# COMMODITY OPTIONS—REVISITED

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In 1973, shortly after the collapse of Goldstein Samuelson and the ensuing commodity option scandal, I had occasion to write an article dealing with the treatment of commodity options under the securities laws.[1] Since the publication of that article a great deal more information about option trading has become available and a number of courts have had a chance to pass on the status of these contracts. Therefore it was deemed appropriate to reconsider the positions taken in that original article and consider certain types of options not covered in the earlier treatment of the subject.

It is now apparent that there were three separate types of options being traded in the recent commodity option trading boom. In addition to the naked option which was the primary subject of the original article, trading also took place in "London" options on commodity futures and to a much lesser extent in Mocatta options on actual commodity metals. It is the purpose of this article to discuss the status of all three of these option types under the securities laws with special emphasis on the latter two types.[2]

I think the starting point for any discussion of commodity options must be with a brief statement of what commodity options are and how are they sold. A commodity option is essentially like any other type of option. As the reader should remember, an option is merely a contract whereby, for consideration, the option purchaser or holder is given the right to purchase a particular item or items from the option seller or grantor, at a fixed or determinable price, for a specific period of time. The option holder is not required to exercise his option and may allow it to lapse, in which case he will lose the consideration that he paid to secure the option right. However, if at any time during the option period he elects to exercise the option, then he must pay the agreed price to the option grantor, who in turn becomes obligated to deliver the underlying item or

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1. Long, *The Naked Commodity Option Contract as a Security*, 15 WM. & MARY L. REV. 211 (1973) [hereinafter cited as *Naked Options*].

2. No attempt will be made to discuss the even newer form of option trading, the stock option contract, which is now being offered by the American Stock Exchange and the Chicago Board of Option Exchange. There is no question that stock options *are* securities. The definition of a security found in section 2(1) of the Securities Act of 1933, 15 U.S.C. § 77b(1) (1970), and section 401(1) of the Uniform Securities Act, 1 BLUE SKY L. REP. ¶ 4901, specifically provides that any right to purchase a security is itself a security. Clearly, what the purchaser of a stock option receives is the right for a fixed period of time, to purchase the underlying stock at a fixed price. For a discussion of stock options, see 1971 OP. GA. ATT'Y GEN. 141; H. FILER, UNDERSTANDING PUT AND CALL OPTIONS (1959); Gates, *The Developing Option Market: Regulatory Issues and New Investor Interest*, 25 U. FLA. L. REV. 421 (1973).

items which were the subject of the option. Probably the most common of all options is the real estate option. For example, A pays B $10 for the right to purchase Blackacre from B for the sum of $25,000 with the offer to sell to remain open for a fixed period, say 30 days.

The commodity option, in theory at least, differs little from this hypothetical real estate option. The option purchaser, for a fee, receives from the grantor of the option the contract right to purchase from, or to sell to, the grantor, the underlying commodity or commodity futures contracts at a fixed price at any time during the life of the option. The option fee is often referred to as the "premium." While in the case of the real estate option the amount of the fee is normally a matter for negotiation between the parties, in the case of the commodity option contract it appears that most of the firms offer the options on a take-it-or-leave-it basis.[3] The price at which the underlying commodity is to be bought from or sold to the option grantor is known as the striking price. This striking price normally will be the current market price of the underlying commodity or futures contract,[4] with the result that the market in the commodity must move in the direction of the option before there is any incentive for the purchaser to exercise his option.[5] The period for commodity options ranges from a short one-month to a very long eighteen-months.[6]

The reader should have noticed one appreciable difference between the hypothetical real estate option and the commodity option. While the real estate option was to *purchase* the property from the option grantor, in the case of a commodity option, the option can be either to *purchase* from the grantor or to *sell* to him. If the option is one to *sell* to the grantor, the option is known as a *put* option; while the option to *purchase* from the grantor is known as a *call* option. In most recent commodity option trading, a *put* and a *call* have been combined into a single contract or package. This package is known as a *straddle* or more commonly merely a double option.[7]

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3. *See* HIGASHI, A REPORT TO THE HONORABLE FRANK J. HEALY, CORPORATION COMMISSIONER, STATE OF OREGON, ON COMMODITY PUT AND CALL OPTIONS 1 (undated, issued Spring, 1972) [hereinafter cited as HIGASHI]. It is not clear how the "premium" is calculated. In some cases, it seems to be dictated entirely by a determination of what the dealer thinks the market will bear. In other cases, the dealers claim that other factors, such as the length of the option, are taken into consideration. The longer the option period, the more chance for market fluctuation and more risk for the option grantor and therefore a higher premium. Selling costs also appear to be one of the considerations included in the mix. Barron's, Mar. 5, 1973, at 5, col. 3. One company estimates that the premium will generally run between 5 and 15 percent of the value of the underlying commodity or commodity futures contracts. First Federated Commodity Option Co., The Power of Commodity Options 2 (undated, issued Spring, 1973).

4. HIGASHI, *supra* note 2, at 2.

5. It is possible to have options with striking prices rather than the current market price of the underlying commodity. Such a variation would mean that there would be some profit built into the option or that the market would be profitable. In the first case, one would expect the option to sell for a higher premium because of the "automatic" profit if the option were exercised immediately, while in the latter case, the expectation would be that the premium would be lower than the normal option price because of the reduced risk to the option grantor that the market move would be sufficiently great to make the exercise of the option profitable.

6. HIGASHI, *supra* note 2, at 2.

7. Traditionally both portions of a straddle option could be exercised, if the market

As in the case of the real estate option, the commodity option purchaser theoretically makes his profit from the transaction; not from the option, *but from the dispostion of the underlying property which is the subject of the option.* Thus in the case of a call option, if the price of the underlying commodity or futures goes up, he exercises his option, purchases the commodity from the grantor, and resells the commodity on the open market at the current market price. His profit then is the difference between the current market price and the striking price of his option, less of course, the amount he had to pay for the option. On the other hand, if the purchaser buys a put option, he is betting that the price of the underlying commodity will go down. If this occurs, then he takes the commodity or futures contracts which he acquires at the current market price and delivers them to the grantor at the striking price which is higher. In this case, his profit is the difference between the striking price and the lower current market price or price he paid for the commodity futures contracts, again less the amount of the option price.

I think that the following example will illustrate the theoretical operation of a commodity option market.[8] On September 1, Mr. Brown, expecting the price of silver to rise, pays $1,200 for a one-year call option on a December New York Silver Contract with a striking price of $1.50 an ounce. If, during the year, the price of December New York Silver rises to $1.80 an ounce, Mr. Brown can obtain a return of $0.30 an ounce by buying at his contract option price of $1.50 an ounce from the option grantor and then reselling the silver for $1.80 an ounce on the open market. If the underlying contract calls for 10,000 ounces, Mr. Brown would receive $3,000. This price allows him to recover his $1,200 capital investment and an $1,800 profit. If, however, Mr. Brown had exercised his call option when the market price was only $1.60 an ounce and sold the underlying futures contract at this price, his profit would be only $0.10 per ounce or a total profit of $1,000 on a 10,000 ounce contract. Since he paid $1,200 for his option, this transaction would result in him suffering a net loss of $200.

To return for a moment to our hypothetical real estate option, I think that we can safely make two assumptions about that transaction. First, in an

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fluctuated sufficiently on either side of the striking price to make such exercise profitable. Thus, for example, if the market price for the particular commodity or futures contract underlying the option rose in March to a point where the option holder could recover his initial premium and make a profit, he would exercise the call side of his option and purchase the underlying item from the grantor. The exercise of the call portion of the straddle would have no effect on the put side which would remain outstanding. Then, if in August, the market had turned around and had dropped below the striking price sufficiently that the holder could make a profit by selling the underlying commodity to the grantor, the holder would then exercise the *put* side and sell the underlying commodity or futures to the grantor. However, as currently sold by most option companies, double options or straddles could only be exercised on one side. Thus the exercise of the call option in March in our example would also result in the cancellation of the put at that time.

8. This example is taken from the Stipulation of All Relevant Facts in Lieu of Trial on Preliminary and Permanent Injunction, *SEC v. Goldstein Samuelson, Inc.*, Civ. App. No. 73-472 (C.D. Cal. Oct. 11, 1973).

overwhelming majority of the cases, B, the grantor of the option, will own Blackacre, the underlying subject of the option, at the time that he grants the option, and therefore will be in a position, without further action on his part, to pass title to Blackacre within a reasonable period of time after A elects to exercise the option.[9] Second, again in the vast majority of cases, A, the purchaser of the option, will not consult with or seek the advice of B, the grantor, as to the desirability of purchasing the option in the first place or the appropriate timing as to the exercise of the option. Instead A will rely upon his own business judgment and acumen to decide whether the option is a "good deal" and when to take his profits. If such assumptions could be equally said of the recent trading in commodity options, there would be little justification for classifying their sales as involving the sale of a security.

There are two important inferences from this statement which need clarification. First, it is my contention under present authority in the state and federal courts under the Securities Act of 1933 and state acts having a similar definition of a security to that found in the federal act[10] that commodity contracts and commodity futures contracts are not securities *per se.*[11] This does not mean to say that commodities or commodity futures contracts may not be combined with other features so that the *combined package* constitutes a security. Reference need only be made to the recent decisions holding whiskey

9. If this condition does not exist, then arguably B has sold a security when he sold the option. In every executory contract, including option contracts, there is a risk that the other party to the contract will be unwilling or unable to perform. For example, Blackacre may be seized by a judgment creditor and sold. Such risk is inherent in the nature of an executory contract and should not lead to the classification of the contract as a security. However, when B does not presently own Blackacre, and either has himself an option or contract to buy it or plans to make such arrangements in the future, but does not presently have the assets to do so, but plans to complete the purchase from the money received from A, then the normal contract risk is changed and greatly magnified. It is the presence of this unanticipated risk of B's present inability to perform without the money received from A which has been held to convert what would otherwise be an ordinary executory contract into the sale of a security. *Cf.* Silver Hills Country Club v. Sobieski, 55 Cal. 2d 811, 361 P.2d 906, 13 Cal. Rptr. 186 (1961); Ga. Sec. Comm'r, Release No. 1, 1A Blue Sky L. Rep. ¶ 14,612 (Sept. 18, 1973). In effect, in this type of transaction A is being asked to turn over his money to B and assume the risk that B will use it in such a way that he will be in a position to perform when A requests performance. B may dissipate the money on private items unrelated to the contract or it may be seized by B's creditors. This is exactly the same risk that an investor must accept when he turns over capital to a corporation in exchange for its promise to pay either dividends or interest out of the funds derived from the use of the money. The only difference is in the expected return which the person wishes to receive. A wants Blackacre and the investor wants money in the form of a dividend or interest. The form of the expected return should not control the classification of the agreement for securities purposes. Admittedly, in most cases, A does not realize that he is incurring this additional risk. Yet the acknowledged purpose of disclosure type securities acts such as the Securities Act of 1933 is to force disclosure of the very same risk factors so that presumably the investor can make an intelligent investment decision as to whether he wishes to incur such risk.

