relied on these two decisions to argue that the Interbank market was intended by Congress to be completely free of regulation. As will be discussed further below, these two decisions, along with additional decisions which will also be discussed, dealt only with the issue of CFTC jurisdiction over foreign currency transactions in the Interbank market, and did not in any way discuss or limit the jurisdiction of securities regulators over securities fraud by promoters against investors in the foreign currency markets.

1. The Meaning of "Transactions in Foreign Currency": *CFTC v. American Board of Trade; Salomon Forex, Inc. v. Tauber;* and *Dunn v. CFTC*

Prior to *Dunn*, various courts had addressed the issue of the proper definition of the term "transactions in foreign currency" contained in the Treasury Amendment. In *CFTC v. American Board of Trade,*[35] the Second Circuit found that options in foreign currency were not "transactions in foreign currency" until they were actually exercised.[36] The Fourth Circuit in *Salomon Forex, Inc. v. Tauber*[37] disagreed with the Second Circuit and held that foreign currency options were "transactions in foreign currency."[38] The Supreme Court in *Dunn* addressed this split among the courts and determined that options in foreign currency were in fact "transactions in foreign currency" as the term is used in the Treasury Amendment.[39]

a. *CFTC v. American Board of Trade*

In 1986, the Second Circuit in *CFTC v. American Board of Trade* held that options to buy or sell foreign currencies were not purchases or sales of foreign currencies themselves, and thus were not transactions in those currencies, meaning that they were not excluded from CFTC regulation by the Treasury Amendment.[40] The Second Circuit stated that while an option transaction gave the option holder the right to purchase or sell the specified foreign currency, the option holder did not actually purchase or sell the currency until the option was exercised, and therefore it did not become a transaction in that currency until the option was exercised.[41] The court found that because options on foreign currency were not "transactions in foreign currency," the Treasury Amendment did not exclude the options sold by the American Board of Trade from CFTC jurisdiction.[42]

b. *Salomon Forex, Inc. v. Tauber*

Seven years later, the Fourth Circuit in *Salomon Forex, Inc. v. Tauber* also addressed the issue of whether options transactions were included in the exemption for "transactions in foreign currency" in the Treasury Amendment to the CEA.[43] The court looked at the plain language of the Treasury Amendment and focused on the "unless" clause contained therein.[44] The court reasoned that if Congress had meant for the phrase "transactions in foreign currency" to cover only transactions in the commodity itself, it would not have excluded futures transactions through the "unless" clause contained in the "board of trade" proviso.[45] The court stated that "[t]he class of transactions covered by the general clause 'transactions in foreign currency' must include a larger class than those removed from it."[46] Therefore, if the unless clause referred to futures transactions conducted on an exchange, the court concluded that the phrase "transactions in foreign currency" must include off-exchange futures transactions.[47] Using this reasoning, the court concluded that there was no reason to distinguish off-exchange futures from currency options, as both contemplate the actual delivery of the commodity upon the date of execution.[48] Thus, the court construed the "transactions in foreign currency" phrase to reach beyond transactions where the commodity itself was present to include "all transactions in which foreign currency is the subject matter, including futures and options."[49]

Because of its interpretation of "transactions in foreign currency," the court concluded that "under the appropriate interpretation of the Treasury Amendment, all off-exchange transactions in foreign currency, including futures and options, are exempt from regulation by the CEA."[50] Later in its opinion, after reviewing the legislative history of the CEA, the court clarified its holding to state that only "individually-negotiated foreign currency option and futures transactions between sophisticated, large-scale foreign currency traders fall within the Treasury Amendment's exclusion from CEA coverage."[51] The court appears to have attempted to limit its previous conclusion that all off-exchange transactions in foreign currency were exempt from the CEA. These two positions appear to be irreconcilable because "all off-exchange transactions" would necessarily include unsophisticated investors.[52]

c. *CFTC v. Dunn*

In 1997, the Supreme Court in *Dunn* addressed the issue of whether Congress had authorized the CFTC to regulate "off-exchange" trading in options on foreign currency.[53] The case came to the Supreme Court on a writ of certiorari from the Second Circuit, which, relying on its previous opinion in *American Board of Trade*, affirmed the district court's decision that options were not transactions in foreign currency until exercised.[54] Although William Dunn and the company he controlled, Delta Consultants, conducted its transactions on the "off-exchange" or OTC market and contracted directly with international banks and other financial institutions without the use of any regulated exchange, the lower courts held that the options on foreign currency were not "transactions in foreign currency" and thus were not excluded from CFTC regulation by the Treasury Amendment.[55]

The Supreme Court granted certiorari in order to address the split between the Second and Ninth Circuits in determining the meaning of the phrase "transactions in foreign currency." The Court stated that the outcome of the case was dictated by the "Treasury Amendment" to the CEA, and more specifically that the narrow issue to be decided was whether the phrase "transactions in foreign currency" included options to buy or sell foreign currency.[56] After a discussion regarding the plain meaning of "transactions in foreign currency" and an examination of the legislative history regarding Congress' purpose in enacting the Treasury Amendment, a unanimous Court concluded that an option to buy or sell foreign currency was a "transaction in foreign currency" for the purposes of the Treasury Amendment and thus excluded from CFTC jurisdiction.[57]

Contrary to arguments made by promoters and participants in the OTC and off-exchange foreign currency markets, the Court in *Dunn* did not address the issue of federal or state regulation of securities offerings which involve foreign currency.[58] As the Court stated, the narrow issue to be decided was whether an option on foreign currency was a "transaction in foreign currency" as it relates to the Treasury Amendment to the CEA.[59] The only jurisdictional issue addressed was that of the scope of CFTC jurisdiction granted to it by the CEA. The issue of securities jurisdiction was not addressed by the Court.

2. Interpreting "Board of Trade": *CFTC v. Frankwell Bullion, Ltd.; CFTC v. Standard Forex, Inc.; Rosner v. Emperor Int'l Exchange; Rosner v. Gelderman, Ltd.;* and *Rosner v. Peregrine Financial, Ltd.*

The "board of trade" proviso contained in the Treasury Amendment exempts from the CFTC's jurisdiction "transactions in foreign currency . . . unless such transactions involve the sale thereof for future delivery *on a board of trade.*" (Emphasis added).[60] The CEA defines "board of trade" as "any exchange or association, whether incorporated or unincorporated, of persons who are engaged in the business of buying or selling any commodity or receiving the same for sale on consignment."[61] Some courts have applied this broad statutory definition of "board of trade" to the term "board of trade" as used in the Treasury Amendment and have held that "off-exchange" foreign currency operations do not fall within the Treasury Amendment's exemption from CFTC jurisdiction. These courts have held that the definition of "board of trade" for the purposes of the Treasury Amendment is different from the broad statutory definition contained in § 1a(1), limiting the term as used in the Treasury Amendment to mean organized exchanges; thus, they have held that "off-exchange" foreign currency operations are excluded from the CFTC's jurisdiction. It should be noted that even though the Supreme Court in *Dunn* did not specifically address the issue of the meaning of "board of trade," the Court did seem to say in dicta that the transactions involved in *Dunn* were "off-exchange" transactions and that these were the types of transactions that Congress was attempting to exempt from CFTC regulation when it enacted the Treasury Amendment.[62]

a. *CFTC v. Frankwell Bullion*

In *Frankwell*, the Ninth Circuit addressed the issue of whether spot currency transactions executed on the Interbank market fell under the jurisdiction of the CFTC.[63] Frankwell Bullion, Ltd. was in the business of offering investments in the foreign currency market to the general public.[64] The CFTC brought an action against Frankwell Bullion, Ltd. and its affiliates for violations of the CEA.[65] The Ninth Circuit, as did the Supreme Court in *Dunn,* focused on the Treasury Amendment to the CEA, but unlike the Supreme Court's narrow issue of whether an option on foreign currency was a "transaction in foreign currency," the Ninth Circuit in *Frankwell* focused on the entire meaning of the term "board of trade" in the Treasury Amendment.[66]

The district court below had held that Frankwell was not a "board of trade" as used in the Treasury Amendment and thus not under CFTC jurisdiction.[67] In adopting the district court's holding, the Ninth Circuit first looked to the statutory definition of "board of trade" contained in § 1a(1) of the CEA.[68] After reviewing the statutory definition, the court stated that applying the plain meaning from the statutory definition of "board of trade" to the Treasury Amendment would render the amendment meaningless.[69] Because of this potential outcome, the court turned to the legislative history associated with the Treasury Amendment to determine the meaning Congress intended to attach to the phrase "board of trade," as it applies to the Treasury Amendment.[70]

The court noticed that the legislative history constantly referred to the terms "on organized exchanges" and "formally organized futures exchange."[71] The court also looked to the letter from the Treasury Department to the Senate Committee, commonly known as the "Treasury Letter," regarding the Treasury's concerns that the CEA as it was proposed would grant the CFTC jurisdiction over foreign currency transactions other than on organized exchanges.[72] Included in the Treasury Letter was a proposed amendment to the CEA limiting the jurisdiction of the CFTC over certain foreign currency transactions.[73] The Senate adopted the Treasury's proposed amendment almost verbatim.[74] The Ninth Circuit interpreted the language of the Treasury Letter and the proposed amendment as an attempt by the Treasury to draft language exempting the entire off-exchange markets from CFTC regulation.[75] After a review of the pertinent legislative history regarding the Treasury Amendment, the court determined that Congress intended a narrower definition of "board of trade" for the Treasury Amendment than the broad statutory definition of "board of trade" contained in § 1a(1) of the CEA and held that Congress intended the Treasury Amendment to exempt all off-exchange transactions in foreign currency.[76]

b. *CFTC v. Standard Forex*

Before the Ninth Circuit addressed the "board of trade" issue in *Frankwell*, the Eastern District of New York had the opportunity to examine the same issue in *CFTC v. Standard Forex*.[77] Unlike *Frankwell*, the court in *Standard Forex* did not differentiate between the statutory definition of "board of trade" in § 1a(1) and the definition of "board of trade" as it is used in the Treasury Amendment.[78] The court noted that several other courts had previously interpreted the term "board of trade" broadly.[79] The *Standard Forex* court determined that because applying the statutory definition of "board of trade" to the term as it is used in the Treasury Amendment would mean that the "unless conducted on a board of trade " clause in the amendment would threaten to "swallow the whole," it must look to the legislative history to determine the purpose behind the enactment of the Treasury Amendment.[80]

The court noted that the CEA was expanded in 1974 because many important futures markets were unregulated, including a number of foreign currency markets, and that Congress determined that persons trading on those markets should receive the same protection as those trading on regulated markets.[81] Although the court noted that the Treasury Amendment was added to the CEA in order to pare back the expansion of the CEA into foreign currency instruments, unless such trading is conducted on a formally organized futures exchange,[82] the court focused on the rationale of protecting unsophisticated investors in determining the definition of "board of trade." The court held that Congress "intended to exempt only Interbank transactions that were already regulated by the banking regulatory agencies."[83] The court also appeared to find that the off-exchange market consists of two distinct markets, one being the Interbank market, which includes banking institutions regulated by the Federal Reserve and the Comptroller of the Currency and which involves highly sophisticated participants, and the second being all other participants which are not under federal banking regulation. Only by defining "board of trade" in such a broad manner and by finding two distinct off-exchange markets, could the court attempt to provide a remedy for Standard Forex, Inc.'s defrauded customers.[84]

c. The *Rosner* Line of Cases: *Rosner v. Emperor International Exchange, Co.; Rosner v. Gelderman, Ltd.;* and *Rosner v. Peregrine Finance Limited*

Recently, the United States District Court for the Southern District of New York interpreted the meaning of the term "board of trade" as it applied to the Treasury Amendment in the *Rosner* line of cases.[85] The district court quickly determined that, based on the Supreme Court's holding in *Dunn*, the transactions entered into by Korbean, the company in which Rosner was the court-appointed receiver, were "transactions in foreign currency" within the meaning of the Treasury Amendment.[86] After addressing that issue, the court stated that the "sole issue was whether the transactions at issue were 'conducted on a board of trade'."[87] The court looked first to the statutory definition of "board of trade" and stated that while several cases outside of the Second Circuit have interpreted the term "board of trade," neither the Second Circuit nor the Supreme Court has addressed the issue.[88] The court then discussed the Ninth Circuit's holding in *Frankwell.* It noted that the *Frankwell* court determined that the term "board of trade" was ambiguous, and thus had turned to the legislative history of the Treasury Amendment.[89] While the *Frankwell* court concluded that Congress intended "transactions conducted on a board of trade" to mean only "on-exchange" trades,[90] the district court noted that the *Frankwell* decision expressly disagreed with the previous decision by the district court for the Eastern District of New York in *Standard Forex.*[91] After reviewing *Standard Forex* and the legislative history of the CEA, the *Rosner* court agreed with the court in *Standard*

Forex and held that the Treasury Amendment only exempted "off-exchange" Interbank transactions which are already regulated by the federal banking authorities.[92]

3. Conclusion

The cases discussed above show that courts have varied in interpreting the applicability of the CEA to foreign currency operations. While the Supreme Court clearly defined what was a "transaction in foreign currency" in *Dunn,* it did not address the issue of whether the CEA grants jurisdiction to the CFTC over off-exchange foreign currency operations.[93] Several courts have addressed the issue of the correct definition of "board of trade" as it applies to the Treasury Amendment. These decisions range from the Ninth Circuit's holding in *Frankwell* that all off-exchange transactions are exempt from the CEA's coverage to the *Salomon Forex* and *Rosner* court decisions finding that only Interbank transactions between sophisticated investors were exempted. It is likely that as more cases are brought against foreign currency operations, the disagreement between the courts regarding the applicability of the CEA to foreign currency will only grow, and certainty as to the proper definition of "board of trade" as applied to the Treasury Amendment will not exist until the matter is addressed either by the Supreme Court or by Congress.

IV. DISPELLING ARGUMENTS REGARDING THE EXCLUSIVITY AND PREEMPTION OF THE CEA OVER FEDERAL AND STATE SECURITIES LAWS

With the recent rise in fraud involving foreign currency instruments, it is necessary to address the issues regarding the exclusive grant of jurisdiction given to the CFTC by the CEA over certain types of commodity transactions and how that exclusive jurisdiction affects the application of federal and state securities laws to commodity-related activities, specifically foreign currency transactions. Section 2 of the CEA grants exclusive jurisdiction to the CFTC over certain commodity investments, but it contains several limitations to that jurisdiction, including the future delivery requirement, two savings clauses, and the Treasury Amendment.[94]

Also, during the CFTC's reauthorization processes in 1978 and 1982, Congress noted that the CFTC did not have the resources to regulate all off-exchange commodities fraud and thus amended the CEA in order to expand the role of federal and state regulators.[95]

A. Exclusive Jurisdiction Granted to the CFTC and the Limits on that Grant by the "Treasury Amendment" and the "Future Delivery" Requirement

1. CFTC Exclusive Jurisdiction

The first sentence of § 2 grants the CFTC exclusive subject matter jurisdiction over commodity futures, options on futures, and "leverage" commodity transactions.[96] This first sentence is the provision in the CEA which preempts federal and state securities laws, as well as state commodities laws, with respect to the transactions enumerated within the sentence. This provision does not grant the CFTC exclusive jurisdiction over securities, such as investment contracts, which involve the instruments or transactions enumerated in the first sentence of § 2, as the term security or securities are not found within the exclusive jurisdiction provision of § 2.