10. 15 U.S.C. § 2(1) (1970). *See, e.g.,* Uniform Securities Act § 401(1).

11. *See, e.g.,* McCurnin v. Kohlmeyer & Co., 340 F. Supp. 1338 (E.D. La. 1972); Schwartz v. Bache & Co., 340 F. Supp. 995 (S.D. Iowa 1972); Sinva v. Merrill, Lynch, Pierce, Fenner, & Smith, Inc., 253 F. Supp. 359 (S.D.N.Y. 1966); 5 Op. Kan. Att'y Gen. 135 (Sept. 23, 1966).

purchase schemes[12] and gold and silver coin "margin" contracts[13] to be securities to verify this point.[14] Nor does it mean that commodity futures are not securities under many state securities statutes today. As a result of the commodity option scandal, many states have abandoned the traditional definition of a security and amended their acts to cover specifically commodity futures, commodity options and transactions in gold and silver coins.[15] It is merely an acknowledgment that without some type of additional feature or special legislation the majority of state and federal courts are not willing at least at this time to treat commodity or futures contracts as securities.

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12. *See, e.g.*, Glen-Arden Commodities, Inc. v. Costantino, 493 F.2d 1027 (2d Cir. 1974); SEC v. Haffenden-Rimar Int'l, Inc., 362 F. Supp. 323 (E.D. Va. 1973), *aff'd per curiam*, 496 F.2d 1192 (4th Cir. 1974); SEC v. M.A. Lundy Associates, 362 F. Supp. 226 (D.R.I. 1973); OP. PA. ATT'Y GEN. No. 49, 3 BLUE SKY L. REP. ¶ 71,094 (July 17, 1973); OP. IOWA ATT'Y GEN., 3 BLUE SKY L. REP. ¶ 71,153 (Feb. 12, 1973); Statement of Policy, *Investment Interests in Whiskey*, 2 BLUE SKY L. REP. ¶ 23,629 (Md. Sec. Comm'n Apr. 9, 1974); Statement of Policy, *Whiskey Warehouse Receipts*, 2 BLUE SKY L. REP. ¶ 37,628 (N.D. Sec. Comm'n May 1972). Problems with warehouse receipts are not new. The question of the status of these receipts for whiskey and other commodities for securities purposes was first raised in the 1930's. The early attorney general opinions on the subject appear to be in confusion, some holding receipts to be securities, others holding them not to be securities. *See generally* Annot., 1 BLUE SKY L. REP. ¶ 1715 (1975). However, the better reasoned cases and opinions distinguished between the bare offer of a warehouse receipt and the offering of such a receipt combined with other investment features. The first was generally held not to be a security, *e.g., Mutual Bankers Co. v. Terrell*, 130 Fla. 583, 178 So. 399 (1938) and 25 OP. N.C. ATT'Y GEN. 35 (June 2, 1939), while the second generally was. *See, e.g.*, State v. Unger, 237 Wis. 318, 296 N.W. 629 (1941); OP. WASH. ATT'Y GEN. (Feb. 13, 1942). A number of states, unwilling to treat the two types separately, amended their securities acts to include all whiskey warehouse receipts or warehouse receipts in general as securities. *See, e.g.*, FLA. STAT. § 517.02 (1973); LA. REV. STAT. § 51:701(1) (1950); MINN. STAT. § 80A.29 (1973); N.H. REV. STAT. ANN. § 421:2 (1955); OHIO REV. CODE § 1707.34 (1953).

13. SEC v. Western Pac. Gold and Silver Exch. Corp., [1974-1975 Transfer Binder] CCH FED. SEC. L. REP. ¶ 95,064 (D. Nev. Jan. 30, 1975); State v. Coin Wholesalers, Inc., 3 BLUE SKY L. REP. ¶ ——— (Minn. Dist. Ct., 4th Jud. Dist. May 5, 1975); People v. Monex Int'l, Ltd., 3 BLUE SKY L. REP. ¶ 71,156 (N.Y. Sup. Ct., N.Y. County July 26, 1974); *In re* Pacific Coast Coin Exch. — D.L.R.3d — (Ont. Div. Ct. Jan. 16, 1975), *aff'd*, — D.L.R.3d — (Ont. June 10, 1975), *reprinted in* 28 OKLA. L. REV. 333 (1975); *In re* Western Pac. Coin & Silver Exch. 3 BLUE SKY L. REP. ¶ 71,203 (Iowa Ins. Comm'n Jan. 23, 1975); *In re* American Coin Exch., 3 BLUE SKY L. REP. ¶ 71,163 (Wis. Sec. Comm'n May 17, 1974). *Cf.* SEC v. Brigadoon Scotch Distribs. Ltd., [1974-1975 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,980 (S.D.N.Y. Feb. 11, 1975). *But see* State v. Monex Int'l, Ltd., 3 BLUE SKY L. REP. ¶ 71,233 (Tex. Dist. Ct., 14th Jud. Dist., Dallas County July 10, 1974), *aff'd*, 3 BLUE SKY L. REP. ¶ 71,234 (Tex. Civ. App. Aug. 29, 1975). *See generally* Note, *Securities Regulation: Coin and Bullion Investment Programs—The Newest Security?*, 28 OKLA. L. REV. 433 (1975).

14. See also *Berman v. Dean Witter & Co.*, 44 Cal. App. 3d 999, 119 Cal. Rptr. 130 (Dist. Ct. App. 1975), holding that a futures contract in foreign currency is a security under both California and New York law.

15. *See, e.g.*, ARIZ. REV. STAT. § 44-1801, *as amended* [1974] Ariz. Laws ch. 126, § 1; DEL. CODE ANN. tit. 6, § 7302(m) (1973); HAWAII REV. STAT. § 485-1(12), *as amended* [1973] Hawaii Laws ch. 208, § 1; IND. CODE § 23-2-1-1(k) (1971), *as amended* [1975] Ind. Laws P.L. 261, § 1; OKLA. STAT. tit. 71, § 2(20)(o) (1974 Supp.); WIS. STAT. § 551.02(13)(a) (1971). The continued validity of these provisions is in question by virtue of the passage of the Commodity Futures Trading Commission Act of 1974, 7 U.S.C. §§ 4a-22 (Supp. IV, 1974), which contains a pre-emption clause. This problem will be discussed in detail later, see *infra* Section IV. At least one state securities department has indicated that it will not enforce its provision pending clarification of the pre-emption question. *See* Oklahoma Securities Commissioner, Internal Opinion to ACLI International Commodity Services, Inc. (June 25, 1975).

I am not completely convinced that such a conclusion is mandated by the language of the definitional sections and that in certain cases[16] these contracts are not clearly within the purpose of the securities acts as originally conceived.[17] The distinction between commodities trading and securities law

16. For example, if a person sells a commodity futures contract without possessing the necessary underlying commodity to satisfy that contract upon the settlement date, the purchaser of the commodities futures contract is subject to the same risk as outlined in note 9, *supra*. Arguably the presence of that risk converts the transaction into one involving the sale of a security. The Georgia Securities Commission has taken such a position. Ga. Sec. Comm'r, Release No. 1, 1A BLUE SKY L. REP. ¶ 14,612 (Sept. 18, 1973). It is my understanding that many, if not most, commodity futures contracts are issued by persons who do not have the necessary "actuals" to satisfy their contractual obligations.

17. I think that there has been a very large tendency in the 1950's and early 1960's to treat the reach of the securities acts as applying only to the regular type of securities traded in the normal securities market. Vestiges of this approach can still be found. This past term the United States Supreme Court refused to hold that stock in a cooperative housing corporation was a security, in part at least, on the basis that such stock did not fall within the "many types of instruments that in our commercial world fall within the ordinary concept of a security." United Housing Foundation, Inc. v. Forman, 421 U.S. 837, 847-48 (1975), *quoting from* H.R. REP. No. 85, 73d Cong., 1st Sess. 11 (1933). The problem with using this type of language to determine Congressional intent is that in order to understand what Congress intended to include within the purview of the statute it is necessary to establish what was considered a security by the commercial world of 1933. This most authors and courts have not been willing to do. It must be remembered that the Securities Act of 1933 was adopted against a backdrop of almost 20 years of state securities regulation and that the definition of a security as adopted by the Congress was intended to reflect the culmination of experiences of the various states. *See* SEC v. W.J. Howey Co., 328 U.S. 293 (1946). Few courts have bothered to discover that many of the schemes that have developed in the last 10 years such as the Glenn Turner operations are really nothing more than the modernization of schemes which were the cause of the changes in the definition of a security in the Teens and Twenties. For example, an opinion in the 1918 Illinois Attorney General Opinions contains a cattle feeding scheme not radically different from that held to be a security in *People v. Witzerman*, 29 Cal. App. 3d 169, 105 Cal. Rptr. 284 (Dist. Ct. App. 1972). *See* 1917-18 OPS. ILL. ATT'Y GEN. 81 (Sept. 25, 1918). In that opinion the agreement was held not to be a security, even though it clearly provided for a "profit-sharing" arrangement, because the definition of a security in the Illinois Act at that time was limited to "stocks, bonds, debentures and other securities." This lack of coverage was immediately remedied the following year when a new definition of a security was adopted which provided: "The word 'securities' shall include stocks, bonds, debentures, notes, participation certificates of shares or interests, preorganizational certificates and subscriptions, certificates evidencing shares in trust estates or associations and *profit sharing certificates*." [1919] ILL. LAWS § 2, at 353 (emphasis added).