2. The Treasury Amendment

As previously discussed, the Treasury Amendment was added to the CEA at the request of the Treasury Department for the purpose of exempting certain foreign currency transactions, and other enumerated instruments, from the jurisdiction of the CFTC.[97] Many foreign currency promoters have attempted to mischaracterize the Treasury Amendment and the holdings in *Dunn* and *Frankwell* as mandating that the amendment does not allow federal or state securities agencies to regulate transactions involving foreign currency. In reality, there are no reported cases holding that federal or state securities regulators are preempted by the Treasury Amendment from enforcing their respective securities laws against the offer and sale of securities which involve transactions or instruments in foreign currency.[98] It is also interesting to note that Justice Ginsberg, in the *Dunn* oral argument, stated that the activities entered into by Dunn and Delta Consultants created investment contracts, even though those activities included transactions involving foreign currency.[99] The Treasury Amendment limits the jurisdiction of the CFTC, not the jurisdiction of securities regulators, and there have been no reported opinions found holding that the Treasury Amendment has any effect, preemptive or otherwise, other than on the jurisdictional grant to the CEA.[100]

3. For "Future Delivery": Spot and Forward Transactions

The CEA grants exclusive jurisdiction to the CFTC over "transactions involving contracts of sale for a commodity for future delivery."[101] The Treasury Amendment also exempts from CFTC jurisdiction transactions in foreign currency "unless such transactions involve the sale thereof *for future delivery* . . . ." (Emphasis added).[102] The CEA states that the "term 'future delivery' does not include any sale of any cash commodity for deferred shipment or delivery."[103]

Spot and forward transactions do not involve future delivery, but are instruments that involve deferred shipment or delivery.[104] The spot market is often referred to as the "cash market" because it involves the actual purchase of the underlying commodity, even though in reality, through the use of very small margin requirements, the investor pays only a small amount of the actual purchase price.[105] The CEA, legislative history and relevant case law indicate that the CFTC's jurisdictional grant covers only activities involving commodities for future delivery and thus does not cover spot and forward transactions.

In *Salomon Forex*, the Fourth Circuit stated that "Congress never purported to regulate spot transactions or cash forward transactions where the commodity is presently sold but its delivery is, by agreement, delayed or deferred."[106] The court also noted that futures regulated by the Act do not include transactions involving the actual or deferred delivery of the commodity.[107] In *CFTC v. Co. Petro*,[108] the Ninth Circuit noted that even though the defendant was engaged in both spot and futures markets, the CFTC took action only as to the futures trading activity and not on the spot market activity.[109] The Eastern District of New York, in *Bank Brussels Lambert v. Intermetals Corporation*,[110] also addressed the issue of spot transactions and, after applying the Second Circuit's reasoning in *American Board of Trade,*[111] held that the CEA covers only commodities for "future delivery" and because the transactions in question were on the spot market, they were not covered by the CEA.[112]

Few courts have had the opportunity to address the issue of when a spot or forward transaction can become a transaction in a commodity for future delivery, and thus be under the jurisdiction of the CFTC. The Ninth Circuit in *Frankwell* refused to address the issue of whether the foreign currency transactions entered into by Frankwell Bullion, Ltd. were futures or spot trades. It agreed with the district court's holding that "whether the foreign currency transactions are futures or spot trades, they are exempted from CFTC jurisdiction because they are not . . . on a board of trade."[113] In *Standard Forex*, the Eastern District of New York addressed the issue of whether spot transactions could be considered futures transactions.[114] The court determined that although all of the transactions occurred on the spot market, the positions were maintained open for long periods of time and there was no expectation of actual delivery, thus making them futures.[115]

B. The Role of the Savings Clauses of § 2(i), and the Grants of Jurisdiction to Federal and State Authorities through § 13a-2(1) and § 16(e).

1. The Savings Clauses

The second sentence in § 2(i) of the CEA is a statutory savings clause and was enacted to avoid CFTC infringement into the Securities and Exchange Commission's territory[116] and to preserve a measure of state authority.[117] By enacting this savings clause, Congress expressly specified that except for the grant of exclusive CFTC jurisdiction "hereinabove provided" which is contained in the first sentence of § 2(i), "nothing contained in this section shall (I) supersede or limit the jurisdiction at any time conferred on the Securities and Exchange Commission or other regulatory authorities under the laws of the United States or of any State, or (II) restrict . . . other authorities from carrying out their duties and responsibilities in accordance with such laws."[118]

The plain meaning of the phrase "this section" contained in the first savings clause is all of § 2, including subsections (i) and (ii).[119] This savings clause allows for concurrent jurisdiction between the CFTC and federal and state securities regulators over certain commodity-related securities which are not covered by the exclusive jurisdiction provision of § 2.[120] This first savings clause makes it clear that if an instrument is not included in the list of enumerated ones in the first sentence of § 2(i), the CFTC does not have exclusive jurisdiction and thus federal and state securities regulators are not preempted from regulating activities involving such instruments.

The second savings clause is contained in the third sentence of § 2(i) and is a more expansive savings clause enacted to preserve the jurisdiction of both the state and federal judiciary.[121] This section mandates that the exclusive jurisdiction provision contained in the first sentence shall not limit the jurisdiction of any federal or state court.

2. Expanding State Jurisdiction Through CEA § 13a-2

During the 1978 reauthorization process for the CFTC, Congress addressed the need for additional regulation over off-exchange commodities activity, stating that it had become evident that "the CFTC's budget and resources were inadequate to control a variety of off-exchange commodities activities, some of which are fraudulent in nature."[122] Congress amended the CEA to include § 13a-2 which granted additional jurisdiction to the states under the CEA,[123] allowing states to seek injunctions or civil damages in federal court for violations of the CEA against individuals other than a contract market, clearinghouse, floor broker, or floor trader.[124] States may also bring actions in state court based on violations of any general civil or criminal anti-fraud statute.[125] This amendment was the first step taken by Congress after the enactment of the 1974 Treasury Act to address the growing amount of fraud in certain commodity operations. This exemption from exclusive jurisdiction for the states does not appear to allow states to apply their respective securities laws as they are not general civil or criminal statutes.

3. The "Open Season Provision"

In 1983, Congress amended the CEA to include § 16(e).[126] The adoption of § 16(e) is perhaps the most important addition to the CEA as it pertains to federal and state securities regulators. Section 16(e) begins with the phrase "Nothing in this chapter shall supersede or preempt..." meaning that this section applies to all of the CEA, and that even the § 2(i) exclusive grant of jurisdiction is no longer the only controlling factor when it comes to preemption of federal and state law by the CEA.[127] The enactment of § 16(e) allows securities regulators to argue that the exclusivity provisions and exemptions contained in § 2 are not determinative of their securities jurisdiction, but rather § 16(e) outlines when federal or state securities laws are superseded or preempted by the CEA.

The legislative process surrounding the enactment of § 16(e) included input from industry representatives and securities regulators.[128] This section was labeled the "open season" provision of the CEA, as the House Report declared open season on off-exchange commodities fraud.[129] The "open season" provision allows any federal or state law to be applied to individuals who, although required to be registered, do not obtain registration or designation under the CEA or who engage in commodity-related transactions outside the CEA's regulatory structure, such as off-exchange futures or commodities investments.[130] The "open season" provision does exempt a limited number of activities from the grant of federal and state jurisdiction, as the provision does not apply to exchange-traded futures, authorized commodity options, and regulated leverage transactions.[131] Because almost all fraudulent foreign currency operations do not involve trading on an exchange or authorized options, these exemptions should have little or no effect on the regulation of foreign currency fraud by securities regulators.

The legislative history is quite clear regarding the purpose for enacting the "open season" provision and the limited exemption from federal and state regulation contained within. The House report stated that the CFTC lacked the necessary resources to control a variety of off-exchange commodities fraud[132] and the Senate report agreed, stating that it had become clear that the CFTC alone could not be primarily responsible for policing all of the enterprises operating under a "commodity" theme.[133] The Senate Committee was eager to encourage state use of § 16(e) and to involve them in actions against individuals offering off-exchange investments under a "commodity" theme.[134] The Senate went on to say that the "open season" provision would specifically authorize all federal and state officials to prosecute all off-exchange commodity enterprises under any relevant law or regulation.[135]

It is clear there was a need for additional regulation and prosecution of commodity theme offerings. The "open season" provision and its related legislative history show a clear intent by Congress to include federal and state securities regulators in the grand scheme of off-exchange commodities regulation.

C. Conclusion

The CEA grants specific exclusive jurisdiction to the CFTC over certain enumerated instruments which involve "future delivery," grants concurrent jurisdiction over certain instruments with other federal and state regulators and also exempts certain transactions from their jurisdiction. The amending of the CEA to include § 13a-2 expanded the authority of state regulators by allowing them to bring actions under the CEA and to enforce their general anti-fraud laws. In addition, the "open season" provision of § 16(e) allows both federal and state regulators to bring actions under any relevant law for any commodity-related fraud and grants preemptive jurisdiction to the CFTC over a few exchange-traded and registered instruments. Once the original grant of exclusive jurisdiction in § 2 and the limitations on that jurisdiction are viewed under the light of the original savings clauses, the Treasury Amendment, and the later added "open season" provision, it is clear that federal and state securities regulators are free to prosecute securities-related activity operating under a commodity theme.

V. APPLICATION OF INVESTMENT CONTRACT ANALYSIS: DEFINING FOREIGN CURRENCY TRANSACTIONS AS "SECURITIES"

After the rulings in *Dunn* and *Frankwell* and the addition of §§ 13a-2 and 16(e) to the CEA, the trend appears to be in the direction of expanding the scope of the Treasury Amendment's exemption from CFTC jurisdiction and adding enabling legislation to the CEA to permit additional regulation by federal and state regulators over the variety of off-exchange fraudulent commodities transactions which continue to increase in number. While the threat of regulation by the CFTC over the Interbank market declines, however, unsophisticated investors must be protected from securities fraud. One of the most useful tools to characterize off-exchange foreign currency transactions as "securities" and bring them within the jurisdiction of federal and state securities regulators is the investment contract theory. The Securities and Exchange Commission[136] as well as several states[137] have used the investment contract theory as an enforcement tool against fraudulent foreign currency offerings. Because most of the states have adopted the investment contract elements as established in the landmark case of *SEC v. W.J. Howey Co.*[138] and its progeny, this section of the article will focus on federal investment contract case law and will discuss how the elements of the investment contract can be applied to fraudulent foreign currency offerings.

In applying the investment contract analysis to fraudulent foreign currency offerings, enforcement attorneys must focus on the relationship between the promoter and the investor instead of the relationship between the promoter and the entity through which the promoter trades foreign currency. This is an important point, because it has been argued by promoters that securities regulators are attempting to regulate the foreign currency market as a whole, and that such regulation would have an adverse impact on the usefulness and efficiency of the Interbank market.[139] However, securities regulators have little, if any, interest or expertise in regulating a highly-complex market in which the main players are commercial banks and other highly sophisticated financial entities. Instead, we have the goal of protecting investors in the relationship created by the offer and sale of securities, whose underlying item of value is foreign currency, by the promoter to the investor.

Likewise, the SEC was not attempting to regulate the citrus grove industry when it brought the *Howey* case, or the oil and gas industry when it brought the *SEC v. C.M. Joiner* case, or the real estate industry when it brought the *Los Angeles Trust Deed & Mortgage* case.[140] The purpose of the investment contract theory is to adapt the numerous varieties of investment schemes which could not possibly be listed by name in the definition of a security. Due to their nature, these investments invariably constitute a security based on the entrustment by a single investor or a group of investors of their money to someone else to invest in the underlying good, service, or product, and the corresponding reliance by the investor(s) on that person's skills and expertise to make the investment work and make them more money, with little or no effort on the investor's part. This is invariably the kind of relationship which exists between investors and foreign currency promoters, and regardless of the underlying currency investment, should be subject to securities regulation.

A. *SEC v. W.J. Howey Co.*

The investment contract test was articulated by the Supreme Court in *Howey,* which involved the application of the term "investment contract" found in § 2(a)(1) of the Securities Act of 1933[141] to an offering of units of a citrus grove development coupled with a contract for cultivating, marketing, and remitting the net proceeds to the investor.[142] The Court defined the term "investment contract" with a test which requires 1) the investment of money; 2) in a common enterprise; 3) with an expectation of profits; 4) to come solely from the efforts of others.[143] In the Court's opinion, Justice Murphy stated that this definition embodies a flexible principle that is capable of adaptation to meet the countless schemes devised by those who seek to use the money of others on the promise of profits.[144] Relying on the Court's admonition about flexibility, the Ninth Circuit in *SEC v. Glenn W. Turner Enterprises, Inc.*[145] brought into question the inflexibility of the term "solely" in the fourth element of the *Howey* test, and reasoned that promoters could easily circumvent the "*solely* from the efforts of others" element by requiring investors to exercise some efforts on behalf of the enterprise.[146] Acknowledging the Ninth Circuit's rationale, the Supreme Court restated the fourth element of the *Howey* test in 1975 in the case of *United Housing Foundation, Inc. v. Forman,*[147] to require only the "entrepreneurial or managerial efforts of others."[148] The Court in *Forman* noted the rationale of the *Glenn Turner* court that the word "solely" must be construed realistically to include those schemes which, in substance, involve securities.[149]

Since 1975, the revised *Howey* test has been widely applied by both state and federal courts alike to a variety of investment schemes. Because of the test's development through the case law and because of its evolving adaptation to meet various schemes, promoters often argue ignorance when they are found to have offered and sold investment contracts. However, the Court in *Howey* stated that even though the respondent's failure in that case to abide by the Securities Act resulted from a bona fide mistake as to the law, such a failure could not be sanctioned under the Act.[150] Therefore, securities regulators should not hesitate to apply the test to fraudulent foreign currency offerings for the first time in their jurisdictions, as long as the elements discussed below are present in the offering.

1. Investment of Money

In *International Brotherhood of Teamsters v. Daniel,*[151] the Supreme Court stated that in every decision of the Court recognizing the presence of a security, the investor gave up some tangible and definable consideration in return for an interest that had substantially the characteristics of a security.[152] The Court, relying on the rationale of *Forman* stated that the term "investment" should be construed realistically and include consideration taking the form of cash, goods, or services in order to meet the definition of an investment contract.[153]

Proving this element is not difficult in foreign currency offering cases. All of the enforcement actions regarding foreign currency offerings which have been brought or are pending are uncomplicated in the sense that they do not involve the payment of goods or services.[154] The typical foreign currency transaction involves the payment of cash by the investor to the foreign currency promoter for the purpose of investing in foreign currency or options in foreign currency.[155]

2. Common Enterprise

The common enterprise element of the *Howey* test is the most disputed by the courts as to how it should be defined.[156] Some courts apply the common enterprise test strictly and require that the investors' fortunes be linked with each other or with the promoter. Other courts ignore the common enterprise requirement and simply require dependence by the investors on the efforts or expertise of the promoter. Scholastically speaking, there are three theories of common enterprise currently being used by the circuit courts: 1) horizontal commonality; 2) broad vertical commonality; and 3) narrow or strict vertical commonality. The Second Circuit recently discussed these three theories and explained which circuits follow each approach in *Revak v. SEC Realty Corp.*[157] Realistically speaking, however, most courts which have applied the common enterprise test have not been specific as to which theory or approach they are using, and have applied the test flexibly according to the equitable considerations in each case.

a. Horizontal Commonality

In a common enterprise marked by horizontal commonality, the fortunes of each investor depend upon the profitability of the enterprise as a whole.[158] In *Revak,* the second circuit summarized the horizontal commonality approaches used in several other circuits to come up with this definition of horizontal commonality: "the tying of each individual investor's fortunes to the fortunes of the other investors by the pooling of assets, usually combined with the pro-rata distribution of profits."[159] Although the Supreme Court has not held that pooling of investor funds is a requirement for a common enterprise, the Third, Sixth, and

Seventh circuit courts have adopted this approach.[160] Since horizontal commonality presupposes the existence of multiple investors, there can be no investment contract when there is only a single investor.[161]

Horizontal commonality between investors will be found to exist in the majority of foreign currency offerings. Promoters often pool investor funds to purchase large positions or, to use the parlance of the market, make "bulk buys" in the foreign currency market, and distribute any profits to investors in proportion to their respective investments. Promoters in these types of offerings often track customer positions through internal accounting and provide investors with statements reflecting the status of their holdings, but the funds are typically maintained in the name of the foreign currency promoter in an "omnibus"[162] account at the entity with which the promoter trades foreign currency.[163] Although promoters in these types of offerings argue that investors have their own accounts, this argument is easily defeated by virtue of the pooling of funds and the fact that no individual purchases are made for each investor account. To the contrary, all investors in these types of offerings make profits or losses as the result of a single transaction by the foreign currency promoter. Therefore, the successes and failures of each investor is linked, through the promoter, to the success of other investors, giving them a common goal to succeed.

b. Broad Vertical Commonality

Under the broad vertical approach, the emphasis is on the relationship between the investors and the promoter, and a common enterprise may exist even though there is no pooling of investor funds.[164] Arguably, a common enterprise may even exist if there is one investor, both with respect to broad vertical commonality and narrow vertical commonality, which will be discussed further below.[165] Broad vertical commonality was pioneered by the Fifth Circuit. In *SEC v. Continental Commodities Corp.*,[166] the Fifth Circuit embraced what it termed a "resilient standard" under which "the critical inquiry is confined to whether the fortuity of the investments collectively is essentially dependent upon promoter expertise."[167] Continental Commodities maintained numerous discretionary accounts for trading in and rendering investment counseling on options on commodities futures.[168] Continental undertook to recommend which options to invest in, when to sell or exercise the options, and if exercised, when to sell the specific futures contract.[169] Each individual invested in different options, the accounts of the individual investors were unrelated, and there was no understanding or expectation that investors would share in a common fund comprised of the returns on their investments.[170] Lacking the market acumen possessed by promoters, investors relied on Continental's guidance for the success of their investment.[171] The fact that Continental invested in different options on commodities futures for some investors and not for others did not vitiate the fact that the success of the trading enterprise and individual customer investments was contingent upon the investment counseling of Continental.[172]

The broad vertical commonality test has been criticized for merging the common enterprise element with the fourth element of the *Howey* test (solely from the efforts of others). In *Revak,* the Second Circuit refused to adopt the broad test, stating that "[i]f a common enterprise can be established by the mere showing that the fortunes of investors are tied to the efforts of the promoter, two separate questions posed by *Howey* - whether a common enterprise exists and whether the investors' profits are to be derived solely from the efforts of others - are effectively merged into a single inquiry: 'whether the fortuity of the investments collectively is essentially dependent upon promoter expertise.'"[173] The court felt that broad vertical commonality was inconsistent with *Howey* and that it effectively did away with the common enterprise requirement.[174]

The Fifth Circuit recently had an opportunity to revisit its decision in the *Continental Commodities* case in *Long v. Shultz Cattle Co.*[175] In *Long*, which involved cattle feeding consulting agreements, Shultz Cattle Company requested an en banc rehearing to allow the Fifth Circuit to reconsider *Continental Commodities'* approach to the common enterprise element.[176] Shultz Cattle argued that the broad form of vertical commonality effectively eliminates the second prong of the *Howey* test and is at odds with the stricter approaches taken in other circuits which require horizontal commonality or narrow vertical commonality.[177] The court acknowledged that the *Continental Commodities* decision seemed to hold that a particularly strong showing of the last prong of the *Howey* test "could compensate for a weak showing of the second prong," but refused to reconsider *Continental Commodities*.[178]

The investors in Shultz Cattle Company were individuals who possessed neither the knowledge nor the desire to buy, raise, and market cattle on an individual basis.[179] Investors looked to Shultz Cattle Company's touted experience in the cattle business and commodity market to manage their cattle purchases.[180] Therefore, the offering met the Fifth Circuit's broad vertical commonality test. However, the investment schemes offered by Shultz Cattle Company were securities under *any* circuit's definition due to the pooling of assets to purchase the cattle (horizontal commonality) and payment to the promoters of a flat fee for rendering of professional advice (narrow vertical commonality), and for this reason the court refused to grant the rehearing.[181] Thus, the court stated that any attempt to use the facts of this case to overhaul the Fifth Circuit's definition of common enterprise would only further confound an already perplexing and controversial area of securities law.[182]

The court, however, stated that in a factual context more analogous to *Continental Commodities*, and subject to the requirements of its en banc proceedings, it would take a fresh look at the policy issues raised in that case.[183] The court's remarks seem to indicate that given the opportunity to revisit the discretionary commodity trading account issue, it will swing in favor of the approach taken by the Third, Sixth, and Seventh Circuits, which have held that these types of accounts are not securities.[184] However, whereas these circuits have held that discretionary commodity trading accounts are not securities because there is no pooling, the court in *Long* hinted in its opinion that given the opportunity to take a fresh look at *Continental Commodities*, it would hold that discretionary commodity trading accounts are not securities because they involve stand-alone transactions between an adviser and an investor for a flat commission, in which the trading accounts are unaffected by the scale of the brokerage operation or, indeed, by whether there are any other investors at all.[185]

Most foreign currency offerings are likely to satisfy the broad vertical commonality approach because of the investors' dependence on the self-proclaimed expertise of the promoter for their profits, even if the promoter does not share in the profits or losses. Promoters of foreign currency offerings almost always tout their experience and expertise in the foreign currency market and emphasize their ability to make suitable purchases and sales of foreign currency or options on foreign currency. Especially in offerings where investor funds are pooled, which of course would create horizontal commonality, trades must be made on a discretionary basis without prior approval from each investor because the promoter makes a single trade on behalf of all the investors. Thus, investors must rely on the promoter to make profitable trades. However, even in offerings where the promoter consults with the investor and makes recommendations prior to each purchase and sale of foreign currency, most investors have little, if any, experience in trading in the foreign currency market, and must rely on the claimed expertise and recommendations of the promoter to make their profits. Thus, these types of accounts are de facto discretionary accounts, because the investors must rely on the trading expertise of the promoter as to which foreign currencies to purchase and sell, and when.

Furthermore, foreign currency investors often are not even familiar with the name of the entity or entities with which the promoter trades, and are forced to rely on the promoter's ability to choose the right trading entities, set up an omnibus trading account in the promoter's name at the trading entity, ensure that any trades in the account are handled correctly and efficiently, and keep track of trades in the account. In addition, in foreign currency offerings where investor funds are pooled, investors often rely on promoters to distinguish and track their individual holdings from the rest of the pooled funds. Thus, in foreign currency offerings the investors are extremely dependent on not only the success of the promoter in trading the account, but also the efforts of the promoter in running the enterprise.

c. Narrow or Strict Vertical Commonality

Narrow or strict vertical commonality requires that the fortunes of the investors be tied to the fortunes of the promoter.[186] The Ninth Circuit established the concept of narrow vertical commonality in *SEC v. Glenn W. Turner Enterprises, Inc.*[187] As defined by *Glenn Turner*, narrow vertical commonality exists when "the fortunes of the investor are interwoven with and dependent upon the efforts and success of those seeking the investment or of third parties."[188]

Instead of requiring a dependence on the promoter like the broad vertical commonality test, the narrow vertical commonality test requires an *interdependence* between the promoter and the investor in terms of shared profits or losses. Thus the narrow test requires a direct relationship between the success (as opposed to the efforts) of the promoter and that of the investors.[189] As in the case of broad vertical commonality, narrow vertical commonality arguably may exist even if there is only one investor.

In *Brodt v. Bache & Co., Inc.*,[190] the Ninth Circuit applied the narrow vertical commonality test to a discretionary commodities trading account and held that there was no commonality because the success or failure of Bache as a brokerage house did not correlate with individual investor profit or loss. On the contrary, Bache could reap large commissions for itself and be characterized as successful, while the individual accounts could be wiped out. Strong efforts by Bache would not guarantee a return, nor would Bache's success necessarily mean a corresponding success for Brodt. Weak efforts or failure by Bache would deprive Brodt of potential profits, but would not necessarily mean that Brodt would suffer losses. Thus, since there was no correlation with either the success or failure side, the court held that there was no common enterprise between Bache and Brodt.[191]

Thus, narrow vertical commonality may not exist if the promoter is profiting through commissions, even if the investor is losing money, because of the requirement of the narrow test that both the promoter and the investor share in the profits and losses.[192] Therefore, in most foreign currency offerings narrow vertical commonality does not exist because promoters typically profit through trading commissions. Narrow vertical commonality is more likely to exist in an arrangement where the promoter shares in the profits by earning a fee based on the returns in the account, which would probably occur in a situation where the investor wants to engage in aggressive trading in foreign currency, and the promoter agrees to a fee-based arrangement so that the funds in the account are not swallowed by trading commissions.

There is a definite trend by the courts that discretionary commodity trading accounts are not securities because they do not have the characteristics required by horizontal or narrow vertical commonality. While these accounts may fit the mold of broad vertical commonality as in the case of *Continental Commodities*, even that decision is now subject to question based on the Fifth Circuit's comments in *Long* that, given the opportunity, it would reconsider its decision in that case. However, other than being consciously aware of their existence, securities regulators should not be too concerned by how these decisions affect foreign currency offerings. The courts have always held that where there are broadly marketed, large-scale operations in which investors' expectations of profitability are dependent upon the managerial expertise of others for the success of the enterprise, the fundamentals of *Howey* are present for the finding of a security. For example, in *Long*, the court stated that the economics of the broadly marketed, large-scale cattle feeding operation, in which investors relied upon the managerial and cattle-raising expertise of others were fundamental *Howey* economics. As most foreign currency offerings are broadly-marketed, large-scale operations involving hundreds of investors who rely on the promoters' expertise in the foreign currency markets and the promoters efforts in performing a variety of additional efforts, public policy mandates that these offerings be defined as securities.

3. Expectation of Profits

The expectation of profits element of the *Howey* test was defined by the *Forman* case, in which the Court stated that "[b]y profits, the Court has meant either capital appreciation resulting from the development of an initial investment, or a participation in earnings resulting from the use of investors' funds."[193] In foreign currency offerings, there is little dispute that investors expect to earn profits from investing in foreign currency. Investors are promised that they can earn substantial returns, ranging from 50% to 300% in a matter of weeks or months, by taking advantage of fluctuations in the foreign currency market. Therefore, foreign currency investors expect to participate in earnings resulting from the use of their funds in trading on foreign currency.

In many fraudulent foreign currency offerings, investors are convinced to invest more money after receiving assurances that their accounts have substantially increased in value. For example, in *State of Texas v. Options Trading Group,*[194] after investing an initial amount and receiving assurances that it had increased in value, investors received solicitations from foreign currency promoters every few days assuring them that if they invested additional sums of money, their investments would return $5,000 for each point of movement, then would double, then would earn them $100,000 in profits, then would reach half a million dollars in a week, etc. Each time that investors agreed to send more money, they were motivated by an expectation of profits.

4. Entrepreneurial or Managerial Efforts of Others

As discussed in the beginning of this section, the Ninth Circuit questioned the literal limitations of *Howey's* fourth element ("solely from the efforts of others") in *Glenn Turner*. The Supreme Court in *Forman* noted the Ninth Circuit's rationale, holding that the fourth element of the *Howey* test requires only the "entrepreneurial or managerial efforts of others." Most circuits[195] have followed this reasoning in finding that "efforts" refer to managerial efforts or to the right to make a decision that will determine whether the investment is a success or a failure.[196] "If the investor shares in the management of the project and the decisions that determine whether the investment is a success or a failure, then he does not need the protection of the securities acts because he is the master of his own destiny, and his position gives him the right to demand all the information necessary to make the appropriate business decisions."[197]

Foreign currency promoters often argue that investor profits are derived from fluctuations in the foreign currency markets, and not from the efforts of the promoters themselves. However, the fluctuating market price merely provides the *motive* for trading.[198] It is the efforts of the promoter that determine whether the investor actually receives the profits. Investors in foreign currency offerings rely on promoters to use their expertise, which the investors do not have, to select the currencies or options necessary to assure profits in their accounts. Foreign currency promoters actively seek and solicit investors who are not familiar with foreign currency markets. Investors rely on foreign currency promoters to know what procedure to use to purchase and sell foreign currencies. Thus, the promoter's expertise will consist of using discretion to select the most profitable foreign currency to purchase, buying the currency for the investors, holding it, and then reselling it at the appropriate time. In the case of currency options, a promoter must determine what type of option to purchase, when to exercise the option, if at all, and when to close the position by entering into an opposing position. The decisions of the promoter affect the success of the investor because significant losses may occur if the promoter does not exercise the option. Investors in foreign currency offerings do not exert any significant efforts to make a profit, and it is always the managerial efforts of the foreign currency promoter that determine their trading successes and failures.

VI. CONCLUSION

Hopefully, this article has alerted the reader about what type of arguments to expect when bringing enforcement actions against foreign currency offerings, and how to respond to those arguments. Additionally, it was the intent of the authors to arm enforcement attorneys with the most important cases, legislative materials, and supplementary sources which are applicable in the context of foreign currency offerings.

There are several issues regarding the jurisdiction of securities regulators over investments which involve foreign currency. The CEA preempts certain commodity offerings and transactions from other federal and state jurisdiction, while allowing for concurrent jurisdiction between the CFTC and federal and state securities regulators in certain circumstances. The CEA also limits the jurisdiction of the CFTC over certain types of commodity transactions involving certain types of instruments. So while the CEA does grant exclusive jurisdiction to the CFTC for specific types of transactions, it also limits the jurisdiction regarding many off-exchange transactions. Over the years, many courts have addressed the issue of CFTC jurisdiction. While the courts have focused on the limitations imposed by the CEA, the holdings by many of the courts have differed on the proper interpretation of the CEA and of its legislative history. This inconsistency has caused uncertainty as to the role of the CFTC, its exclusive jurisdiction, and the limits to its jurisdiction, which in turn has caused uncertainty among securities regulators regarding how the CEA affects their respective jurisdictions. While Congress attempted to clarify the jurisdictional issues by adding sections 13a-2 and 16(e) to the CEA, the effect of those sections has not been addressed by any court. There are several cases pending in various states and in federal court concerning the issues of securities regulators' jurisdiction over off-exchange foreign currency offerings and the decisions in these cases could shed additional light on the issue. There is also the possibility of Congress addressing the issue of the role of the CFTC in regulating off-exchange commodities and complex financial instruments and whether to diminish or expand the jurisdiction granted to the CFTC by the CEA.