The following year the Minnesota court had occasion to examine another new phase in the definition of a security—the investment contract. Having no legislative basis for interpreting the phrase, the court in *State v. Gopher Tire & Rubber Co.*, 146 Minn. 52, 54, 177 N.W. 937, 938 (1920), looked to a standard dictionary definition and concluded that an investment involves "[t]he placing of capital or laying out of money in a way intended to secure income or profit from its employment. . . ." Thus, it reasoned, an investment contract was any contract involving such an investment. An examination of these and other early cases and statutes indicates that the state securities acts were intended not merely to protect the classical passive investment in stocks and bonds but to provide an extremely broad measure of consumer protection. Recently the Minnesota court specifically rejected the narrow interpretation placed on investment contracts by the federal courts and returned to the *Gopher Tire* definition. *See* State v. Investors Security Corp., 297 Minn. 1, 209 N.W.2d 405 (1973). This approach has been followed by other courts. *See In re* Pacific Coast Coin Exch., — D.L.R.3d — (Ont. Div. Ct. Jan. 16, 1975), *aff'd*, — D.L.R.3d — (Ont. June 10, 1975), *reprinted in* 28 OKLA. L. REV. 333. *In re* Western Ontario Credit Corp., — D.L.R.3d — (Ont. Div. Ct. 1975); Shapiro v. First Federated Commodity Trust Corp., 3 BLUE SKY L. REP. ¶ 71,071 (Md. Cir. Ct., Baltimore County May 30, 1973).

appears to be more the result of historical happenstance than conceptual distinction. It is clear that the commodities and securities markets developed independently of each other, each being traded upon its own series of exchanges. This separation of the two markets was perpetuated by Congress when it entered these regulatory areas by passing the Securities Act of 1933 and the Commodities Exchange Act of 1936.[18] Further, any need to classify a commodity futures contract as a security at the federal level was largely vitiated when the federal courts held[19] that there was an implied civil cause of action for fraud under the Commodities Exchange Act similar to that implied under SEC rule 10b-5.[20]

This separate treatment of the two areas at the federal level stands in sharp contrast to their treatment at the state level. Until recently there was little attempt by the states to provide a comprehensive scheme of commodity regulation. Even today only California has a completely separate regulatory scheme for commodity futures and options.[21] What regulation there was of the commodity industry appeared however to apply equally to both securities and commodities. Thus, for example, the early "bucket shop"[22] acts applied equally to the bucketing of commodity or securities contracts.[23]

This conclusion that commodity and futures contracts are not *per se* securities is relevant to our discussion in this way. We must be extremely careful not to confuse the status of the basic contract with the option to purchase the basic commodity or futures contract. All too often the option promoters try to argue that since the basic commodity or futures contract is not

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18. 7 U.S.C. § 1 et seq. (1970). This act has recently been completely revised. The impact of these revisions on securities regulation will be considered below. *See infra* Section IV.

19. *See, e.g.*, Booth v. Peavey Co. Commodity Servs., 430 F.2d 132 (8th Cir. 1970).

20. 17 C.F.R. § 240.10b-5 (1975).

21. CAL. CORP. CODE §§ 29500-29590 (West 1974 Supp.). There is substantial doubt as to the continued validity of this provision in light of the pre-emptive language found in the Commodity Futures Trading Commission Act of 1974, 7 U.S.C. §§ 4a-22 (Supp. IV, 1974), discussed *infra* Section IV.

22. A "bucket shop" is "a place where wagers are made on the fluctuations of the market prices of grain and other commodities. . . ." Bergstrom v. Ridgway Co., 138 App. Div. 178, 181, 123 N.Y.S. 29, 32 (1910) *quoting* Bryant v. Western Union Tel. Co., 17 F. 825, 828 (D. Ky. 1883). For a discussion of how a bucket shop operates, see 1 L. Loss, SECURITIES REGULATION 39 n.62 (2d ed. 1961).

23. *See, e.g.*, OKLA. STAT. tit. 15, § 564 (1971). It has been argued that the selling of "naked" commodity options where the parties never intend the changing hands of the underlying commodity futures, but merely a cash settlement, constitutes nothing more than the operation of an old-fashion bucket shop operation. *In re Commodity Options*, 1 BLUE SKY L. REP. ¶ 9722 (Colo. Sec. Comm'n May 22, 1973); Ga. Sec. Comm'r, Release No. 1, 1A BLUE SKY L. REP. ¶ 14,612 (Sept. 18, 1973); *In re Commodity Options*, 3 BLUE SKY L. REP. ¶ 47,656 (Utah Sec. Comm'n Mar. 2, 1973); *cf.* 1971 OPS. GA. ATT'Y GEN. 1410. California authorities have filed criminal charges against one commodity option dealer on this theory in *State v. Kandriu*, No. 300,860 (Cal. Super. Ct., Los Angeles County, filed Sept. 20, 1973), and a conviction was recently obtained under the Canadian federal criminal bucket shop provision in *Regina v. Thomas Boyle* (unreported criminal case in the Provincial Court, Toronto Sept. 20, 1974). *See also* Then, *Section 341 of the Criminal Code: The Significance of the "Bucketing" Provision in Relation to Trade of Commodities, reprinted as* Appendix E in ONTARIO MINISTRY OF CONSUMER AND COMMERCIAL RELATIONS, REPORT OF THE INTERMINISTERIAL COMMITTEE ON COMMODITY FUTURES TRADING 109 (1975).

a security, ipso facto the option contract itself cannot be a security either. Such a broad generalization is clearly not supportable. Each is a separate item whose "securitiness" must be established or denied by reference to its own attributes. However, like most broad generalizations there is some grain of truth in the statement. It is true that if the basic commodity or futures contract itself is not a security, then the option contract does not become a security *automatically* by virtue of the fact that it is "a warrant or right to subscribe to or purchase" a security.[24] This of course does not mean that the option contract cannot become a security by virtue of satisfying some other portion of the definition.

However, the second inference that can be drawn from my basic statement is that the option contract by itself does not fit any of the other definitions of a security and, therefore, *also* is not a security *per se*. The true commodity option contract as we have seen differs little from an option contract to purchase a piece of real or personal property. No one would argue that such a contract involves the sale of a security and therefore no one should argue that the true commodity option contract is a security. We only enter the realm of security regulation when something is added to the basic option to create an investment package[25] or something which is not a true option contract is marketed under that heading.[26] This is the situation in the case of sales of at least two out of the three types of options that have been offered recently to American investors. Let us now turn to a consideration of each of the option forms individually.

## I. The American or "Naked" Commodity Futures Option

The American[27] or "naked" commodity option was the most popular form of commodity option sold in the recent commodity option boom in this country.[28] The popularity of the "naked" option was due primarily to the

24. UNIFORM SECURITIES ACT § 401(1).

25. The same is true in the case of the sale of real or personal property. The bare sale of a vacation homesite or condominium is not a security, but when other elements are added the sale of the package becomes a security. Lundquist v. American Campgrounds, Inc., 3 BLUE SKY L. REP. ¶ 71,196 (Wash. Super. Ct., King County Oct. 30, 1973); 1973 OPS. GA. ATT'Y GEN. 38 (Mar. 5, 1973) (recreational land development scheme); 1973 OPS. GA. ATT'Y GEN. 173 (condominium with rental pool); *cf.*, Oregon Corporations Commissioner, Internal opinion to Vacations Unlimited, 3 BLUE SKY L. REP. ¶ 40,705 (Dec. 18, 1973) (time sharing leases); OP. NEV. ATT'Y GEN. NO. 186, 3 BLUE SKY L. REP. ¶ 71,200 (Mar. 18, 1975) (hotel accommodation license).

26. This distinction will become extremely important in discussing the effects of the pre-emption provisions of the new Federal Commodity Futures Trading Commission Act of 1974, 7 U.S.C. §§ 4a-22 (Supp. IV, 1974). *See infra*, Section IV.

27. It is really a misnomer to refer to these options as "American" because naked options are also sold in London, and the European market is presently suffering the same fraud problems that developed in this country during the recent commodity option boom. See *The Wall Street Journal* (S.W. ed.), June 23, 1975, at 1, col. 6, discussing the collapse of the London and Luxembourg based ABI Commodity Options Ltd. I refer to these options as "American" because they appear to have first gained their wide acceptance in this country.

28. Canada also experienced a commodity option boom. For a discussion of the Ca-

efforts of Harold Goldstein of the firm of Goldstein Samuelson. Mr. Goldstein's apparent success in selling "naked" options[29] caused many firms to try to emulate his operation even after the first round of regulatory action leading to the collapse of Goldstein Samuleson.[30]

Goldstein hit upon the idea[31] to sell options on unregulated commodity futures on a mass scale. Trading in options on these "international" or unregulated[32] futures was not completely new to the United States. London options had been available in this country through old-line commodity brokers and securities dealers with commodity departments. However, these options had never been mass marketed and had never received wide acceptance. On the other hand, options on domestic commodity futures had been extensively traded on various exchanges during the 1920's and early 30's, but were banned by the Commodity Exchange Authority when it was established to regulate the domestic futures.[33]

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nadian experience, see Ontario Ministry of Consumer and Commercial Relations, *Report of the Interministeral Committee on Commodity Futures Trading* (Feb. 1975).

29. Goldstein began business on April 28, 1971 with an initial investment of $800 by selling his first option for $250. Over approximately a two year period he was able to parlay this $800 investment into a corporation, having more than 100 outlets throughout the world, which sold over 175,000 options worth more than $88 million. This meteoric rise, however, ended April 30, 1973 when Goldstein Samuelson was declared bankrupt after having been the subject of investigation and legal proceedings in a number of states including Oklahoma and California. *See* Stipulation of All Relevant Facts in Lieu of Trial on Preliminary and Permanent Injunction, SEC v. Goldstein Samuelson, Inc., Civ. App. No. 73-472 (C.D. Cal. Oct. 11, 1973), at 3-7. It is estimated that Goldstein Samuelson left behind between $14 and $85 million in unsatisfied claims by purchasers of its options. The exact amount of the claims probably will never be known as the corporate financial records are in total disarray.

30. For a discussion of the rise of several of the early firms which attempted to copy Goldstein Samuelson, see *Barron's*, Jan. 8, 1973, at 5, col. 2. One firm, Secured Commodities, was operating in Arkansas and Arizona selling "naked" options as late as January 1974. *See In re* Secured Commodities, Inc., 3 Blue Sky L. Rep. ¶ 71,125 (Ark. Sec. Comm'n Jan. 22, 1974). It is my understanding that option companies are re-emerging in the wake of the effective date of the Commodities Futures Trading Commission Act with the question of State pre-emption.

31. Goldstein admitted in an interview published in *Forbes Magazine* several months after the collapse of Goldstein Samuelson that the entire operation had been a gigantic hoax to defraud the public from the very beginning. Forbes, Aug. 15, 1973, at 66.