Enforcement attorneys should use the investment contract test to bring fraudulent foreign currency offerings within the ambit of their regulatory statutes. The authors have attempted to describe the types of foreign currency offerings experienced by securities regulators and to illustrate how the investment contract test may be applied to these offerings. Fraudulent foreign currency offerings will probably eventually diminish in number and promoters will move on to a new type of scheme. At the present time, however, foreign currency offerings are a very "hot" item with promoters, and will continue to be so as long as there is uncertainty regarding the application of the CEA and how it affects the jurisdiction of securities regulators and world news coverage of the volatility in foreign currencies continues to be as prevalent as it presently is. As with anything else, investors will learn that foreign currency offerings are not all they are made out to be. Until then, it is our role as securities regulators to educate investors and to bring actions when necessary to protect investors.

Sonia Mayo is an Enforcement Attorney with the Texas Securities Board. At the time this article was submitted for publication, John Oses was an Enforcement Attorney with the Texas Securities Board. They have worked as a team in investigating foreign currency offerings and drafting pleadings in foreign currency enforcement actions brought by the Texas Securities Board. Any views expressed in this article are those of the authors and not necessarily of the Texas Securities Board or NASAA. *The authors wish to express appreciation to William Steven Bryant, a student intern from the University of Texas School of Law, for his research contributions to this article.*

ENDNOTES

[1] Alabama, Arizona, California, Florida, Georgia, Idaho, Kansas, North Carolina, New Hampshire, Massachusetts, and Texas have all brought either administrative, civil, or criminal actions regarding offerings involving foreign currency. The Securities and Exchange Commission has also brought several actions against foreign currency offerings.

[2] Dunn v. CFTC, 519 U.S. 465 (1997).

[3] *CFTC v. Frankwell Bullion, Ltd*, 99 F.3d 299 (9th Cir. 1996).

[4] "Interbank" or "off-exchange" transactions do not occur on any regulated exchanges such as the Chicago Board of Trade and the Philadelphia Stock Exchange. The foreign currency offerings in which securities regulators are currently bringing actions and which are discussed in this article involve the Interbank or off-exchange market, as opposed to the regulated national exchanges.

[5] Commodity Exchange Act, 7 U.S.C. § 1, *et seq*. (1996).

[6] 7 U.S.C. § 1a(3). "Commodity": "The term 'commodity' means wheat, cotton, . . . and all other goods and articles, . . . and all services, rights and interests in which contracts for future delivery are presently or in the future dealt in." This definition encompasses futures trading in foreign currencies. *See generally* Treasury Letter, *infra*, note 72.

[7] 7 U.S.C. § 2(i).

The Commission shall have exclusive jurisdiction, except to the extent otherwise provided in section 2a of this title, with respect to accounts, agreements (including any transaction which is of the character of, or is commonly known to the trade as an "option", "privilege", "indemnity", "bid", "offer", "put", "call", "advance guaranty", or "decline guaranty"), and transactions involving contracts of sale of a commodity for future delivery, traded or executed on a contract market designated pursuant to section 7 of this title or any other board of trade, exchange, or market, and transactions subject to regulation by the Commission pursuant to section 23 of this title.

[8] *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946).

[9] For a historic look at commodity options and futures regulation, *see* Thomas A. Tormey, *A Derivatives Dilemma: The Treasury Amendment Controversy And The Regulatory Status Of Foreign Currency Options*, 65 FORDHAM L. REV. 2313, 2323-33 (1997).

[10] The "contract size" is the amount of the underlying commodity to be delivered. The "strike price" or "exercise price" is the price at which the option holder can purchase or sell the underlying commodity to or from the option writer. The "premium" is the price of the option paid by the buyer of the option to the writer of the option. The "expiration date" is the date on which the option and the right to exercise that option ceases to exist. *See generally*, THE OPTIONS INSTITUTE, THE EDUCATION DIVISION OF THE CHICAGO BOARD OPTIONS 'EXCHANGE, OPTIONS: ESSENTIAL CONCEPTS AND TRADING STRATEGIES (1990).

[11] *See* Tormey, *supra* note 9, at 2328.

[12] For further explanation and insight and an overview of foreign currency markets, including a complete glossary of terms, *see* CORNELIUS LUCA, TRADING IN THE GLOBAL CURRENCY MARKETS (Prentice Hall

1995); *see also* RUSSELL R. WASENDORF, SR. & RUSSELL R. WASENDORF, JR., FOREIGN CURRENCY TRADING: FROM THE FUNDAMENTALS TO THE FINE POINTS (McGraw-Hill 1998).

[13] UNITED CURRENCY OPTIONS MARKET, PHILADELPHIA STOCK EXCHANGE, A USERS' GUIDE TO CURRENCY OPTIONS 4 (1996). For a copy of the guide, contact the Philadelphia Stock Exchange, 1900 Market Street, Philadelphia, PA. 19103-3584, telephone: 215/496-5321.

[14] Spot transactions involve an agreement to exchange one currency for another currency, at a set rate of exchange, and are typically entered into for settlement in two (2) days. LUCA, *supra* note 12, at 91. A spot transaction is considered a deferred delivery contract because the cash sale has taken place but delivery is deferred for two days. The CEA covers only "transactions involving contracts of sale of a commodity for future delivery . . . ." CEA § 2(I), and the definition of "future delivery" does not include the sale of any cash commodity for deferred shipment or delivery. 7 U.S.C. § 1a(11). This status will gain importance during the later discussion of preemption under the CEA and exclusive jurisdiction of the CFTC.

[15] *Id.* at 155.

[16] Forex is used as a shorthand term for the Foreign Exchange Market.

[17] LUCA, *supra* note 12, at 91.

[18] *Id.* at 100.

[19] *Id.*

[20] *Id.* at 100-01.

[21] Entering into an opposing position, with the same trading entity with whom the initial position was entered into, will close the corresponding open position. If currency had been purchased, a corresponding position to sell the exact amount of identical currency will "cancel out" or close the position, with the profit or loss being the difference between the price paid for the currency and the price at which the currency was sold, plus or minus any transaction costs, such as commissions or margin costs. If currency had been sold, a position buying the exact amount of identical currency will close that position.

[22] "Storage" and "margin" fees are charged on all positions maintained overnight. There is some debate over the legitimacy of these fees and the fact that they have been used by fraudulent promoters, in addition to commission charges, as a way to extract money from investors' accounts.

[23] A currency option is the right, but not the obligation, to buy or sell a set amount of one currency for another at a predetermined price at a predetermined time in the future. A "call" option allows the individual to purchase the underlying currency and a "put" option allows the individual to sell the underlying currency. The individual purchasing the option is the

option buyer and the individual selling the option is the option seller/writer. An "American" style option may be exercised on any business day prior to the expiration/strike date of the option. A "European" style option may only be exercised on the expiration/strike date. *See* UNITED CURRENCY OPTIONS MARKET, PHILADELPHIA STOCK EXCHANGE, *supra* note 13, at 4; *see also Salomon Forex v. Tauber*, 8 F.3d 966, 971 (4th Cir. 1993); *see also* Tormey *supra* note 9, at 2316 n.5.

[24] *See* LUCA, *supra* note 12, at 270.

[25] *Id.*

[26] *See* THE EDUCATION DIVISION OF THE CHICAGO BOARD OPTIONS EXCHANGE, OPTIONS, *supra* note 10. There are Exchange traded futures contracts with standardized terms, and there are over-the-counter, or Interbank, futures contracts with negotiated terms. *Id. see also Salomon Forex*, 8 F.3d at 971.

[27] *See Salomon Forex,* 8 F.3d at 971. A futures contract is an "executory, mutually binding agreement providing for the future delivery of commodity on a date certain where the grade, quantity and price at the time of delivery are fixed."

[28] *See* LUCA, *supra* note 12, at 92. The delivery date is always set for at least two (2) days after the agreement was consummated, because if delivery was contemplated within two days, the participants would enter into a spot market transaction. A forward contract may also be referred to as a deferred delivery contract. *See also Salomon Forex*, 8 F.3d at 971.

[29] 7 U.S.C. § 2(ii), commonly referred to as the "Treasury Amendment."

[30] *Dunn,* 519 U.S. at 467.

[31] *Frankwell,* 99 F.3d at 304.

[32] 7 U.S.C. § 2(ii).

[33] Tormey, *supra* note 9, at 2327-29.

[34] *Id.* at 2331-33.

[35] *CFTC v. American Board of Trade*, 803 F.2d 1242 (2nd Cir. 1986).

[36] *Id.* at 1248.

[37] *Salomon Forex,* 8 F.3d 966.

[38] *Id.* at 975.

[39] *Dunn,* 519 U.S. at 469.

[40] *American Board of Trade*, 803 F.2d at 1248. The CFTC claimed that the American Board of Trade (ABT) was engaged in the offer and sale of options on various commodities, including gold and silver bullion, silver coins, platinum, copper, plywood, and several foreign currencies. *Id.* at 1244. At the time of the sales, ABT was not registered with the CFTC. The Court determined that all of the commodities offered by ABT were covered by the CEA and turned to the issue of whether the Treasury Amendment excluded

foreign currency from CFTC regulation. *Id.* at 1248. For a comprehensive look at the activities of ABT, *see* Tormey, *supra* note 9, at 2334-36.
[41] 803 F.2d at 1248.
[42] *Id.*
[43] *Salomon Forex,* 8 F.3d at 975. The action by Salomon Forex, Inc. was based on the recovery of a debt. Dr. Laszlo Tauber was a client of SFI and had sustained substantial trading losses and SFI brought suit to recover over 25 million dollars. Dr. Laszlo entered into over 2,700 transactions with SFI and during that period also traded with a dozen other foreign exchange companies and was involved in exchanging billions of dollars worth of foreign currency. The District Court estimated that Dr. Tauber was worth over half a billion dollars. Due to the amount of transactions, his history, and his high net worth, the Fourth Circuit considered Dr. Tauber a sophisticated investor who did not need the protection of a regulatory agency. This may have been a factor in the Court's decision. *Id.* at 969.
[44] *Id.* at 975. The word "unless" appears in what is generally known as the "board of trade proviso" contained in the Treasury Amendment: "Nothing in this chapter shall be deemed to govern or in any way be applicable to transactions in foreign currency ... *unless such transactions involve the sale thereof for future delivery conducted on a board of trade.*" 7 U.S.C. § 2(ii) (emphasis added).
[45] *Salomon Forex*, 8 F.3d at 975.
[46] *Id.*
[47] *Id.*
[48] *Id.*
[49] *Id.*
[50] *Id.* at 976.
[51] *Id.* at 978.
[52] It appears that the court was trying to support the decision in *American Board of Trade,* which involved an unsophisticated investor, while reaching a completely opposite outcome in its own case, which involved a sophisticated investor who was attempting to avoid the application of the CEA by arguing that his debts were unenforceable because they arose from off-exchange futures and options contracts executed in violation of the CEA. It also appears that the court was concerned that its decision could result in a rise in the offer of off-exchange currency contracts to the general public within its jurisdiction. Tormey, *supra* note 9, at 2341. This concern may have prompted the Court to limit its initial finding in order to protect the general public from foreign currency promoters.
[53] *Dunn*, 519 U.S. at 467-80.
[54] *See* Tormey, *supra* note 9, at 2342.

[55] William C. Dunn was the principal of Delta Consultants, Inc., the entity under which the solicitations and transactions were made. Dunn, through Delta Consultants, represented to investors that their funds would be used to invest in options to purchase or sell various foreign currencies. No options were ever sold directly to the investors, but their positions were tracked through internal accounts generated by Delta Consultants, and investors were provided with weekly reports which indicated the status of their accounts. Dunn's customers sustained heavy losses and thus the CFTC brought an action requesting the appointment of a temporary receiver. The district court granted the request for appointment of a receiver and the Court of Appeals for the 2nd Circuit affirmed. The Supreme Court granted certiorari and reversed the lower court and remanded for further proceedings. *Dunn*, 519 U.S. at 468.

[56] 519 U.S. at 468. The Treasury Amendment was placed into the CEA at the request of the Treasury Department, *see infra* note 72. It reads as follows:

Nothing in this chapter shall be deemed to govern or in any way be applicable to transactions in foreign currency, security warrants, security rights, resale of installment loan contracts, repurchase options, government securities, or mortgages and mortgage purchase commitments, unless such transactions involve the sale thereof for future delivery conducted on a board of trade.

7 U.S.C. § 2(ii).

[57] *American Board of Trade*, 803 F.2d at 916. The legislative history surrounding the Treasury Amendment is discussed further in section IV.A.2 of this article.

[58] The only instance of any discussion regarding the jurisdiction of securities regulators took place during the oral argument in *Dunn*, where Justice Ginsburg stated that "What Dunn/Delta are doing . . . doesn't fall between the regulators because clearly what Dunn is doing falls within the SEC bailiwick because . . . what you are doing is having contracts with your investors and those would count as securities." *See* Tormey, *supra* note 9, at 2344 n.212 (*citing* Supreme Court Oral Argument at 22, *Dunn v. Commodity Futures Trading Comm'n,* 58 F.3d 50 (2nd Cir. 1995)).

[59] *Dunn*, 519 U.S. at 469.

[60] 7 U.S.C. § 2(ii). For a complete reading of the Treasury Amendment *see supra* note 56.

[61] 7 U.S.C. § 1a(1). The term "board of trade" means any exchange or association, whether incorporated or unincorporated, of persons who are engaged in the business of buying or selling any commodity or receiving the same for sale or consignment. Note that although the CEA grants the CFTC

jurisdiction only over contracts for the sale of a commodity for future delivery (7 U.S.C. § 2), the definition of "board of trade" does not contain any proviso regarding future delivery and includes persons who only buy or sell a commodity.

[62] *Dunn,* 519 U.S. at 467-76.

[63] *Frankwell,* 99 F.3d at 300-01.

[64] Frankwell sold investments in the foreign currency spot market to the general public through cold-call solicitation. Investors could purchase standardized "lots" of specific foreign currencies and could take either "long" or "short" positions in these currencies based on the Interbank spot market price. The investors would purchase the foreign currency on margin and would settle their positions by entering into an offsetting transaction in the respective foreign currencies. *Id.* For additional explanation of spot market transactions, *see* LUCA, *supra* note 12, at 91.

[65] The District Court initially imposed a temporary restraining order and receivership, but later denied the request for a preliminary injunction, dissolved the temporary receivership, and subsequently granted Frankwell's motion for summary judgment. The CFTC appealed the District Court's ruling to the Ninth Circuit, which affirmed the rulings of the District Court. *CFTC v. Frankwell Bullion, Ltd.*, 904 F. Supp. 1072 (N.D. Cal. 1995); *see also Frankwell,* 99 F.3d at 300.

[66] 7 U.S.C. § 2(ii).

[67] *Frankwell,* 99 F.3d at 300.

[68] 7 U.S.C. § 1a(1).

[69] *Frankwell*, 99 F.3d at 302.

[70] *Id.*

[71] *Id. (citing* S. REP. NO. 93-1131, at 1 (1974), *reprinted in* 1974 U.S.C.C.A.N. 5843).

The Senate Committee report also combines a focus on bank activities with a repeated description of the amendment as excluding all transactions not on organized exchanges: In addition, the Committee amendment provides that inter-bank trading of foreign currencies and specified financial instruments is not subject to Commission regulation . . . Also, the Committee included an amendment to clarify that the provisions of the bill are not applicable to trading in foreign currencies and certain enumerated financial instruments unless such trading is conducted on a formally organized exchange.

[72] *Frankwell,* 99 F.3d at 302. (*citing* S. REP. NO. 93-1131, at 1 (1974), *reprinted in* 1974 U.S.C.C.A.N. 5843, 5887-89). This letter is commonly known as the "Treasury Letter" and reads as follows:

THE GENERAL COUNSEL OF THE TREASURY
Washington, D.C., July 30, 1974

HON. HERMAN E. TALMADGE,
Chairman, Committee on Agriculture and Forestry,
U.S. Senate, Washington D.C.

DEAR MR. CHAIRMAN: The attention of the Department has been directed to H.R. 13113, S. 2485, S. 2578 and S. 2837, bills to regulate futures trading in agricultural and other commodities, which are currently pending before your Committee.

Each of these bills would establish a Federal regulatory agency with sweeping authority to regulate futures trading in virtually any commodity, good, article, right or interest. This authority would extend to the regulation of futures trading in foreign currencies. Moreover, H.R. 13113 and S. 2578 would amend the Commodity Exchange Act, 7 U.S.C. Sec. 1, *et seq*., to subject futures trading in foreign currencies to the regulatory requirements of the Act.

The Department believes the bills contain an ambiguity that should be clarified. The provisions of the bills do not clearly indicate that the new regulatory agency's authority would be limited to the regulation of futures trading on organized exchanges and would not extend to futures trading in foreign currencies off organized exchanges. We do not believe that either the House of Representatives or your Committee intends the proposed legislation to subject the foreign currency futures trading of banks or other institutions, other than on an organized exchange, to the new regulatory regime.

The Department feels strongly that foreign currency futures trading, other than on organized exchanges, should not be regulated by the new agency. Virtually all futures trading in foreign currencies in the United States is carried out through an informal network of banks and dealers. The dealer market, which consists primarily of the large banks, has proved highly efficient in serving the needs of international business in hedging the risks that stem from foreign exchange rate movements. The participants in this market are sophisticated and informed institutions, unlike the participants on *organized* exchanges, which, in some cases, include individuals and small traders who may need to be protected by some form of governmental regulation.

Where the need for regulation of transactions on other than organized exchanges does exist, this should be done through strengthening existing regulatory responsibilities now lodged in the Comptroller of the Currency and the Federal Reserve. These agencies are currently taking action to achieve closer supervision of the trading risks involved in these activities. The Commodity Futures Trading Commission would clearly not have the expertise to regulate a complex banking function and would confuse an already highly regulated business sector. Moreover, in this context, new regulatory limitations and restrictions could have an adverse impact on the usefulness and efficiency of foreign exchange markets for traders and investors.

Section 201 of H.R. 13113 currently contains broad language that would appear to authorize the new agency to regulate bank foreign currency departments. Section 201 provides that the new Commodity Futures Trading Commission would have "exclusive jurisdiction of transactions dealing in, resulting in, or relating to contracts of sale of a commodity for future delivery, traded or executed on a domestic board of trade, contract market or on any other board of trade, exchange, or market." This bill would amend the Commodity Exchange Act, 7 U.S.C. 1 *et seq.*, to broaden the definition of commodity to include all goods, articles, services, rights and interests "in which contracts for future delivery are presently or in the future dealt in." (Section 201). Since this definition would encompass foreign currencies, it seems clear that the language of the bill would give the Commission authority to regulate futures trading in foreign currencies by banks. Moreover, the language "or any other board of trade, exchange, or market" is sufficiently broad to authorize the Commission to regulate trading in foreign currencies by banks in the over-the-counter market.

S. 2837, S. 2485, and S. 2578 are also, in our view, unclear whether they would authorize the regulation of futures trading in foreign currencies by banks. For example, section 301 of S. 2837 provides that it "is unlawful for any person to buy or sell, or offer to buy or sell, any futures contract except on an exchange registered under section 201." Section 201(a) provides that it is unlawful for an exchange to permit futures contracts to be traded on it unless the exchange is registered with the Futures Exchange Commission. A futures contract is defined as "an agreement to buy or sell for delivery at a future time any specified quantities of goods, services, or other tangible or intangible things." (Section 102(3)). This definition is broad enough to include futures contracts in foreign currencies. The term "exchange" is defined broadly to mean "any place where futures contracts are traded." (Section 102(10)).

Accordingly, S. 2837 could be construed to prohibit banks from engaging in futures trading in foreign currencies unless they register as an exchange with the new Futures Exchange Commission and become subject to its regulation. We believe that this is a serious defect in the proposed legislation that would, if enacted, impair the usefulness and efficiency of our foreign exchange markets.

In addition, the Department is concerned that the language of the bills is broad enough to subject to regulation by the proposed futures trading regulatory agency a wide variety of transactions involving financial instruments, such as puts and calls, warrants, rights, resale of installment loan contracts, repurchase options in Government securities, Federal National Mortgage Association mortgage purchase commitments, futures trading in mortgages contemplated by Federal Home Loan Mortgage Corporation, etc. We feel that regulation of these transactions, which generally are between large, sophisticated institutional participants, is unnecessary, and could be harmful. For this reason, we do not believe it is contemplated that the bills should regulate transactions in financial instruments of that nature.

In view of the foregoing, we strongly urge the Committee to amend the proposed legislation to make clear that its provisions would not be applicable to futures trading in foreign currencies or other financial transactions of the nature described above other than on organized exchanges. This could be accomplished by inserting a new section at an appropriate place reading as follows:

"Sec. Nothing in this Act shall be deemed to govern or in any way be applicable to transactions in foreign currency, security warrants, security rights, resales of installment loan contracts, repurchase options, government securities, mortgages and mortgage purchase commitments, or in puts and calls for securities, unless such transactions involve the sale thereof for future delivery conducted on a board of trade."

The Department has been advised by the Office of Management and Budget that there is no objection from the standpoint of the Administration's program to the submission of this report to your Committee.

Sincerely yours,
DONALD L. E. RUTGER
Acting General Counsel

[73] S. REP. NO. 93-1131, at 1 (1974), *reprinted in* 1974 U.S.C.C.A.N. 5843, 5887-89; *see supra* note 72, second to last paragraph of Treasury Letter.

[74] *Frankwell*, 99 F.3d at 302-03.

[75] *Frankwell*, 99 F.3d at 303.

[76] *Frankwell*, 99 F.3d at 304.

[77] *CFTC v. Standard Forex, Inc.*, Comm. Fut. L. Rep. (CCH) ¶ 26,063 (E.D.N.Y. 1993). Standard Forex, Inc. was in the business of offering foreign exchange spot or forward contracts. Since investors lost over three million dollars investing with Standard Forex, Inc., the CFTC commenced this action. The court determined that the spot transactions entered into by Standard Forex, Inc.'s customers were in reality futures contracts.

[78] The court in *Frankwell* discussed the holding in *Standard Forex* and agreed with the district court that the term "board of trade" as used in the Treasury Amendment was ambiguous but did not agree with the holding by the district court that Congress only intended to exempt Interbank transactions already regulated by the banking regulatory agencies. *Frankwell*, 99 F.3d at 304.

[79] *Standard Forex*, Comm. Fut. L. Rep. (CCH) ¶ 26,063 (*citing* cases). This line of cases interprets the statutory term "board of trade" as it appears in sections of the CEA other than the Treasury Amendment.

[80] *Id.*

[81] *Id.* (*citing* S. REP. NO. 93-1131, at 1 (1974), *reprinted in* 1974 U.S.C.C.A.N. 5843, 5859).

[82] *Standard Forex*, Comm. Fut. L. Rep. (CCH) ¶ 26,063 (*citing* S. REP. NO. 1131 ... U.S.C.C.A.N. 5843, 5887-88).

[83] *Id. see also* Tormey, *supra* note 9, at 2353. The Federal Reserve and the Comptroller of the Currency regulate the activities of all federally chartered banking institutions and have various rules and regulations regarding Interbank foreign currency trading, yet a complete discussion regarding the regulation of these federal agencies over foreign currency is beyond the scope of this article.

[84] Tormey, *supra* note 9, at 2354.

[85] *Rosner v. Emperor International Exchange, Co.*, 1998 WL 255437 (S.D.N.Y.); *Rosner v. Gelderman, Ltd.*, 1998 WL 255439 (S.D.N.Y.); and *Rosner v. Peregrine Finance Limited*, 1998 WL 249197 (S.D.N.Y.). All citations will be to *Rosner v. Emperor International Exchange, Co.*, unless otherwise noted. These cases were brought by Rosner, the receiver of

Korbean International Investment Corp. (Korbean). The CFTC brought an action against Korbean and had obtained a temporary injunction and obtained the appointment of a temporary receiver (the receiver and injunction later became permanent under a consent judgment agreed to by Korbean and its principals). *Rosner* 1998 WL 255437, at 1. Korbean's offering materials suggested that it was involved in spot and forward contracts to its investors, but the court determined that in fact, Korbean was selling off-exchange futures contracts. *Id.* at 1. The receiver commenced these actions against the entities with which Korbean traded on the grounds that their activities were in violation of the CEA and sought disgorgement of funds Korbean deposited with those entities. *Id.* at 2. It is important to note that the court in *Rosner* was faced with an extreme case of fraud, finding that Korbean represented that it would guarantee investors' initial investment, customers would receive a 30-40% return within two months, and that customers would make a profit whether the market rose or fell. In reality, Korbean failed to disclose to its customers that it was using funds from new investors to repay existing investors, the hallmark of a "Ponzi" scheme, and that all investor funds were "pooled" together. *Id.* at 1.

[86] 1998 WL 255437, at 3.

[87] *Id.*

[88] *Id.*

[89] *Id.* at 4

[90] *Id.* (*citing Frankwell*, 99 F.3d at 304).

[91] *Standard Forex,* Comm. Fut. L. Rep. (CCH) ¶ 26,063.

[92] 1998 WL 255437, at 5.

[93] *Dunn,* 519 U.S. at 466-80.

[94] 7 U.S.C. § 2. This section provides:

The Commission shall have exclusive jurisdiction, except to the extent otherwise provided in section 2a of this title, with respect to accounts, agreements (including any transaction which is of the character of, or is commonly known to the trade as, an "option", "privilege", "indemnity", "bid", "offer", "put", "call", "advance guaranty", or "decline guaranty"), and transactions involving contracts of sale of a commodity for future delivery, traded or executed on a contract market designated pursuant to section 7 of this title or any other board of trade, exchange, or market, and transactions subject to regulation by the Commission pursuant to section 23 of this title. Except as hereinabove provided, nothing contained in this section shall (I) supersede or limit the jurisdiction at any time conferred on the Securities and Exchange Commission or other regulatory authorities under the laws of the United States or any State, or (II) restrict the Securities and Exchange Commission and such other authorities from carrying out their duties and responsibilities in accordance with such laws. Nothing in this section shall supersede or limit the jurisdiction conferred on courts of the United States or any State. (ii) Nothing in this chapter shall be deemed to govern or in any way be applicable to transactions in foreign currency, security warrants, security rights, resales of installment loan contracts, repurchase options, government securities, or mortgages and mortgage purchase commitments, unless such transactions involve the sale thereof for future delivery conducted on a board of trade.

[95] H.R. REP. NO. 97-565 (Part I) (1982), *reprinted in* 1982 U.S.C.C.A.N. 3871, 3881 & 3893.

[96] *In the Matter of Forex Investment Services Corp. et al.*, Arizona Corporation Commission, Docket No. S-03177A-98-0000, Securities Division's Response in Opposition to Respondent's Motion to Dismiss Re: Lack of Jurisdiction and Division's Claim for Restitution, Mark C. Knops (1999) (*citing Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Curran*, 456 U.S. 353, 386-87 (1982)).

[97] *Supra* notes 56 and 72.

[98] *Dunn* and *Frankwell* addressed only the limits of the CFTC's jurisdiction.

[99] Tormey *supra* note 9, at 2344 n.212.

[100] *In the Matter of Forex Investment Services Corp.*, *supra* note 96.

[101] 7 U.S.C. § 2(i). "The Commission shall have exclusive jurisdiction . . . with respect to accounts, agreements . . . and transactions involving contracts of sale of a commodity *for future delivery*. . . ." (emphasis added).

[102] 7 U.S.C. § 2(ii) (emphasis added).

[103] 7 U.S.C. § 1a(11).

[104] It should be noted that speculation in the spot market usually involves investors who have no intention of ever taking delivery and either close their spot positions by taking an offsetting position, or maintain the position for a longer period of time by rolling over the position or by paying "storage fees" to keep the positions open.

[105] *See generally* LUCA *supra* note 12.

[106] *Salomon Forex,* 8 F.3d at 970.

[107] *Id.*

[108] *CFTC v. Co. Petro*, 680 F.2d 573 (9th Cir. 1982).

[109] *Id.* at 576.

[110] *Bank Brussels v. Intermetals Corp.*, 779 F. Supp. 741 (S.D.N.Y. 1991).

[111] *American Board of Trade*, 803 F.2d at 1248.

[112] *Bank Brussells,* 779 F. Supp. at 748.