32. They are called "unregulated" because the Commodities Exchange Act of 1936 did not give control over these commodities to the Commodity Exchange Authority. Most domestic commodities such as wheat, cotton and corn are "regulated" commodities. However, certain commodities were considered to be "world" or "international market" commodities which it was originally thought should not be subject to regulation. Basically these commodities include silver, coins, platinum, cocoa, plywood, copper, coffee and world sugar. There are other "world" commodities, but generally the market in these commodities is too thin to support any kind of mass option trading. As a result of the commodity option scandal the decision to exclude these commodities from regulation has been re-examined and the new Commodity Futures Trading Commission has been given jurisdiction over all commodity futures sold in the United States whether trading takes place on an American or foreign exchange. *See* Section IV *infra.*

33. This ban was imposed because of the part that such options had played in the collapse of several commodity markets in the early 1930's. The Wall Street Journal (S.W. ed.), Feb. 22, 1973, at 1, col. 1. It is interesting to observe that the ban was made statutory when the Commodity Futures Trading Commission Act of 1974 was passed, but the ban was not extended to options on the previously unregulated commodities. Instead, the new Commission was to study the trading in these options to determine whether they should be regulated or banned. To date the Commission has acted only to the extent of passing

I think that the sales pattern followed in the marketing of these new "naked" options provides a classical study in how a form of doing business can be taken over and perverted to such a degree that the end product has no relation whatsoever to the original form.

An extended discussion of the naked option operation is not warranted here as that was done in the original piece. However, briefly, this is what took place. The options were mass marketed to persons who had little or no understanding of the commodities market, much less the intricacies of futures or option trading.[34] Further, by and large, such marketing was directed to the small investor who had little or no investment experience of any kind.[35] As a result, in practice, the investors relied heavily upon the advice of their account executive as to which options to buy and when to exercise the option.[36]

This reliance is further underscored by the fact that a number of the option firms had a standing policy that all options in which the client had a profit would automatically be exercised on the last day of the option period regardless of whether the account executive had received notification from the client to exercise the option or not.[37] Such a policy was necessary to avoid irate clients who, because of their total lack of understanding of the option system, did not realize that they had to exercise the option in order to receive their "profits." Such a policy was clearly against the economic interests of the broker who, as the issuer of the options, stood to lose on each option which was exercised.[38] This practice goes a long way to show that the entire option

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an anti-fraud rule very similar to that found in SEC Rule 10b-5, 17 C.F.R. § 240.10b-5 (1974), 40 Fed. Reg. 26505 (1975).

34. *The Wall Street Journal* quotes several commodity experts as stating that 90 percent of the transactions entered into by small commodity speculators end in loss to the speculator. The Wall Street Journal (S.W. ed.), Feb. 22, 1973, at 1, col. 1. The SEC and Goldstein are able to agree that the figure is at least 75 percent. Stipulation of All Relevant Facts in Lieu of Trial on Preliminary and Permanent Injunction, SEC v. Goldstein Samuelson, Inc., Civ. App. No. 73-472 (C.D. Cal. Oct. 11, 1973), at 21. This is to be contrasted with Goldstein's claim that purchasers of options made a profit in 70 percent of the cases. *Id.* The bankruptcy records on the other hand cast doubt on this claim. They show that of the 175,000 options Goldstein Samuelson wrote, only 85,000 were subsequently repurchased by the company, indicating a customer profit. The total repurchases amounted to only $19 million on a gross sales of $88 million. *Id.* at 7.

35. *In re* Goldstein Samuelson, Inc., 3 BLUE SKY L. REP. ¶ 71,095 (Okla. Sec. Comm'n Feb. 23, 1973). In his testimony before the Oklahoma Securities Administrator, Harold Goldstein bragged about serving the small investor with his options, investors which Goldstein indicated for the most part had been refused trading accounts at other brokerage houses. Testimony of Harold Goldstein, Transcript of Hearings before the Oklahoma Securities Administrator, *In re* Goldstein Samuelson, Inc., at 89 (Nov. 23, 1972).

36. *In re* Goldstein Samuelson, Inc., 3 BLUE SKY L. REP. ¶ 71,095 (Okla. Sec. Comm'n Feb. 23, 1973). Since the account executive is also an employee of the issuing firm, this places him in a position of a conflict of interest. If he favors the client, he is being disloyal to his employer and may cause it to lose substantial amounts. More than likely he is going to favor the employer and provide less than satisfactory investment advice to the investor. For a discussion of this problem see *Naked Options, supra* note 1, at 223-24.

37. *See, e.g. In re* Goldstein Samuelson, Inc., 3 BLUE SKY L. REP. ¶ 71,095 (Okla. Sec. Comm'n Feb. 23, 1973). *See generally Naked Options, supra* note 1, at 224.

38. Normally the option issuer is very happy for the profitable option not to be exercised.

operation was a sham and merely an investment device cast in the form of option trading.[39]

Turning our attention now from the nature of the investor to the mechanics of the transactions themselves, it is clear from the very beginning that the option dealers were not selling these options against existing stocks of the underlying commodity which they owned or against futures contracts which they held in their inventory.[40] Instead they claimed they were hedging their position in the market. However, they argued that it was economically impossible to maintain a complete hedge or a futures contract for each option on a futures contract sold.[41] Rather they have likened their hedging operation to the cash reserve position maintained by a bank or insurance company. They argued that no bank or insurance company maintains all its assets in cash against the possibility that all depositors or policy holders will want their

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39. This point will be extremely relevant when we consider the effect of the pre-emption language found in the new Commodity Futures Commission Trading Act. *See infra* Section IV.

40. Some dealers claimed to be nothing more than brokers, selling options written by others. In most cases this claim was patently false, as an examination of their own literature would have indicated. Unlike in the London market, where there are individuals and firms which write options which are then marketed through the exchanges or by brokers, in this country there were no individuals or firms writing the options marketed by Goldstein Samuelson and most of the other firms. The firms themselves wrote the contracts and thus were not acting as agents for the purchasers but rather as principals. In a limited number of cases, local firms would in effect job options written by the larger firms. Thus, in Oklahoma, Goldstein Samuelson's options were marketed through the auspices of Samuel Brokerage. Even here, however, it would appear that the jobber was the agent of the option seller rather than acting as the agent of the option *purchaser*.

41. The validity of this contention as far as the call options are concerned is open to serious question. As we will see in section II, *infra*, Mocatta Metals, Inc., fully hedged their options either with "actuals" in inventory or a futures contract owned by the company. Similarly, Pacific Coast Coin Exchange, which sold bags of silver coins on a margin agreement very similar to an option, claimed to have hedged its sales within plus or minus three percent in future or forward contracts of silver coins or silver bars. Likewise, many banks are finding it profitable to sell call stock options on securities held by their trust accounts. Thus it would seem not only physically, but also economically, possible for the commodity option dealers to cover all call options. Put options, on the other hand, present a different problem. Here the option dealer is obligated to purchase the tendered futures contracts. The only way that such a contract can be hedged is either to put aside the cash necessary to perform for the term of the option or sell a futures contract short. The latter is not desirable because the option may not be exercised, and then the dealer would have to purchase a contract on the open market to satisfy the short sale at a loss to himself. It would be better to treat the put option similarly to a stand-by commitment from a bank, where for a fee, the bank reserves money to loan to a customer against a later claim. If the customer does not take the loan, the bank earns the stand-by fee. If, on the other hand, the customer takes the loan, then the bank gets the stand-by fee, but may be obligated to loan the money at a lesser rate of interest than the going market. Similarly, in the case of an option, the dealer gets the option premium if the option is not exercised. If the option is exercised then he will get the option premium, but stands to suffer a loss on the resale of the futures contract which he is obligated to purchase at less than the going market. Thus it is submitted that sound fiscal practice would require that the put option seller set aside as a reserve the funds necessary to meet his purchase obligations. The sale of a double option would seem to require that the option seller maintain a complete hedge in the form of futures contracts for the call portion of the option and a cash reserve to cover the put side of the option. If the option is a true double option which can be exercised on both sides, exercise of one leg of the option should only act as a release of the reserve supporting that leg, with the reserve supporting the other leg remaining intact until such time as the other leg is exercised or the option expires.

funds at one time. Instead, experience will indicate that a portion of a reserve must be maintained to meet normal demands. Thus, the option dealers claim that they can fulfill the delivery requirements of their option holders by maintaining an inventory of futures contracts far below their actual obligations to deliver. It is rumored that the hedging was to be in the neighborhood of 35 to 40 percent of the total number of futures contracts on which the firm had options outstanding.

It should be obvious that such a practice introduces a substantial risk that the company will be unable to perform all its obligations should all the option holders demand delivery at one time. I think that it is the existence of this risk that makes the analogy to the bank or insurance company so apropos. These industries, because of this *high risk of non-performance*, have traditionally been two of the most heavily regulated industries in terms of capital required to enter the field, reserves required to be maintained, and the nature and percentage of investments which can be made. Yet the option dealer wishes to engage in a similarly high risk industry with little or no capital,[42] no control over reserves other than his own undisclosed hedging formula, which he is not required to follow and, in fact, did not follow, and no control over his investment policies.[43] Further he even resents having to tell the potential investor the risk that the investor must incur if he purchases such an option! It is interesting to note that it is the presence of *this very risk* which has caused an *investment* in either insurance[44] or a bank[45] to be classified as a security.[46]

42. Harold Goldstein started Goldstein Samuelson, Inc., with $800 and no other capital was ever contributed. The remaining capital structure consisted entirely of retained earnings. Stipulation of All Relevant Facts in Lieu of Trial on Preliminary and Permanent Injunction, SEC v. Goldstein Samuelson, Inc., Civ. App. No. 73-472 (C.D. Cal., Oct. 11, 1973), at 19.

43. The option dealers and Pacific Coast Coin Exchange have steadfastly maintained that the money they received either from the sale of the options or the silver coin bags on margin belongs exclusively to the company and can be used for any type of purpose or investment that the company chooses to make.

44. The annuity-type policy as opposed to the pure insurance-type policy. The status of the pure insurance-type policy as a security is not entirely free from doubt. It could be argued that the pure insurance policy is as much an investment contract as the annuity policy on the theory that the purchaser has to undergo the risk that the insurance company will be unable to provide the benefit he bargained to receive, *i.e.*, the payment of the policy upon certain contingencies, if the company is inadequately capitalized. *Cf.* Silver Hills Country Club v. Sobieski, 55 Cal. 2d 811, 361 P.2d 906, 13 Cal. Rptr. 186 (1961). Such a question is largely of academic interest since the Securities Act of 1933, 15 U.S.C. § 77c (a)(8) (1970), contains an exemption from registration for such policies. This of course leaves open the question of whether such policies are subject to the anti-fraud provisions. See 1 H. BLOOMENTHAL, SECURITIES AND FEDERAL CORPORATE LAW § 2.08 (1975) rejecting such contention. The status of these policies is much clearer at the state level where a provision has been inserted in the definition of a security specifically excluding these contracts from the coverage of that term. *See, e.g.*, UNIFORM SECURITIES ACT § 401(1).

45. Savings accounts or certificates of deposit as opposed to purely depository accounts such as checking accounts.

46. *See, e.g.*, SEC v. United Benefit Life Ins. Co., 387 U.S. 202 (1967); SEC v. Variable Annuity Life Ins. Co. of America, 359 U.S. 65 (1959) (holding that variable annuities and separate accounts are investment contracts to be securities and not within the exemption for insurance policies and annuities found in 15 U.S.C. § 77c(a)(8) (1970)); SEC v. First American Bank & Trust Co., 481 F.2d 673 (8th Cir. 1973); OP. ARIZ. ATT'Y GEN., [1954-1971 Transfer Binder] BLUE SKY L. REP. ¶ 70, 246 (1954) (holding savings accounts and certificates of deposit to be securities).

Further, this risk in the case of the option dealer is substantially increased by the fact that the hedging that he does conduct is done for the most part on the margin. Thus, the option dealer does not buy outright 35 to 40 percent of the contracts necessary to satisfy his obligations, *he merely makes a downpayment on them of from 8 to 25 percent of their market price.* Thus, whether he will have any contracts to satisfy his obligations will depend upon whether, at the time he is required to settle, he has sufficient funds to pay the remaining amount due on the margin contracts so that he can take delivery of the futures contracts and honor his option contract by re-delivering them to the option holder.

As bad as this practice may seem, the practical operation of the various option companies during the past boom was even worse. While they advertised that they were applying their secret formulas for hedging, in fact they were not purchasing any futures contracts;[47] or even worse, they were entering the market on the side opposite to their holders in an attempt to manipulate it and drive the underlying futures price down to avoid having to redeem many of the outstanding options.[48]

Those courts which have recently had to consider the question whether a particular transaction involved the sale of a security have unanimously agreed that the particular form a transaction is cast in is virtually irrelevant; rather the test for "securitiness" lies in whether, in economic substance, the transaction in question falls within the type of thing that the securities acts were intended to regulate.[49] Applying this economic substance or "realities" test to naked commodity options as they were sold during the recent commodity option boom, as I have outlined above, it was my position in the original article that these options could come within any or all of the following three categories of securities found in the "standard" definition of a security:[50] (1) evidence of

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47. Thus in effect they were bucketing the options.

48. *See, e.g.*, United Housing Foundation, Inc. v. Foreman, 421 U.S. 837 (1975).

49. *Id.*

50. The "standard" definition of a security would have to be considered the one found in section 2(1) of the Securities Act of 1933, 15 U.S.C. § 77b(1) (1970), which reads as follows:

> (1) The term "security" means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, or, in general, any interest or instrument commonly known as a "security", or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

This definition itself is a combination and codification of the various general terms found in the earlier state acts. It was incorporated into the Uniform Securities Act with only minor change. UNIFORM SECURITIES ACT § 401(1). This act in varying forms has been enacted in over thirty American jurisdictions. *See* 1 BLUE SKY L. REP. ¶ 4901 (1973). The federal act definition has also served as the model for most non-uniform state act definitions. *See generally* Long, *Introduction* to Student Symposium, *Interpreting the Statutory Definition of a Security: Some Pragmatic Considerations*, 6 ST. MARY'S L.J. 95, 97-99 (1974).

indebtedness; (2) investment contracts; and (3) any instrument commonly known as a security. Every court or administrative agency which has considered the question with two exceptions[51] have found these options to come within one or more of the outlined terms. Let us consider briefly the rationale advanced in the original article for including the naked options in each of these categories and then discuss the subsequent decisions which support those positions.

### A. *Evidences of Indebtedness*

The most widely accepted definition of evidence of indebtedness for non-regular debt instruments was formulated by the court in *United States v. Austin.*[52] In that case, Austin and several other defendants sought out construction companies in need of money to complete various projects and offered, for a price, "letters of commitment," which, in essence, were promises by the defendants to secure funds from a third party or, if a third-party lender could not be found, to advance the money themselves. In upholding a finding that the letters of comitment were evidences of indebtedness, the court said:

> The term "evidence of indebtedness" is not limited to a promissory note or other simple acknowledgment of a debt owing and is held to include all contractual obligations to pay in the future for consideration presently received.
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> . . . .
>
> It is true that the letter of commitment is not an indicium of debt in the same sense as a promissory note, but as used in the Securities Act no such restriction is appropriate. In last analysis, this letter of commitment was sold for a substantial consideration, and the buyer received what appeared to be an enforceable obligation which contemplated the flow of funds. It indicated a binding and legally enforceable right. Therefore, we can find no fault with the ruling of the trial court insofar as it regarded the letter of commitment as plainly being a security.[53]

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51. Glazer v. National Commodity Research & Statistical Serv., Inc., [1974-1975 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,978 (N.D. Ill. 1974); International Commodity Trust, Inc. v. Fisher, 3 BLUE SKY L. REP. ¶ 71,075 (Okla. Dist. Ct., Okla. County May 14, 1973). A third case, *SEC v. Continental Commodities Corp.*, Civ. App. No. 3-6976-D (N.D. Tex. Apr. 9, 1973), was reversed on appeal. SEC v. Continental Commodities Corp., 497 F.2d 516 (5th Cir. 1974). All of these cases were tried under the investment contract portion of the definition and the courts held that the common enterprise element of the *Howey* test for investment contracts was not present. *See* SEC v. W.J. Howey Co., 328 U.S. 293 (1946). This test is more fully discussed below. *See* text accompanying notes 66-77 *infra*. Each of the courts adopted the pooling of investor funds requirement for a "common enterprise" as developed in *Milnarik v. M-S Commodities, Inc.*, 457 F.2d 274 (7th Cir.), *cert. denied*, 409 U.S. 887 (1972). This test was, of course, binding on the court in *Glazer*, but the Fifth Circuit specifically rejected it in *Continental Commodities*. The *International Commodity Trust* case was not appealed because the Governor signed an amendment to the definition of a security as found in the Oklahoma Securities Act to specifically include commodity options as securities the day following the trial court's decision. *See* 71 OKLA. STAT. § 2(20)(*O*) (1974 Supp.).

52. 462 F.2d 724 (10th Cir.), *cert. denied*, 409 U.S. 1048 (1972).

53. United States v. Austin, 462 F.2d 724, 736 (10th Cir.), *cert. denied*, 409 U.S.

Applying this definition to the naked options *as they were sold* during the recent boom, it should be apparent that the options can be classified as evidences of indebtedness. As has been pointed out, in the vast majority of cases the naked option dealer, instead of making a delivery of the underlying futures contracts, "repurchases" the option from the contract holder, paying him the difference between the current market price and the option striking price. In some cases, the sales literature specifically indicates that this is the way the transactions are to be handled.[54] While in other cases, the essence of the buy-back agreement, although not specifically mentioned in the sales literature, is conveyed to the customer as a part of the sales promotion.[55] Further, in most cases the option firms had a standing policy of automatically exercising all options in which the customer had a profit on the last day of the option period regardless of whether the firm had received instructions from the customer to do so. Such a policy appeared necessary to prevent widespread dissatisfaction from the vast majority of customers who, not knowing or caring about the mechanics of option trading, did not realize that such action was necessary on their part.

Taking these factors altogether, I think it is clear that the naked option dealers have merely used the form of option trading without the corresponding substance. Instead the economic reality of these option transactions, as recognized by the substantial majority of option customers, was that the customer would pay the option dealer money in exchange for the dealer's promise to repay the customer money under certain conditions.[56] Clearly this economic substance brings the transaction within the test set out in *Austin* for an evidence of indebtedness of a contractual obligation "to pay in the future for consideration presently received."[57]

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1048 (1972). The Securities Commissioners of Alaska and Michigan have taken similar positions on such advance fee schemes. *See In re* Bailey, 3 BLUE SKY L. REP. ¶ 71,176 (Alas. Sec. Div. Dec. 3, 1974); MICH. SEC. COMM'N BULL. 1 (Sept. 1, 1972).

54. For example, one dealer in its literature states: "First Federated Commodity Option Company is the grantor of the options and guarantees upon demand to redeem any and all Options, either Put or Call or Put and Call (Double Options) which have been duly registered on its books, for value." First Federated Commodity Option Co., The Power of Commodity Options 2-3 (undated, issued Spring 1973). *See also* Goldstein Samuelson, Inc., Investment Opportunity 7 (undated, issued Spring 1972), indicating that the firm would always buy back profitable options. This same buy back idea has been carried forward into the sale of gold and silver coins on the margin. Again, few if any customers take delivery of their coins; instead, they sell them back to the seller who indicates that he stands ready to repurchase. This repurchase agreement has been held significant in classifying these sales as the sale of a security. *See, e.g., In re* Pacific Coast Coin Exch., — D.L.R.3d — (Ont. 1975); State v. Coin Wholesalers, Inc. (Minn. Dist. Ct., 4th Jud. Dist. May 5, 1975).

55. People v. Puts and Calls, Inc., 3 BLUE SKY L. REP. ¶ 71,090 (Cal. Super. Ct., Los Angeles County June 21, 1973).

56. *See* Commodities Int'l, Inc. v. Eure, 207 S.E.2d 777 (N.C. App. 1974).