[113] *Frankwell*, 99 F.3d at 301.
[114] *Standard Forex,* Comm. Fut. L. Rep. (CCH) ¶ 26,063.
[115] *Id.* The court in *Standard Forex* used a significant amount of judicial license in deciding that the spot transactions conducted by Standard Forex were in reality futures transactions. It appears that the court was attempting to help the investors who had been defrauded and to punish the principals of Standard Forex. Note that the *Standard Forex* court also determined first, that the Treasury Amendment exempted all off-exchange foreign currency transactions from CFTC jurisdiction, but later limited that exemption to only Interbank trading between regulated entities, reasoning that unsophisticated investors require protection.
[116] *Messer v. E.F. Hutton & Co.*, 847 F.2d 673, 675 (11th Cir. 1988).
[117] 1 A. BROMBERG & L. LOWENFELS, BROMBERG AND LOWENFELS ON SECURITIES FRAUD & COMMODITIES FRAUD, § 4.6 (2nd. ed. 1998).
[118] 7 U.S.C. § 2(i), the original savings clause; *see also In the Matter of Forex Investment Services Corp.*, *supra* note 94, at 5.
[119] *In the Matter of Forex Investment Services Corp.*, *supra* note 96, at 5.
[120] *Id.* at 6 n.9 (Arizona Brief) (*citing* 1 A. BROMBERG & L. LOWENFELS § 4.6, *supra* note 117)).
[121] 7 U.S.C. § 2(i) ("Nothing in this section shall supersede or limit the jurisdiction conferred on courts of the United States or any State."); *see also Curran,* 456 U.S. at 486-87.
[122] H.R. REP. 97-565(I) at 3893.
[123] 7 U.S.C. § 13a-2; *see also Curran,* 456 U.S. at 366. (discussing the 1978 Amendments which authorized states to bring actions under the CEA for violations of the Act).
[124] 7 U.S.C. § 13a-2(1); *see also* H.R. REP. 97-565(I) at 3893.
[125] 7 U.S.C. § 13a-2(7); *see also* H.R. REP. 97-565(I) at 3893.
[126] 7 U.S.C. § 16(e). The CEA was amended by the Futures Trading Act of 1982 which was enacted on January 11, 1983.
[127] 7 U.S.C. § 16(e).
[128] H.R. REP. 97-565(I) at 1 (1982), *reprinted in* 1982 U.S.C.C.A.N. 3871, 3971.
[129] *Id.* at 3871, 3893.
[130] *Id.* at 3881.
[131] *Id.*
[132] *Id.* at 3893.
[133] S. REP. No. 97-384 at 1 (1982).
[134] *Id.*
[135] *Id.*

[136] *SEC v. Unique Financial Concepts,* Docket No. 99-4033 (11th Cir. 1999).
[137] *Supra* note 1.
[138] The first Supreme Court case actually interpreting the meaning of the term "investment contract" in the Securities Act of 1933 was *SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344 (1943) ("[t]he reach of the Act does not stop with the obvious and common-place. Novel, uncommon, or irregular devices, whatever they appear to be, are also reached if it be proved as a matter of fact that they are widely offered or dealt in under terms or courses of dealing which established their character in commerce as 'investment contracts.'"). This case created the foundation upon which the *Howey* case was built.
[139] This position likely stems from the arguments used by the Department of Treasury against the CFTC's regulation of futures trading in foreign currency in its letter to the Senate Committee on Agriculture and Forestry, Treasury Letter, *supra* note 72.
[140] The cases in this paragraph are mentioned here only for purposes of illustration. *Joiner,* 320 U.S. 344 (1943); *Los Angeles Trust Deed & Mortgage Exchange,* 285 F.2d 162 (1960).
[141] 15 U.S.C. 77 (b)(a)(1); (Securities Act of 1933).
[142] *Howey,* 328 U.S. at 294.
[143] *Id.* at 298-99.
[144] *Id.* at 299.
[145] *SEC v. Glenn W. Turner Enterprises*, 474 F.2d 476, (9th cir. 1973), *cert. denied*, 414 U.S. 821 (1973).
[146] *Id.* at 482.
[147] *United Housing Foundation, Inc. v. Forman,* 421 U.S. 837 (1975).
[148] *Id.* at 852.
[149] *Id.* at 852.
[150] *Howey,* 328 U.S. at 300.
[151] *International Brotherhood of Teamsters v. Daniel,* 439 U.S. 551 (1979).
[152] *Id.* at 560.
[153] *Id.* at 560 n.12.
[154] *Supra* note 1.
[155] *Id.*
[156] *See Mordauni v. Imcomco*, 469 U.S. 1115, 1116 (1985) (reasoning that a "clear and significant split" in the Circuits should be resolved, three Justices dissented from the denial of a petition for certiorari in a case presenting the vertical versus horizontal commonality issue).
[157] *Revak v. SEC Realty Corp.,* 18 F.3d 81, 87 (2nd Cir. 1994).
[158] *Id.*

[159] *Revak*, 18 F.3d at 87 (*citing* cases).
[160] *Id.* (*citing Milnarik v. M-S Commodities, Inc.*, 457 F.2d 274, 276- 77 (7th Cir. 1972), *cert. denied,* 409 U.S. 887 (1972)) (discretionary commodity futures trading account was not a security where promoter entered into similar discretionary contracts with numerous investors and they were not joint participants in the same investment enterprise); *Hart v. Pulte Homes of Michigan Corp.*, 735 F.2d 1001, 1004 (6th Cir. 1984) (horizontal commonality ties the fortunes of each investor in a pool of investors to the success of the overall venture); *Salcer v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 682 F.2d 459, 460 (3rd Cir. 1982) (commodity trading account was not a security because it was not "part of a pooled group of funds"); *see also Curran v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 622 F.2d 216 (6th Cir. 1980), (*aff'd. on other grounds,* 456 U.S. 353 (1982)) (discretionary commodity trading account was not a security where pooling of investors' interests did not occur); *Hirk v. Agri-Research Council, Inc.*, 622 F.2d 216 (6th Cir. 1980) (discretionary trading account was not an investment contract because of the absence of a pooling of the funds of multiple investors).
[161] COX, HILLMAN & LANGEVOORT, SECURITIES REGULATION 134 (1991).
[162] The term "omnibus" means "for all." *See* BLACK'S LAW DICTIONARY (5th. ed. 1983). If the term "Omnibus Account" is mentioned in a foreign currency offering brochure, this is a good clue that there is pooling of investor funds involved. It is not uncommon for the promoter to open an account with the trading entity in its own name because foreign currency offerings often consist of hundreds of investors, and the promoter cannot possibly open accounts in the names of each individual investor with a large trading entity which requires a large minimum trading balance to be maintained in each account.
[163] *See, e.g., Dunn*, 519 U.S. at 467-68. In *Dunn*, investors were told that their funds would be invested using complex strategies involving options to purchase or sell various foreign currencies. However, no options were ever sold directly to Dunn's customers, their positions were merely tracked through internal accounts, and they were provided with weekly reports showing the putative status of their holdings.
[164] COX, *supra* note 161, at 135.
[165] *Id.* at 134.
[166] *SEC v. Continental Commodities Corp.*, 497 F.2d 516 (5th Cir. 1974).
[167] *Id.* at 522.
[168] *Id.* at 521.
[169] *Id.* at 522.

[170] *Id.* at 521.
[171] *Id.* at 522.
[172] *Id.* at 522-23.
[173] *Revak,* 18 F.3d at 88.
[174] *Id.*
[175] *Long v. Shultz Cattle Co., Inc.,* 896 F.2d 85 (5th Cir. 1990).
[176] *Id.* at 86.
[177] *Id.*
[178] 896 F.2d at 86 n.1.
[179] *Id.* at 87.
[180] *Id.*
[181] *Id.* at 88.
[182] *Id.*
[183] *Id.*
[184] *See supra* note 159.
[185] *Shultz,* 896 F.2d at 87.
[186] *Revak,* 18 F.3d at 88.
[187] *SEC v. Glenn W. Turner Enterprises, Inc.,* 474 F.2d 476, 482 n.7 (9th Cir. 1973)
[188] *Id. see also Villeneuve v. Advanced Business Concepts Corp.,* 698 F.2d 1121, 1124 (11th Cir. 1983), *aff'd. en banc,* 730 F.2d 1403 (1984).
[189] *Mordaunt,* 469 U.S. at 1116 (1985).
[190] *Brodt v. Bache & Co., Inc.,* 595 F.2d 459 (9th Cir. 1978).
[191] *Id.* at 461.
[192] *See Meyer v. Dans un Jardin, S.A.,* 816 F.2d 533 (10th Cir. 1987).
[193] *Forman,* 421 U.S. at 852.
[194] *In the District Court of Travis County, Texas,* 261st Judicial District, Case No. 9808160.
[195] For a discussion of the circuits that have followed the Ninth Circuit's rationale that the word "solely" should not be taken literally, *see Rivanna Trawlers Unlimited v. Thompson Trawlers, Inc.,* 840 F.2d 236, 240 n.4 (4th Cir. 1988) (*citing* cases).
[196] *See* Joe Long, *The Anatomy of an Investment Contract,* ENFORCEMENT LAW REPORTER, 176 (1997).
[197] *Id.*
[198] *See Dunn,* 519 U.S. at 470. There are some cases in the limited context of commodity options on gold and silver coins which hold that the profits depend on the fluctuations in the market. *See SEC v. Belmont Reid & Co., Inc.,* 794 F.2d 1388, 1391 (9th Cir. 1986) (profits to the gold coin buyer depended upon the fluctuations of the gold market, not the managerial efforts of the promoter); *Noa v. Key Futures, Inc.,* 638 F.2d 77 (9th Cir. 1980) (*per*

curiam) (holding that the sale of silver bars was not an investment contract because the expected profits came from market fluctuations). However, there has also been an instance where promoters argued that investor profits were determined by the fluctuations in the market price of gold and silver coins, and the court rejected the argument because investor funds were pooled and the promoters had absolute discretion as to how to invest the pooled funds; therefore, although the investor's potential profit was measured by the fluctuations in the market, his ability to realize that profit was absolutely dependent upon the managerial efforts of the promoters. *Jenson v. Continental Financial Corp.*, 404 F. Supp. 792, 805 (1975). Foreign currency offerings are more like the second case than the first.

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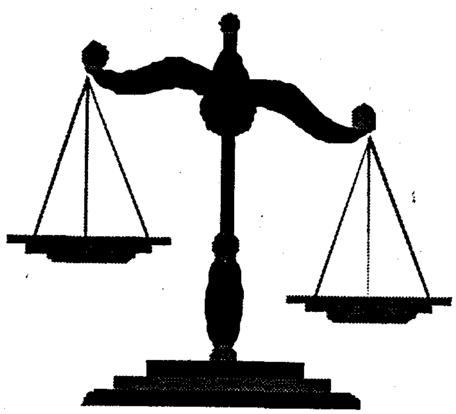

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FOREIGN CURRENCY SPOT TRANSACTIONS AND THE MODEL STATE COMMODITY CODE: A REGULATOR'S PERSPECTIVE

By Eric Benink, J.D., M.B.A.

I. INTRODUCTION

The fraudulent offer and sale of commodities in off-exchange transactions is a problem that has plagued state and federal regulators for many years.[1] Recently, however, the number of persons offering small investors the opportunity to buy and sell foreign currencies through the Interbank spot market has risen to epidemic proportions in some areas of the country.[2] The reasons for the escalation in foreign currency offerings on the retail level are many. First, new technologies now permit foreign currency promoters to access the Interbank market or at least create the appearance of such access. Second, recent federal cases like *Dunn*[3] and *Frankwell*[4] have created a fallacy among promoters and investors that such transactions are completely unregulated. Finally, promoters have used the well-publicized volatility of foreign economies and currencies to entice investors to invest.

State regulators should be concerned about the rise in foreign currency spot transactions on the retail level because no regulatory body oversees such transactions. There are no record-keeping or net capital requirements, no audits, no licenses, and no disciplinary proceedings for rogue brokers. This lack of oversight provides ample opportunities for foreign currency promoters to defraud investors.

While oversight is lacking, regulation is not. In 1984, the North American Securities Administrators Association, Inc.[5] ("NASAA") promulgated a Model State Commodity Code[6]

("MSCC") to combat commodities fraud and prohibit, if states adopting the code desired, most off-exchange activity altogether. This article will illustrate that a state statute based on the MSCC is an effective weapon in combating off-exchange spot trading on the retail level. It presents an overview of the Interbank market and its participants, describes spot transactions, explains that federal law does not, contrary to popular belief, preempt states from prohibiting or regulating off-exchange foreign currency spot transactions, and discusses in detail the MSCC provisions available to state regulators.

II. AN OVERVIEW OF THE INTERBANK MARKET AND ITS PARTICIPANTS

The Interbank or "forex"[7] market is an international network of commercial banks, investment banks, and multinational companies who exchange foreign currencies through electronic means such as computer networks called Reuters Dealing 2000-2 and the Electronic Banking System ("EBS") and also by telephone and telefax.[8] Both electronic networks link the various participants by computer workstations that display the bid and ask prices at which each participant is willing to buy and sell various currencies and permit the players to transact orders as well. In 1997, electronic trading accounted for nearly one-third of all Interbank trading.[9] While the Interbank market is unregulated for the most part, it is self-policed through organizations like the International Forex Association. Banks are also subject to numerous capital adequacy guidelines promulgated by the Federal Reserve Board, the Comptroller of the Currency, and the Federal Deposit Insurance Corporation.[10] As no physical exchange exists, the Interbank market is best described as an over-the-counter market.

The banks and financial institutions comprising the Interbank network are some of the largest players in the banking and financial industries and include Bank of America, Chase Manhattan Bank, Goldman Sachs & Co., and Swiss Bank Corporation.[11] The banks and financial institutions who participate, act as dealers, making a market in the currencies and accepting orders for clients.[12] Other firms and individuals broker such activity, acting as intermediaries between the dealers.[13] Brokers receive commissions and do not realize a profit or loss on transactions.[14] Each Interbank participant must secure credit with any other institution with which it intends to transact business. Thus, the average investor cannot readily participate directly in this market because he or she will not likely be able to secure the requisite credit from the other participants. In addition, the size of the spot transactions, which average $3.4 million,[15] effectively prohibit small investors from participating directly. However, some banks and institutions will place trades on behalf of individual investors provided the size of the transaction is sufficiently large.

While it was probably impossible for a small investor to readily partake in Interbank transactions ten years ago, the evolution of computer technology has opened the door to the general public.[16] Small investors may now access real-time foreign currency prices through computers and transact business almost instantaneously with anyone in the world. This technology has spawned niche players like companies who have established relationships with Interbank dealers and facilitate trades for introducing brokers,[17] and also companies marketing forex-related software.[18] The end result is simplified access for the small investor, and a means for the investor to participate in the Interbank market, which in turn has popularized foreign currency spot transactions as an investment vehicle.

III. SPOT TRANSACTIONS

In the Interbank market, foreign currencies are traded through options, forward and spot contracts and also in swap transactions.[19] In a foreign currency options contract, the seller of the option gives the purchaser a right, but does not obligate him or her, to buy or sell a certain quantity of a foreign currency at a certain price from the seller before a certain date.[20] A forward contract is similar to a futures contract traded on an exchange[21] in that, like a futures contract, the purchaser is obligated to buy a certain quantity of a foreign currency at a certain price on a certain date from the seller. The difference is, in forward contracts, the delivery date is much shorter, albeit always longer than two days. Futures contracts are also smaller and more standardized than forward contracts.[22] In a swap transaction, the parties exchange the currencies and then agree to "swap" them again at a later date enabling each to hedge against unfavorable price movements.[23]

A spot transaction is similar to a forward transaction except the currencies are bought and sold (exchanged) within two days of entering into the contract.[24] The prices at which Interbank participants are willing to exchange foreign currencies today is thus called the spot or cash price. For corporations buying supplies or paying employees in foreign countries, spot trading serves a legitimate and necessary business function.[25] Small investors transacting business through a forex operator on the retail level, on the other hand, enter into spot transactions to speculate on spot price movements. The currencies are exchanged, but the trade is always reversed with an off-setting transaction at a later point. This activity is much like gambling in that it is a zero-sum game. To make matters worse, forex promoters allow customers to trade on margins as great as 100 - 1 and thus any unfavorable price change can spell immediate disaster. The Interbank participants and their clients likewise speculate on foreign currencies in the spot market, but also use such transactions for hedging other investments subject to risk from fluctuations in currency prices. In 1998, the average daily volume of spot trading in the United States alone was an astounding $148 billion and comprised 42% of all Interbank transactions.[26]

IV. THE CFTC'S LACK OF JURISDICTION OVER SPOT TRANSACTIONS

The greatest hurdles state regulators face in their attempt to control the proliferation of forex operations are a handful of federal cases in which circuit courts and the Supreme Court have held that the Commodity Futures Trading Commission ("CFTC"), the federal agency charged with enforcing the Commodities Exchange Act, cannot regulate off-exchange foreign currency transactions. Ironically, it has been the perception that these decisions created, not the holdings themselves, that have caused the difficulty for state regulators. States that have enacted a statute based on the MSCC are free to regulate such transactions despite federal decisions limiting the CFTC's jurisdiction. As discussed at greater length in Part V., Congress intended to confer upon the states the authority to regulate most off-exchange commodities transactions when it enacted the Futures Trading Act ("FTA") in 1982.[27]

Despite a clear mandate from Congress that the states not be preempted by the CEA and thus be authorized to regulate off-exchange transactions, state regulators utilizing the MSCC should be familiar with the holdings in Dunn and Frankwell which affect only federal law. The confusion surrounding these cases is so pervasive, that, invariably, subjects of enforcement actions attempt to avail themselves of these decisions.