57. United States v. Austin, 462 F.2d 724, 736 (10th Cir.), *cert. denied*, 409 U.S. 1048 (1972). While it has been generally considered that the concept of "evidence of indebtedness" contemplates that the payment in the future will be in money or, in the words of the *Austin* court, result in "an enforceable obligation which contemplate[s] the flow of funds," it has been suggested by the Oregon Corporation Commission that "evidence of indebtedness" may be broad enough to encompass those situations where there is merely a

The fact that the obligation of the dealer to pay is conditional, *i.e.*, tied to the market moving in such a way that the customer has profit, does not alter this conclusion. While we often think of evidences of indebtedness being absolute obligations to pay a fixed amount, neither of these elements is inherent in the concept. Last fall during the credit crunch, several major corporations including Standard Oil of Indiana offered corporate bonds whose coupon rate was tied to the prime lending rate and varied up or down according to the variations in that rate. Similarly, in *Curtis v. Johnson*[58] the court held that the conditional nature of a person's promise to pay does not prevent that promise from being an evidence of indebtedness.

Since the publication of the original article the concept of evidence of indebtedness has been applied to the naked options in a number of court and administrative decisions. The first decision to do so was *In re Secured Commodities, Inc.*[59] After quoting from *Austin*, the Arkansas Commissioner said:

> In this instance the reality of the situation is that respondents' customers, who have an option which has turned out to be profitable, want money and have every right to expect money. None of the customers are expected to take delivery of commodities upon a profitable option; all would expect to be paid in cash. . . . It makes no difference that the obligation may never ripen as to some investors; this only goes to the degree of risk involved and not to the question of whether it is a security. . . . The fact is that the moment the market price of the underlying commodities rises above the option holders striking price the certificates become an evidence of indebtedness and both respondents and the customer fully intend from the outset that a debt should be owed by the respondents to the customer at the earliest possible time.[60]

The evidence of indebtedness theory was also recognized by the court in *King Commodity Co. v. State*.[61] Again the starting point was the above quoted language from the *Austin* case. The court then points out that King's sales literature describes the exercising of a double option as " 'selling both the put and call back to King . . . .' "[62] It then goes on to indicate that the customer

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promise to deliver any goods in the future. *In re* Constitution Mint, Inc., Notice of Proposed Order to Cease and Desist (Ore. Corp. Comm'n Int. Op.); *In re* International Precious Metals Corp. (May 20, 1974). *But see* State v. Coin Wholesalers, Inc., 3 BLUE SKY L. REP. ¶ ——— (Minn. Dist. Ct., 4th Jud. Dist. May 5, 1975).

58. 92 Ill. App. 2d 141, 234 N.E.2d 566 (1968). *See also In re* Secured Commodities, Inc., 3 BLUE SKY L. REP. ¶ 71,125 (Ark. Sec. Comm'n Jan. 22, 1974); *In re* Meed Invs., Inc., 3 BLUE SKY L. REP. ¶ 71,171 (S.D. Comm'n Aug. 30, 1974); *In re* Clayton Brokerage Co., 3 BLUE SKY L. REP. ¶ 71,132 (Tex. Sec. Comm'r Dec. 18, 1973), *aff'd*, 520 S.W.2d 802 (Tex. Civ. App. 1975).

59. 3 BLUE SKY L. REP. ¶ 71, 125 (Ark. Sec. Comm'n Jan. 22, 1974).

60. *In re* Secured Commodities, Inc., 3 BLUE SKY L. REP. ¶ 71,125 at 67,500 (Ark. Sec. Comm'n Jan. 22, 1974). This language is virtually a verbatim quotation from the earlier *In re Clayton Brokerage Co.*, 3 BLUE SKY L. REP. ¶ 71,132 at 67,524 (Tex. Sec. Comm'n Dec. 18, 1973), a case involving London Options. Very similar language was used in *In re Meed Investments, Inc.*, 3 BLUE SKY L. REP. ¶ 71,171 (S.D. Sec. Comm'n Aug. 30, 1974).

61. 508 S.W.2d 439 (Tex. Civ. App. 1974).

62. King Commodity Co. v. State, 508 S.W.2d 439, 445 (Tex. Civ. App. 1974). The

apparently has a theoretical right to demand delivery of the particular underlying commodity, but that King had no right to demand that delivery be taken. Further the evidence indicated that in actual practice King always settled by a cash payment. Finally, the court concludes saying:

> In other words, King represented to the customer that whenever he chose to exercise his option, King . . . would have his profit in the bank and would pay it to him in cash on demand. Regardless of the fact that the market price determined the amount to be paid and even whether any amount was due, the options were sold as "guaranteed" obligations of King to pay money on certain contingencies. Therefore, they were "evidences of indebtedness" subject to registration as "securities" within the Act.[63]

Most recently the Tennessee Attorney General in an opinion issued in August 1974, again relying upon the *Austin* case, held that the naked commodity option was an "evidence of indebtedness" within the language of the Tennessee Securities Act.[64]

### B. *Investment Contracts*

An equally strong argument can be made for including naked commodity options within the category of an investment contract. There are generally recognized to be three different tests for the existence of an investment contract.[65]

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court goes on to quote the following passage from the operating rules and procedures issued by King:

> As an additional customer safeguard, any fluctuation of the market for an option buyer which results in an equity from the striking price, that equity will be deposited on a daily basis in a segregated customer account. For example, if a customer bought a silver option and the striking price was \$2.3000 and the price moved to \$3.000 resulting in an option holders equity of \$700.00, that \$700.00 is deposited in the segregated account and any additional equity is deposited on a daily basis.

*Id.*

63. *Id.* at 445.

64. OP. TENN. ATT'Y GEN. No. 27, 3 BLUE SKY L. REP. ¶ 71,164 (Aug. 21, 1974). *But see* State v. Coin Wholesalers, Inc., 3 BLUE SKY L. REP. ¶ ——— (Minn. Dist. Ct., 4th Jud. Dist. May 5, 1975).

65. There is also a fourth test which is derived from *State v. Gopher Tire & Rubber Co.*, 146 Minn. 52, 177 N.W. 937 (1920), where the court said that an investment contract was a contract or scheme for "the placing of capital or laying out of money in a way intended to secure income or profit from its employment." *Id.* at 53, 177 N.W. at 938. This test has been overshadowed in recent years by the other tests which are described in the text. However, there is some indication that this test will again re-emerge as a major test for investment contracts. Both the Minnesota court and a lower court in Maryland have rejected the *Howey* test as the exclusive test and have adopted the *Gopher* test. *See* State v. Investors Sec. Corp., 209 N.W.2d 405 (Minn. 1973); Shapiro v. First Federated Commodity Trust Co., 3 BLUE SKY L. REP. ¶¶ 71,058 and 71,071 (Md. Cir. Ct., Baltimore County Feb. 22, 1973 and May 30, 1973). Likewise, a Canadian court recently indicated that it thought the *Gopher* test was the most desirable test. *See In re* Pacific Coast Coin Exch., — D.L.R.3d — (Ont. Div. Ct. Jan. 3, 1975), *aff'd*, — D.L.R.3d — (Ont. July 10, 1975), *reprinted in* 28 OKLA. L. REV. 333 (1975). *See also In re* Western Ontario Credit Corp., — D.L.R.3d — (Ont. Div. Ct. Mar. 25, 1975). It is interesting to note that two of these cases, the *Shapiro* case and the *Pacific Coast Coin* case, involve commodity options or margin account sales of gold and silver coins which we will see *infra* are in substance indistinguishable from the sale of options. *See also* State v. Coin Wholesalers, Inc., 3 BLUE SKY L. REP. ¶ ——— (Minn. Dist. Ct., 4th Jud. Dist. May 5, 1975).

The first and still probably the most widely-cited definition of investment contract was formulated by the United States Supreme Court in the now famous *SEC v. W.J. Howey Co.*[66] In this case, the Court held that "an investment contract for purposes of the Securities Act means a contract, transaction, or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party . . . ."[67] The Court also added another admonition which is relative to our discussion of commodity option contracts: "The statutory policy of affording broad protection to investors is not to be thwarted by unrealistic and irrelevant formulae."[68]

It is generally considered that the *Howey* test contains four basic requirements. First, the investor must make an investment of money. Subsequent cases have made clear that this includes not only money, but money's worth in the form of goods or services.[69] Second, this money must be invested in a "common enterprise." Third, the investor must expect to receive a profit as a result of this investment.[70]

Finally this profit must come from the efforts of others than the investor. Again there has been a dispute here as to whether these efforts have to come "solely" from others or whether the investor may participate to a limited extent. The Supreme Court in *Howey* couched its test in terms of "solely" through the efforts of others. However, more recently other courts have tended to soften

66. 328 U.S. 293 (1946). The Court three years earlier in *SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344 (1943), decided another case which is very important to the understanding of the scope of the investment contracts concept. In that case the Court made the following statement which must be kept in mind when viewing commodity options: "In the enforcement of an Act such as this it is not inappropriate that promoters' offerings be judged as being what they were represented to be." *Id.* at 353. For a detailed discussion of the various tests for investment contracts in the commodity option setting see *Naked Options*, *supra* note 1, at 246-61. For a general discussion of these definitions, see, *e.g.*, Long, *Introduction* to Student Symposium, *Interpreting the Statutory Definition of a Security: Some Pragmatic Considerations*, 6 ST. MARY'S L.J. 95 (1974); Long, *An Attempt to Return "Investment Contracts" to the Mainstream of Securities Regulation*, 24 OKLA. L. REV. 135 (1971).

67. SEC v. W.J. Howey Co., 328 U.S. 293, 298-99 (1946).

68. *Id.* at 301.

69. *See, e.g., In re* Continental Marketing Associates, Inc., 3 BLUE SKY L. REP. ¶ 71,016 (Ind. Sec. Comm'n Oct. 27, 1969).

70. There has been some question whether this profit has to take the form of a tangible monetary return or can consist of some intangible benefit such as the use of country club facilities. The Oregon Corporation Commission took the position that the benefits could be intangible or could be in the form of money saved. *In re* Jet Set Travel Club, 3 BLUE SKY L. REP. ¶ 71,175 (Ore. Corp. Comm'n Oct. 28, 1974), *rev'd*, 535 P.2d 109 (Ore. App. 1975). *See also* Oregon Corporation Commission, Internal Opinion to Vacations Unlimited, 2 BLUE SKY L. REP. ¶ 40,705 (Dec. 18, 1973). A similar approach was accepted by the Second Circuit in *Forman v. Community Services, Inc.*, 500 F.2d 1246 (2d Cir. 1974), *rev'd sub nom., United Housing Foundation, Inc. v. Forman*, 421 U.S. 837 (1975). While the Supreme Court refused to accept a broad concept of "profits" in the context of the *Forman* case, involving the shares of a public housing project, I submit that the concept is still a very appropriate one for other situations. *See generally* Long, *Introduction* to Student Symposium, *Interpreting the Statutory Definition of a Security: Some Pragmatic Considerations*, 6 ST. MARY'S L.J. 96, 117-19 (1974). Fortunately this question does not come up in connection with commodity options since in all cases the investor is seeking a monetary profit.

this requirement, and the Supreme Court in its recent decision in *United Housing Foundation, Inc. v. Forman*[71] refused to express an opinion as to whether it approved these modifications.

The modification has generally taken two forms. Either the court will change the "solely" requirement to "substantially" as was done in *SEC v. Glenn W. Turner Enterprises, Inc.*,[72] or the court will look to the type of efforts which it thinks the *Howey* court intended. Thus, in *State v. Hawaii Market Center, Inc.*,[73] the court indicated that the critical efforts were managerial efforts as opposed to physical non-control type "efforts." It is these efforts which will determine whether the investment is a success or failure. I submit that the latter approach is the more desirable and that a particular item should not be classified as a security if the investor, by his investment, has a right, which he has not tacitly surrendered, to participate in the management or control of the investment.[74]

In applying the *Howey* test to the naked commodity option, we must again look to the economic substance of the transaction and not the form in which it is cast. In substance the transaction amounts to the investor turning over funds to the grantor of the option for him to use in any way that he sees fit, in exchange for the grantor's promise to pay the investor a profit as measured by an external source, the rise and fall of the commodity futures market. While the *amount* of the return will be determined by this market, the *ability* of the option grantor to *pay* the investor the contracted return will depend entirely upon what the grantor does with the money received from the investor.

It should be clear under this analysis that there is an investment in the form of the premium paid by the customer for his option. Thus, clearly the first requirement of the *Howey* test is met. Further, it is clear that the investment is being made by the customer in hopes that he will receive a monetary "profit" from the investment, and therefore the third requirement of the *Howey* test is also satisfied.

The dispute over whether these options are investment contracts under the *Howey* test has centered around the second and fourth elements of that test; whether there is a common enterprise present and whether the profits come

71. 421 U.S. 837, 850 n.15 (1975).
72. 474 F.2d 476 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973).
73. 52 Hawaii 642, 485 P.2d 105 (1971).
74. I think the following illustration will demonstrate what I believe to be the difference between the two approaches. Assume we have a national accounting firm which is not incorporated, but is a partnership with over 400 general partners—not an uncommon situation among the major accounting firms. By statute, a general partner is entitled to participate in the management of the partnership. Thus, while his vote is only one in four hundred, he is entitled to share in the management of his investment and under the *Hawaii Market Center* "management efforts" test his interest should not be a security. However, since his vote is only one in four hundred it would be difficult to argue that these "managerial efforts" are significant under the *Glenn Turner* rationale and the partnership interest would seem to be a security. Clearly in either case if the partner relinquishes his right by partnership agreement to a committee of managing partners, then his interest is a security.

solely through the efforts of others. The option dealers basic contention is that there is no common enterprise because there is "no pooling" of investor's funds. This concept of "common enterprise" stems from the decision of the Seventh Circuit in *Milnarik v. M-S Commodities, Inc.*,[75] where the court refused to hold that discretionary trading accounts in commodity futures constituted investment contracts under the *Howey* test. The court in that case pointed out that each customer turned money over to the broker-dealer which it invests according to its own discretion without consultation with or obtaining the approval of the customer. While the broker-dealer may have a large number of such accounts with various customers, each customer's account is segregated and co-mingling of customer funds is prohibited by regulation.

In *form* the sale of naked options differs little from this discretionary trading account format. Each customer opens an account with a dealer who may or may not also be the grantor of the option purchased. That dealer will maintain a large number of accounts besides the one opened by our purchaser. Likewise, the grantor of the option may have a sizable number of options outstanding in the hands of grantees other than our customer.

As appealing as this simplistic comparison is,[76] it must fail for two basic reasons.

First, the "pooling" concept of common enterprise has not been widely recognized[77] and has been rejected by a number of courts[78] including the Fifth Circuit in *SEC v. Continental Commodities Corp.*,[79] a case involving commodity option contracts. In rejecting the "pooling" idea of common enterprise, the Fifth Circuit elected to adopt the more widely recognized concept, stemming from the Ninth Circuit's decision in *Los Angeles Trust Deed & Mortgage Exchange v. SEC*,[80] that a "common enterprise" is one in which the fortunes of the investor are interwoven with and dependent upon the efforts and success of either those seeking the investment or of a third party.

Second, and more important, this simplistic view of the commodity option transaction ignores the economic realities of option trading as we have already

75. 457 F.2d 274 (7th Cir.), *cert. denied*, 409 U.S. 887 (1972).

76. It has in fact been accepted by two courts. In *Glazer v. National Commodity Research & Statistical Service, Inc.*, [1974-1975 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,978 (N.D. Ill. 1974), the court was compelled to reach such a conclusion because the *Milnarik* case was a binding precedent upon it. In *International Commodity Trusts, Inc. v. Fisher*, 3 BLUE SKY L. REP. ¶ 71,075 (Okla. Dist. Ct., Oklahoma County May 14, 1973), the court failed to consider the substance of the transaction and was willing to decide the case solely on the form the transaction took.

77. It appears to have been adopted by only two other district courts outside of the Seventh Circuit. *See* Stuckey v. duPont Glore, Forgan, Inc., 59 F.R.D. 129 (N.D. Cal. 1973); Wasnowic v. Chicago Bd. of Trade, 352 F. Supp. 1066 (M.D. Pa. 1972), *aff'd without opinion*, 491 F.2d 752 (3d Cir.), *cert. denied*, 416 U.S. 994 (1974) (both involving discretionary trading accounts).

78. *See, e.g.*, Marshall v. Lamson Bros. & Co., 368 F. Supp. 486 (S.D. Iowa 1974).

79. 497 F.2d 516 (5th Cir. 1974). *See also* SEC v. Koscot Interplanetary, Inc., 497 F.2d 473 (5th Cir. 1974).

80. 285 F.2d 162 (9th Cir. 1960), *cert. denied*, 366 U.S. 919 (1961). *See also* SEC v. Glenn W. Turner Enterprises, Inc., 474 F.2d 476 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973).

developed them. The option grantors steadfastly maintain that the money that they receive from the sale of their options in the form of the option premiums is their money which they can use for whatever purpose they see fit. Most in their literature indicate that at least a part of this money was to be used to "hedge" the options by transactions in the underlying commodity futures. However, there was no contractual obligation on the part of the option dealers[81] to carry on this hedging operation and in fact in the vast majority of cases little if any hedging was actually done.[82] Thus, the economic realities of the transaction were that the underlying commodity futures market served as the yardstick for measuring the *amount* of the profit which the grantor owed the customer, while the grantor's management of his own capital and the premium money taken in determined whether he was going to be in a position to pay the customer the amount owed him. Viewed in this light, it is quite apparent that a common enterprise is present because the ability of the customer to receive the profit that he has earned is interwoven and dependent upon the dealer's or grantor's efforts and success in generating sufficient funds to pay him.[83]

The majority of the courts and administrative agencies which have considered the "naked" option question have followed the lead of the Fifth Circuit and rejected both the "pooling" concept of common enterprise and the simplistic analogy to discretionary commodity trading accounts.[84]

Second, the option dealers claim that the fourth element of the *Howey* test, that the profit expected on the transaction must come solely through the efforts

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81. Normally the option dealer was also the grantor of these "naked" options. However in certain cases, the grantor would subcontract with another dealer to "job" the options created by the grantor. For example, in Oklahoma, Goldstein Samuelson options were sold by the Samuel Brokerage. This company had apparently no connection with Goldstein Samuelson, other than its contractual right to sell options written by Goldstein, *See In re* Goldstein Samuelson, Inc., 3 BLUE SKY L. REP. ¶ 71,095 (Okla. Sec. Comm'n Feb. 23, 1973). This is the practice followed exclusively in the case of the London options as we will see in that section.

82. *See, e.g.*, Stipulation of All Relevant Facts in Lieu of Trial on Preliminary and Permanent Injunction, SEC v. Goldstein Samuelson, Inc., Civ. App. No. 73-472 (C.D. Cal. Oct. 11, 1973).

83. Thus the transaction is not dissimilar to the transaction in which a person deposits money in a savings account at the bank. In this case the amount of the return is easily determinable by the promised rate of interest which can be raised or lowered during the period of deposit by action of the bank, but whether the depositor will actually receive this interest to which he is entitled will depend on whether the bank is successful in investing the deposits of all its customers so that it generates sufficient income to pay the interest. This analogy also points out that there is a "common enterprise" within the "pooling" concept of this term as well. The option premiums are not in any way segregated, but are mixed in a common pool which the grantor uses to generate the funds necessary to meet his obligations to his option customers. These funds may come from successful investment of the capital and premium money or more frequently, the premiums received from later customers will be used to pay off the profits of the earlier ones.

84. *See* People v. Puts and Calls, Inc., 3 BLUE SKY L. REP. ¶ 71,090 (Cal. Super. Ct., Los Angeles County June 21, 1973); King Commodity Co. v. State, 508 S.W.2d 439 (Tex. Civ. App. 1974); OP. TENN. ATT'Y GEN. No. 27, 3 BLUE SKY L. REP. ¶ 71,164 (Aug. 21, 1974); *In re* Secured Commodities, Inc., 3 BLUE SKY L. REP. ¶ 71,125 (Ark. Sec. Comm'n Jan. 22, 1974); *In re* Goldstein Samuelson, Inc., 3 BLUE SKY L. REP. ¶ 71,095 (Okla. Sec. Comm'n Feb. 23, 1973); *See also* Shapiro v. First Federated Commodity Trust Corp., 3 BLUE SKY L. REP. ¶¶ 71,058 and 71,071 (Md. Cir. Ct., Baltimore County 1973); *In re* Meed Invs., Inc., 3 BLUE SKY L. REP. ¶ 71,171 (S.D. Sec. Comm'n Aug. 30, 1974).

of others, is not present in the sale of these options because the customer decides which option he wishes to buy and when he wishes to sell it. Thus, they argue the customer's profit comes through the customer's own efforts and not those of the dealer. In theory, this argument would appear sound, but it does not work that way in practice. In practice, most of the customers are entirely ignorant of the commodity futures market and its workings. As a result they rely almost exclusively upon the investment counsel of their customer representatives as to which options to purchase both in terms of the commodity purchased and the period for which the option is to run. Further, they also rely heavily upon these representatives for advice as to when to dispose of the options purchased.[85] Likewise in certain cases, the customer representatives will encourage the customer to maximize his profits through "jobbing" or "hedging" of an option by taking successive opposite positions in the underlying futures market as that market fluctuates.[86] Again, due to the lack of expertise on the part of the customer the performance of this operation is totally dependent upon the knowledge and efforts of the customer representative. Further, while in most cases he is privileged to follow market fluctuations and make his own decision as to when to sell the option, in most cases the customer is not required to do so. He can establish an automatic price at which his option will be exercised by the customer representative at the time he purchases the option[87] or he can avail himself of the standing policy of most dealers to automatically repurchase any option on the last day of the option period, if the customer has a profit in the option.[88]

Relying upon the "substantially through the efforts of others" variation of the *Howey* test as developed by the Ninth Circuit in *SEC v. Glenn W. Turner Enterprises, Inc.*,[89] most of the courts and administrative agencies to consider the question have had little trouble rejecting the dealers' contention on the basis that what little efforts the customer does expend are not the critical ones determining whether he makes a profit or not.[90]

I would submit, however, that, by examining the things that the investor does or does not do in terms of selecting the option and when to exercise it, that the courts and agencies are again concentrating upon the form of the transac-

85. *See, e.g.*, SEC v. Continental Commodities Corp., 497 F.2d 516, 522 (5th Cir. 1974).