A. Treasury Amendment

In 1974, Congress amended the Commodity Exchange Act of 1936[28] and created the CFTC in an effort to expand and step up enforcement of the new act.[29] In addition to expanding the CEA's coverage, the amendment granted the CFTC broad regulatory authority.[30] Preceding the enactment of the CEA, the Treasury Department, concerned with possible overreaching into the self-regulated and sophisticated Interbank market, requested that the amendment limit the CFTC's jurisdiction over foreign currencies, among other items, unless the transactions were in futures and conducted on a board-of-trade.[31] Heeding the Treasury Department's advice, Congress enacted the so-called Treasury Amendment which states:

> Nothing in this Act shall be deemed to govern or in any way be applicable to transactions in foreign currency, security warrants, security rights, resales of installment loan contracts, repurchase options, government securities, or mortgages and mortgage purchase commitments, unless such transactions involve the sale thereof for future delivery conducted on a board of trade.[32]

B. The "Board of Trade" Controversy

With respect to foreign currency transactions, two areas of controversy arose from the Treasury Amendment. The first concerned the definition of "board of trade." In *Frankwell*, a Ninth Circuit case, a forex promoter claimed that its foreign currency spot transactions were not conducted on a board of trade and were thus exempt from CFTC regulation under the Treasury Amendment.[33] The CFTC argued that the term "board of trade" which is defined in the CEA as "any exchange or association, whether incorporated or unincorporated, of persons who are engaged in the business of buying or selling any commodity or receiving the same for sale on consignment,"[34] was sufficiently broad to include Frankwell's business. The Ninth Circuit, affirming the federal district court's ruling, dismissed the CFTC's definition of "board of trade" noting that it would include any organization of persons involved in buying and selling commodities and thereby render the amendment meaningless.[35] Instead, it looked to the legislative history of the Treasury Amendment and determined that Congress intended the Treasury Amendment to exempt all off-exchange transactions in foreign currency.[36]

Other courts have been more investor-friendly. In *Standard Forex*[37] and *Rosner*,[38] federal district courts in the Eastern and Southern Districts of New York respectively, examined this same legislative history and concluded that Congress intended the term "board of trade" to encompass more than just on-exchange transactions. These courts interpreted the Treasury Amendment to protect from CFTC regulation only Interbank transactions, and not other off-exchange groups or associations trading commodities.

C. Dunn and "Transactions in Foreign Currencies"

Regardless of lower courts' interpretations of "board of trade," the *Dunn*[39] case conclusively established that the CFTC did not have jurisdiction over foreign currency spot transactions. The Supreme Court granted certiorari in *Dunn* to clarify the Treasury Amendment's phrase "transactions in foreign currencies" which had been interpreted differently by the circuit courts.[40] Foreign currency options promoters in *Dunn* challenged the CFTC's jurisdiction by claiming that their businesses involved "transactions in foreign currencies" as enumerated in the Treasury Amendment, and thus were not subject to its jurisdiction.

The CFTC argued that a foreign currency option contract did not fall within the exemption because an option contact was not a transaction "in" the commodity itself, but a right to engage in a foreign currency transaction at some future point. Declining to accept this narrow interpretation, the court unanimously held that off-exchange foreign currency options were included in the exemption, conclusively establishing the CFTC's lack of jurisdiction over off-exchange foreign currency transactions.

It is noteworthy that the court in *Dunn* never directly held that spot transactions in foreign currencies would be included in the exemption. However, the court's plain language approach in interpreting the Treasury Amendment confirmed that all off-exchange transactions in foreign currencies, including spot transactions, are included in the amendment. Even the CFTC's narrow reading of the Treasury Amendment would not have permitted it to regulate spot transactions because unlike options contracts, spot transactions are unquestionably transactions "in" the commodity itself. The court remarked that the CFTC's "interpretation would leave the Treasury Amendment's exemption ... without any significant effect at all, because it would limit the scope of the exemption to forward contracts and 'spot contracts'."[41] Thus, the CFTC's jurisdiction over spot transactions in foreign currencies was never really at issue.

Despite the dramatic erosion of the CFTC's jurisdiction as a result of the *Dunn* and *Frankwell* decisions, the regulation of forex transactions by state authorities has never been jeopardized. Each case related only to the CFTC's jurisdiction and is discussed in this article simply to alert regulators that any attempt by forex promoters to apply these decisions to state commodities statutes is inappropriate, if not ridiculous. As discussed in the following section, state commodities statutes based on the MSCC were enacted specifically to counter such fraud-riddled schemes and can be effectively used to do just that.

V. THE MODEL STATE COMMODITY CODE

There is no paradigm for the promotion of foreign currency spot trading. Some forex operators run boiler rooms, others advertise in newspapers or on the Internet, and many rely on word-of-mouth within a close-knit community to generate excitement. Some provide computers displaying real-time foreign currency spot prices to customers and permit them to make their own trading decisions, while other operators obtain discretionary authority from investors and control all aspects of the trading. Regardless of the manner in which foreign currency promoters operate, the offer to buy and sell, and the purchase and sale of foreign currencies through the Interbank market on this retail level, violates state commodities codes based on the MSCC. More often than not, the forex operator is also in violation of the states' anti-fraud provisions.

A. The Legality of State Commodity Statutes

The Model State Commodity Code ("MSCC"), promulgated by the North American Securities Administrators Association, Inc., has been enacted in whole or in part by twenty states.[42] The MSCC was drafted in response to Congress' enactment of the Futures Trading Act ("FTA") of 1982,[43] which was an amendment to the Commodities Exchange Act of 1974. In section 12(e) of the FTA (7 U.S.C. § 16(e)), Congress declared "open season"[44] against otherwise unregulated off-exchange transactions by authorizing state regulators to enact their own laws to combat off-exchange commodities transactions.[45] Prior to the FTA, the role of the states in regulating any commodities contract was unclear given the sweeping language contained in the preemption clause in the CEA.[46]

While the language of §16(e) clearly permits states to regulate most off-exchange commodities transactions, further evidence of Congress' intention is documented in the legislative history of the FTA. Addressing the expanded role for the states, the House Report stated that the view of both the CFTC and the

Agricultural Committee was that "the States should be extensively involved in actions against those who offer fraudulent off-exchange investments and in policing transactions outside those preserved exclusively for the jurisdiction of the CFTC."[47] The report further noted that the Committee intended that "the resources of the CFTC and State officials should be used together to clean up the continuing problem of off-exchange commodity frauds."[48] Thus, there is no question that states may regulate forex transactions through the enactment of commodities statutes.

B. MSCC Provisions Available to State Regulators

The MSCC consists of a preamble and three major parts. The preamble recites the MSCC's purpose and intent. Part I contains an "offer and sale" and anti-fraud provision similar to securities statutes. It also sets forth exemptions to the "offer and sale" provision. Part II provides a scheme by which administrators may investigate and enforce the provisions in Part I. Part III offers a licensing scheme for states wishing to license persons engaging in off-exchange activity. The enforcement powers in Part II are not unique to commodities and will not be addressed. The licensing provisions will not be discussed either as only two states have enacted licensing schemes.[49] The provisions most useful for regulators prosecuting forex cases are in Part I and are discussed below.

1. Section 1.02 – the Offer and Sale Provision

Section 1.02, the "offer and sale" provision of the MSCC states:

> Except as otherwise provided in Section 1.03 or 1.04, no person shall sell or purchase or offer to sell or purchase any commodity under any commodity contract or under any commodity option or offer to enter into or enter into as seller or purchaser any commodity contract or any commodity option.

Given its broad language, proving that a forex promoter violated Section 1.02 is not difficult. Like any criminal or civil statute or law, each element must be proved.

a) Sell, purchase, or offer to sell or purchase

A regulator may establish this element simply by showing that the investors were incapable of buying and selling the foreign currencies without the assistance of the promoter. Once that is demonstrated, one must conclude that the promoter bought and sold the foreign currencies for the investor. Note that the provision includes "offers." Thus, any verbal solicitation or written, television, or radio advertisement to sell or purchase foreign currencies will likewise establish the element.

b) Commodity

Section 1.01(d) specifically defines a commodity as any foreign currency, among many other items.

c) Under any Commodity Contract or Commodity Option

Since a forex transaction is not an "option," the regulator must focus on the definition of a "commodity contract," which is defined in Section 1.01(e) as "any account, agreement or contract for the purchase or sale, primarily for speculation or investment purposes and not for use or consumption by the offeree or purchaser, of one or more commodities." Again, the language is so broad that any aspect of the transaction will establish this element. A written agreement between the promoter and investor to open a forex account will suffice as long as this agreement contains language demonstrating that the investor will be buying and selling foreign currencies. Account statements and trade tickets showing trades in foreign currencies are powerful evidence of an "account" because the statements usually include details of purchases and sales of the currencies. Physical evidence is not necessary however. The testimony of the investor stating that he or she "agreed" or had an "account" to buy and sell foreign currencies through the promoter certainly establishes the first part of the element.

Regardless of how the first part of this element is established, the regulator must also show that the purpose of buying and selling foreign currencies under the account, agreement or contract was "primarily for speculation or investment purposes." Fortunately, most contracts and agreements use language evidencing such purpose. Again, if the physical evidence is not available, an investor's testimony establishing this intent or purpose is more than adequate. Most small investors would have no other motivation for buying large quantities of British pounds and Japanese yen.

2. Exemptions under Sections 1.03

The most troublesome aspects of enforcing the Model State Commodity Code are the exemptions from Section 1.02 under Section 1.03. Forex operators and regulators unfamiliar with the MSCC often confuse enforcement and regulation issues with licensing issues and mistake Section 1.03 as a licensing scheme. However, the exemptions enumerated in Section 1.03 were inserted in the code simply to preclude the states from regulating persons already subject to regulatory oversight. Upon examination of each exemption, it is clear that most off-exchange transactions are not exempted.

Section 1.03 states that Section 1.02 of [the MSCC] shall not apply to any transaction offered by and in which any of the following persons (or any employee, officer or director thereof acting solely in that capacity) is the purchaser or seller:

(a) a person registered with the Commodity Futures Trading Commission as a futures commission merchant or as a leverage transaction merchant whose activities require such registration;

(b) a person registered with the Securities and Exchange Commission as a broker-dealer whose activities require such registration;

(c) a person affiliated with, and whose obligations and liabilities under the transaction are guaranteed by, a person referred to in paragraph (a) or (b) of this section;

(d) a person who is a member of a contract market designated by the Commodity Futures Trading Commission (or any clearinghouse thereof);

(e) a financial institution;

(f) a person registered under the laws of this state as a securities broker-dealer whose activities require such registration; or

(g) a person registered as a commodity broker-dealer or commodity sales representative in accordance with the provisions of Part III of this chapter.

Subsection (a) and (b) provide exemptions for persons registered with the CFTC and the Securities and Exchange Commission ("SEC"). The key to understanding these exemptions is to focus on the phrase "whose activities require such registration." The apparent purpose of these exemptions is to preclude the states from regulating persons already subject to regulatory oversight, not to permit forex promoters and other off-exchange dealers to avail themselves of an exemption by obtaining an irrelevant license. To claim the exemption, the person must be engaged in regulated activity in addition to the off-exchange activity in question. While a forex promoter may argue that registration with the CFTC or SEC alone is sufficient regulatory oversight, such an argument renders the phrase "whose activities require such registration" superfluous. The exemptions as written and intended, contemplate significant oversight, albeit not necessarily over the unregulated activity.

Subsection (c) exempts affiliates of persons named in (a) and (b) so long as the person in (a) and (b) guarantees the obligations and liabilities of the affiliate under the transaction. A forex operator would probably have difficulty finding a person to make such a guarantee. The CFTC requires futures commission merchants and leverage transaction merchants to become members of futures associations registered under section 17 of the CEA.[50] The National Futures Association ("NFA"), the only futures associations registered under the act,[51] prohibits its members from associating with non-members.[52] Thus, a futures commission merchant and a leverage transaction merchant may not affiliate themselves with forex promoters. Broker-dealers licensed by the SEC would be hard-pressed to engage in such an arrangement because guaranteeing liabilities would affect net capital computations[53] and would need to be reported as well.[54]

Subsection (d) is the most problematic exemption for state regulators attempting to prosecute forex promoters. While the exemptions in (a) and (b) include the phrase "whose activities require such registration," subsection (d) contains no parallel language. The CFTC will designate a board of trade as a contract market after it meets substantial conditions and requirements[55] and performs numerous duties.[56] Subsequent to designation, it imposes numerous reporting requirements on contract markets as well.[57] Therefore, contract markets are heavily monitored by the CFTC. While the costs of membership in most of the designated contract markets is prohibitive for most forex promoters,[58] the membership in at least one contract market was inexpensive enough for a California foreign currency operator to obtain a membership. NASAA likely intended such a member to conduct its business through the designated contract market assuring regulatory oversight, but the language supporting such intention is not present. To exacerbate the matter, the contract market in question does not require its members to conduct any business through the contract market at all. Unlike subsection (a) and (b), the plain language in subsection (d) grants an exemption for membership status, even if the member conducts no activity subject to any federal oversight. However, given the legislative history of the FTA, one could easily argue that the intention of the drafters was to require such contract market participation.

Subsection (e) exempts transactions involving a financial institution which is defined in Section 1.01(j) as a "bank, savings institution or trust company organized under, or supervised pursuant to, the laws of the United States or of any state." Presumably, NASAA had the Interbank market in mind when it drafted this exemption and thus large Interbank participants are not affected by Section 1.01. Obviously, the average forex promoter cannot utilize this exemption.

Subsection (f) is similar to subsection (b) except a *state*-licensed broker-dealer is exempt.

Subsection (g) exempts persons licensed by the state as a commodity broker-dealer or commodity sales representative if said state adopted such a licensing scheme. As discussed above, this licensing scheme will not be discussed in this article.

3. Exemptions under Section 1.04

In addition to exempt person transactions, certain transactions are also exempt under Section 1.04. Without question, these exemptions cannot be used by forex promoters. Section 1.04(a)(1) exempts accounts, agreements, and transactions within the exclusive jurisdiction of the CFTC. As discussed earlier, the CFTC has no jurisdiction over spot currency transactions. Sections 1.04(a)(2) and 1.04(b)-(f) relate to precious metals contracts in which actual physical delivery is contemplated and made and is therefore not applicable. Section 1.04(a)(3) exempts commodity contracts between persons "engaged in producing, processing, using commercially or handling as merchants, each commodity subject thereto, or any by-product thereof" and is obviously not the type of transaction in which a forex promoter engages. Section 1.04(a)(4) exempts transactions in which the offeree or the purchaser is a person in Section 1.03, an insurance company, an investment company, or an employee pension and profit sharing or benefit plan. Forex promoters typically offer and sell to naive investors, not sophisticated entities.

Despite the unavailability of these exemptions, a special mention must be made regarding subsection 1.04(a)(2). California's parallel code section[59] exempts a commodity contract for the purchase of *foreign currencies*, in addition to precious metals, which requires full or partial payment in good funds of the purchase price and under which the purchaser receives, within 28 calendar days from the full or partial payment,[60] substitute delivery of the foreign currencies purchased by that payment. Substitute delivery is explained in the code and, in summary, requires that the foreign currency be delivered into the possession of a regulated third party for the benefit of the purchaser. The purpose of the exemption is to permit persons to take delivery of precious metals or foreign currencies, not to speculate on their prices. In spot transactions on the retail level, delivery is never made and contracts are simply offset, thus this section is unavailable to California forex promoters.

4. Section 1.05 – the Anti-Fraud Provision

Fraud is rampant in the retail spot market. More often than not, promoters misrepresent potential returns, omit to explain the substantial risks or steal investors' funds. It is not uncommon for promoters to simply bucket the trades. There are many reasons forex transactions are riddled with fraud. First, the investor does not understand the Interbank market and cannot independently verify the transactions. The investor relies on the promoter to transact business through brokers and Interbank participants, but typically is not given any information about where or to whom the funds are going. Second, the perception of promoters and investors alike that the activity is unregulated, fosters reckless behavior by all participants and leaves the investor believing there is no recourse after he or she is defrauded. Third, the opportunity to earn spectacular returns on highly leveraged transactions entices unsophisticated and naive investors looking to hit the jackpot, so to speak. Because fraud is so common, the MSCC's anti-fraud provision should be used in conjunction with Section 1.02.

The anti-fraud provision is contained in Section 1.05 and states, in part, that:

> No person, shall directly or indirectly:
>
> (a) cheat or defraud, or attempt to cheat or defraud, any other person or employ any device, scheme or artifice to defraud any other person;
>
> (b) make any false report, enter any false record, or make any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading;
>
> (c) engage in any transaction, act, practice or course of business, including, without limitation, any form of advertising or solicitation, which operates or would operate as a fraud or deceit upon any person; or
>
> (d) misappropriate or convert funds, security or property of any other person.

Fortunately, the broad language in Section 1.05 enables regulators to graft any fraudulent act onto one of its subsections effortlessly. Subsection (b) is comparable to most securities anti-fraud statutes and is appropriate for misrepresentations and omissions. In cases of the theft of investor funds, subsection (d) can be used. Novel and unusual schemes fit nicely into either (a) or (c) and fraud in advertising is specifically mentioned in (c) as well. In essence, the section is flexible enough to accommodate any dishonest activity the regulator has uncovered.

The more difficult, yet common, fraud to prove is where promoters have not traded the foreign currencies at all, manufacture bogus account statements, and simply pocket investor funds. In such cases, and especially in criminal cases where defendants assert their Fifth Amendment privileges, proving the operator's lack of Interbank-related documents through search warrants, administrative subpoenas, discovery mechanisms or receivership actions is one of the few ways to prove such a fraud.[61] The fact that trades are made through electronic means does not mean that there will be no documents representing the trades. The world, while growing increasingly paperless, is still dependent upon physical documents. A judge or a jury responsible for determining whether a fraud has occurred would expect a legitimate currency trader to maintain, at the very least, contracts and correspondence with an intermediary or Interbank participant. In addition to documents maintained by the company, bank records often show investor funds simply going into the hands of the promoters and are extremely damaging evidence of such a fraud.

The second part of the anti-fraud provision explains that the fraud must be in or in connection with activity subject to the provisions of Sections 1.02, 1.03, 1.04(a)(2), or 1.04(a)(4). Thus, the anti-fraud provision applies to Interbank spot transactions engaged in by exempt persons named in Sections 1.03 and 1.04(a)(2), and includes (in addition to unlicensed and unregulated forex promoters) financial institutions, investment companies, insurance companies, state and SEC broker-dealers, and CFTC licensees. In the spirit of the MSCC, activity under the exclusive jurisdiction of the CFTC is not subject to this provision.

IV. CONCLUSION

State statutes based on the MSCC are highly effective and easily employed tools for fighting the proliferation of foreign currency promoters that offer small investors the opportunity to transact business in the Interbank spot market. While the unregulated Interbank market serves an important economic function for its institutional participants, retail promoters typically take advantage of the lack of oversight and defraud their unsophisticated customers. Contrary to popular belief, state commodities statutes are not preempted by federal statute or affected by the *Dunn* and *Frankwell* decisions. In fact, Congress declared "open season" against such off-exchange operations when it enacted the Futures Trading Act of 1982 which permitted the states to enact their own laws. Such statutes can and should be used to protect investors from foreign currency promoters.

Eric Benink is a staff attorney with the California Department of Corporations. The views expressed in this article are those of the author and should not be attributed to the California Department of Corporations or to NASAA.

ENDNOTES

[1] Congress concluded that in the years 1977 through 1981, "thousands of persons nationwide [had] been victimized by fraudulent commodity sales operations" resulting in over $1 billion in losses to investors. S. REP. NO. 495, 97th Cong., 2d. Sess. 49 (1982).
[2] *See, e.g.* "Corporations Commission Orders 18 Companies to Halt Sales – Warns of 'Explosion of Foreign Currency Scams,'" Department of Corporations News Release, June 22, 1998. (A copy of this release can be found on the California Department of Corporation's web site at http://www.corp.ca.gov).
[3] *Dunn v. CFTC*, 519 U.S. 465 (1997).
[4] *CFTC v. Frankwell Bullion*, 99 F.3d 299 (9th Cir. 1996).
[5] The North American Securities Administrators Association, Inc., organized in 1919, is a voluntary association consisting of sixty-five state, provincial, and territorial securities administrators.
[6] A model or uniform code has no legal significance and is typically proposed by public or private organizations for the purpose of attempting to standardize a statute of many jurisdictions. CHRISTINA L. KUNZ ET AL., THE PROCESS OF LEGAL RESEARCH 309 (3rd. ed. 1992). A copy of the MSCC is published in NASAA Reports (CCH) ¶ 4401 (Adopted April 5, 1985, technical amendments Oct 2, 1985, amendments adopted April 29, 1989, November 18, 1997).
[7] The forex (foreign exchange or "FX") market is synonymous with the Interbank market. GARY SHOUP, THE INTERNATIONAL GUIDE TO FOREIGN CURRENCY MANAGEMENT 101 (1998).

[8] Stephen Veltri, *Should Foreign Exchange Be "Foreign" to Article Two of the Uniform Commercial Code?,* 27 CORNELL INT'L L.J. 343, 348; *see also*, The Foreign Exchange Committee 1997 Annual Report, A Survey Assessing the Impact of Electronic Brokering on the Foreign Exchange Market 35 ("1997 Report") and The Foreign Exchange Committee 1998 Annual Report, Foreign Exchange Committee Member Listing 87 ("1998 Report") (These reports may be viewed on the Federal Reserve Bank of New York's web site at http://www.ny.frb.org or can be obtained directly by contacting the Public Information Department at Federal Reserve Bank of New York, 33 Liberty Street, New York, NY 10045-0001).
[9] 1997 Report, *supra* note 8, at 54.
[10] Veltri, *supra* note 8, at 350.
[11] *See* 1997 Report and 1998 Report, *supra* note 8.
[12] SHOUP, *supra* note 7, at 103.
[13] SHOUP, *supra* note 7, at 102.
[14] *Id.*
[15] 1998 Report, *supra* note 8, at 57.
[16] *See* Jason A. Pinson, *Is the Interbank Market Out of Control?: Delta Dunn v. Commodity Futures Trading Commission,* 4 TULSA J. COMP. & INT'L L. 305, 323 – 24 (1997) for a general discussion of how the drafters of the Treasury Amendment (discussed in Part IV) could not have foreseen that individual investors would someday access this market and would have drafted it differently if such technology had been available at the time.
[17] This article uses the terms introducing broker, promoter, and retailer interchangeably.
[18] *See, e.g.* "E-FOREX adds Live Market Info to 24-Hour Forex dedicated Website," PR Newswire, September 16, 1998.
[19] SHOUP, *supra* note 7, at 101.
[20] *Id.* at 117.
[21] Four exchanges, the Chicago Mercantile Exchange, the MidAmerica Commodity Exchange, the Financial Exchange, a division of the New York Cotton Exchange, and the Philadelphia Board of Trade currently trade foreign currency futures. SHOUP, *supra* note 7, at 110.
[22] SHOUP, *supra* note 7, at 114–15.
[23] Veltri, *supra* note 8, at 346-47; SHOUP, *supra* note 7, at 107.
[24] Veltri, *supra* note 8, at 345.
[25] *Id.*
[26] 1998 Report, *supra* note 8, at 54.
[27] Pub. L. No. 97-444, 96 Stat. 2294 (1982) (codified at 7 U.S.C. §§ 1-26 (1999)).
[28] Ch. 545, 49 Stat. 1491 (1936).

[29] 7 U.S.C §§ 1-26 (1997). For a more detailed history of the CEA, *see* Thomas A. Tormey, *Note: A Derivatives Dilemma: The Treasury Amendment Controversy and the Regulatory Status of Foreign Currency Options*, 65 FORDHAM L. REV. 2313, 2325–28.
[30] 7 U.S.C. § 2 (1999). Pursuant to this section, the CFTC has exclusive jurisdiction over all futures and options contracts traded on U.S. exchanges and certain futures and options contracts traded on foreign exchanges.
[31] A copy of the letter to the Senate Committee can be found in S. REP No. 93-1131, 93d Cong., 2d Sess. 49-50 (1974), reprinted in 1974 U.S.C.C.A.N. 5887-88.
[32] 7 U.S.C. § 2(ii) (1999).
[33] 99 F.3d 299.
[34] 7 U.S.C. § 1a(1) (1999).
[35] 99 F.3d 299 at 302.
[36] *Id.* at 302-04.
[37] *CFTC v. Standard Forex, Inc.*, Comm. Fut. L. Rep (CCH) ¶ 26,063 (E.D.N.Y. 1993); 1993 U.S. Dist. LEXIS 19909.
[38] *Rosner v. Gelderman, Ltd.*, Comm. Fut. L. Rep (CCH) ¶ 27,343 (S.D.N.Y. 1998); 1998 U.S. Dist. LEXIS 7352.
[39] 99 U.S. 465.
[40] *See CFTC v. American Board of Trade*, 808 F.2d 1242 (2nd Cir. 1986) (holding foreign currency options not transactions in foreign currencies); *Salomon Forex v. Tauber*, 8 F.3d 966 (4th Cir. 1993) (holding Treasury Amendment applies to all transactions in which foreign currencies are the subject matter).
[41] 99 U.S. 465 at 472.
[42] Those states are Arizona, California, Colorado, Georgia, Idaho, Indiana, Iowa, Maine, Mississippi, Missouri, Montana, Nebraska, Nevada, New Mexico, North Carolina, North Dakota, Oregon, South Carolina, Washington, and West Virginia.
[43] *Supra* note 27.
[44] The phrase "open season" was used in the Agriculture Committee's House Report, H.R. REP. 97-565(I), 97th Congress, 2nd Sess. 122 (1982), reprinted in 1982 U.S.C.C.A.N. 3871.
[45] 7 U.S.C. § 16(e) (1999) states in pertinent part:

> Nothing in this chapter shall supersede or preempt-
> (1) criminal prosecution under any Federal criminal statute;
> (2) the application of any Federal or State statute, including any rule or regulation thereunder, to any transaction in or involving any commodity, product, right, service, or interest (A) that is not conducted on or subject to the rules

of a contract market, or, in the case of any State or local law that prohibits or regulates gaming or the operation of "bucket shops" (other than antifraud provisions of general applicability), that is not a transaction or class of transactions that has received or is covered by the terms of any exemption previously granted by the Commission under subsection (c) of *section 6 of this title*, or (B) (except as otherwise specified by the [CFTC] by rule or regulation) that is not conducted on or subject to the rules of any board of trade, exchange, or market located outside the United States, its territories or possessions, or (C) that is not subject to regulation by the [CFTC] under section 6c or 23 of this title; or

(3) the application of any Federal or State statute, including any rule or regulation thereunder, to any person required to be registered or designated under this chapter who shall fail or refuse to obtain such registration or designation...

[46] Julie M. Allen, *Kicking the Bucket Shop: The Model State Commodity Code as the Latest Weapon in the State Administrator's Anti-Fraud Arsenal*, 42 WASH. AND LEE L. REV. 889, 891 (1985).
[47] *See* H.R. REP. 97-565(I), 9th Congress, 2nd Session 122, 144 (1982), reprinted in 1982 U.S.C.C.A.N. 3871.
[48] *Id.*
[49] Missouri (MO. REV. STAT. § 409.850 – 409. 863 (1998)) and Washington (WASH. REV. CODE § 21.30.230 – 21.30.350 (1999).
[50] 17 C.F.R. § 31.27; 17 C.F.R. § 170.15.
[51] *See* FCM IB Regulatory Guide, 3, distributed by the National Futures Association (This guide can be viewed on the National Futures Association web site at http://www.nfa.futures.org or obtained directly from the National Futures Association, 200 West Madison Street, Chicago, IL 60606).
[52] NFA Bylaw 1101 prohibits a member from conducting business with a non-member that is required to be registered (NFA Manual, ¶ 4239, 9007, Volume 5, No. 3, April 1999). While a forex operator is not required to be registered, clearly the intent is to prohibit a member from engaging in unregulated activity.
[53] 17 C.F.R § 240.15c3-1 (1999).
[54] 17 C.F.R. § 240.17a-3(2) (1999) requires that "[l]edgers or other records reflecting all assets, liabilities, income, expense, and capital accounts" be made and kept current by registered broker-dealers.
[55] 7 U.S.C. § 7.
[56] 7 U.S.C. § 7a.

[57] 17 C.F.R. §§ 16.00–16.07.
[58] On June 21, 1999, a full membership in the Chicago Board Options Exchange was offered at $680,000 on the Chicago Board Options Exchange website (http://www.cboe.com) and a full membership in the New York Cotton Exchange was offered at $165,000 on the New York Cotton Exchange website (http://www.nyce.com).
[59] CAL. CORP. CODE § 29531(b).
[60] The "partial payment" language was added by amendment in 1991. (Stats.1991, c. 262 (S.B. 758), § 5). Its purpose was to close a perceived loophole by which dealers claimed customers had only made partial and not "full" payment, and thus the running of the 28 day period didn't begin until after full payment was made.
[61] Part II of the MSCC (Sections 2.01–2.13) provides for all these enforcement mechanisms.

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