86. *See, e.g.*, *In re* Secured Commodities, Inc., 3 BLUE SKY L. REP. ¶ 71,125 (Ark. Sec. Comm'n Jan. 22, 1974).

87. King Commodity Co. v. State, 508 S.W.2d 439 (Tex. Civ. App. 1974).

88. *See, e.g.*, *In re* Goldstein Samuelson, Inc., 3 BLUE SKY L. REP. ¶ 71,095 (Okla. Sec. Comm'n Feb. 23, 1973).

89. 474 F.2d 476 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973).

90. SEC v. Continental Commodities Corp., 497 F.2d 516 (5th Cir. 1974); King Commodity Co. v. State, 508 S.W.2d 439 (Tex. Civ. App. 1974); *In re* Secured Commodities, Inc., 3 BLUE SKY L. REP. ¶ 71,125 (Ark. Sec. Comm'n Jan. 22, 1974). *See also In re Meed Investments Co.*, 3 BLUE SKY L. REP. ¶ 71,171 (S.D. Sec. Comm'n Aug. 30, 1974) and *Clayton Brokerage Co. v. Mouer*, 3 BLUE SKY L. REP. ¶ 71,132 (Tex. Sec. Comm'n April 18, 1974), *aff'd* 520 S.W.2d 802 (Tex. Civ. App. 1975), reaching the same conclusion in the case of the London options. *But see* International Commodity Trust, Inc. v. Fisher, 3 BLUE SKY L. REP. ¶ 71,075 (Okla. Dist. Ct., Oklahoma County May 14, 1973).

tion and disregarding its substance. Deciding what option to purchase and how long to hold it plays a part in determining the *amount* of the profit, but has nothing to do with the *generation* of that profit. Again, the person who determines whether he will deposit his money in a commercial bank, a savings and loan association, or a credit union plays some part in determining the *amount* of his profit, in that these various institutions normally will differ in interest rates. Likewise the depositor plays a large part in determining the *amount* of his return by deciding how long to leave the money on deposit. Yet neither of these things is what this element of the *Howey* test sought to deal with. This test more than any of the others is attempting to separate the investor who takes an active part in management of his investment from the investor who leaves this management to others. Thus it is the decision making process which leads to the *generation* of the profit which the test seeks to govern not the process by which the dollar amount of the profit is to be fixed. In the case of the naked option where the customer expects the dealer to repurchase the option for cash, the generation process is the option dealer's business. He must take the premium money and any capital that he might have and invest it in such a way that he will be able to pay the customer his profits. Thus the managerial efforts that we should be concerned about here are those of the dealer in managing his own financial affairs. Clearly the customer does not share in any way whatsoever in the management of these affairs, as the dealers steadfastly maintain that what they do with the premium money is their own business. While this approach to the "efforts" test does not appear prominent in the decisions to date, there seem to be several decisions which attempt to distinguish between those efforts directed toward determining the *amount* of the profit from those efforts directed toward the *generation* of the pool of funds from which the profits will be paid.[91]

While the majority of courts and agencies finding that these "naked" options are investment contracts have elected to do so under the *Howey* test, there are two other tests for investment contracts which also could have been used.[92] The first of these is the pure risk capital test as developed by the California Supreme Court in *Silver Hills Country Club v. Sobieski*.[93] In this case, the defendants solicited capital to construct the facilities for a newly formed country club. In return for his money, the investor received only the right to use the facilities, since the legal title to the club remained exclusively with the defendants. The California court held these membership interests to be

91. *See, e.g.*, Clayton Brokerage Co. v. Mouer, 520 S.W.2d 802 (Tex. Civ. App. 1975), *aff'd*, 3 BLUE SKY L. REP. ¶ 71,132 (Tex. Sec. Comm'n Dec. 18, 1973).

92. There are a number of cases holding that these options are investment contracts without elaboration as to which of the various theories the court is adopting. *See* Commodities Int'l v. Eure, 207 S.E.2d 777 (N.C. App. 1974); Wee Mac v. State, 301 So. 2d 101 (Fla. Dist. Ct. App. 1974); State v. Geary, 3 BLUE SKY L. REP. ¶ 71,192 (Iowa Dist. Ct., Polk County Feb. 13, 1975); Huff v. Sioux Options, Ltd., 3 BLUE SKY L. REP. ¶ 71,198 (Iowa Dist. Ct., Woodbury County April 7, 1975).

93. 55 Cal. 2d 811, 361 P.2d 906, 13 Cal. Rptr., 186 (1961).

investment contracts and announced what was to become known as the "risk capital" test. Justice Traynor, speaking for the court, said:

> We have here nothing like the ordinary sale of a right to use existing facilities. Petitioners are soliciting the risk capital with which to develop a business for profit. The purchaser's risk is not lessened merely because the interest he purchases is labelled a membership. Only because he risks his capital along with other purchasers can there be any chance that the benefits of club membership will materialize.[94]

This pure risk capital test has gained acceptance as an alternative to the *Howey* test for investment contracts in three states[95] in addition to California.[96] While the federal courts have considered the test on several occasions for application under the federal securities act and have expressed some interest in it, to date none have accepted it—nor have any totally rejected—its application to some case in the future.[97]

The risk capital test as developed in the *Silver Hills* case appears to require nothing more than the investment of money in an enterprise which may or may not yield some benefit to the investor. While to date, I have found no case which applies this test to the "naked" commodity option, it is clearly applicable in those states which have adopted the test. There is an obvious investment of money in the form of the option premium or fee. In addition, there is an expectation of a benefit in the form of the payment of money by the option dealer or grantor when it "redeems" the profitable option. The only remaining question is whether this money is invested in the risk or economic capital used to generate the monetary benefit expected by the option customer.

This element is also clearly present. The vast majority of the option dealers are woefully undercapitalized. For example, Goldstein Samuelson was formed with an initial capital of $800 and no additional capital was ever contributed. Thus, its entire capital consisted of this $800 and its retained earnings from the sale of commodity options.[98] Thus, it should be manifest

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94. Silver Hills Country Club v. Sobieski, 55 Cal. 2d 811, 814, 361 P.2d 906, 908, 13 Cal. Rptr. 186, 188 (1961).

95. *See In re* Dept. of Commerce v. Spa Athletic Club, Inc., 3 Blue Sky L. Rep. ¶ 71,136 (Alas. Dept. of Commerce May 24, 1974); State *ex rel.* Healy v. Consumer Business Systems, Inc., 5 Ore. App. 19, 482 P.2d 549 (1971); Jet Set Travel Club v. Corporation Comm'n, 3 Blue Sky L. Rep. ¶ 71,207 (Ore. Ct. App. May 12, 1975); Lundquist v. American Campgrounds, Inc., 3 Blue Sky L. Rep. ¶ 71,196 (Wash. Super. Ct., King County Oct. 30, 1973). *See also* Ackerson v. Jet Set Travel Club, Civ. App. No. 772,120 (Wash. Super. Ct., King County Feb. 22, 1974); Stanley v. Commercial Courier Service, Inc., Civ. App. No. 72-931 (D. Ore. Apr. 29, 1975).

96. Apparently California treats the test merely as an alternative test to *Howey*. The California court in the earlier case of *People v. Syde*, 37 Cal. 2d 765, 235 P.2d 601 (1951), adopted the *Howey* test. Both *Howey* and *Syde* were cited with approval in the *Silver Hills* opinion.

97. *See, e.g.*, United Housing Foundation, Inc. v. Forman, 421 U.S. 837, 857 n.24 (1975); El Khadem v. Equity Sec. Corp., 494 F.2d 1224 (9th Cir.), *cert. denied*, 419 U.S. 900 (1974).

98. Stipulation of All Relevant Facts in Lieu of Trial on Preliminary and Permanent Injunction, SEC v. Goldstein Samuelson, Inc., Civ. App. No. 73-472 (C.D. Cal. Oct. 11, 1973) at 3.

that in order to honor their repurchase commitments, Goldstein Samuelson and these other undercapitalized dealers must either invest the money they take in as premiums in such a way as to generate the money,necessary to "redeem" the profitable customer options or redeem the older options out of the proceeds from the sale of new options.[99] Thus the customer's money clearly becomes part of the economic capital used to run the business of the option dealer and is subject to the risk that the dealer will be unable to provide the promised benefit in the form of a money payment when the customer elects to exercise his option.[100]

There would appear to be only one problem with the application of the risk capital concept to "naked" commodity options. In his opinion in *Silver Hills*, Justice Traynor refers to the risk capital doctrine applying to "initial" risk capital.

While the *Silver Hills* opinion needed only to deal with this question in the setting of a newly created enterprise, two subsequent courts have apparently treated this as a limitation upon the availability of this test.[101] A third court, I think quite properly rejected the limitation of the "initial" risk capital saying:

> [Such a test] would not protect the investing public from any well heeled corruption minded company which has been in business for a long time. The unwary and gullible investor can be fleeced much more readily by the other more affluent company which has been long in business. A money short small operation which is just attempting to get started probably would have more difficulty in extracting money from the naive. Accordingly, a test which is restricted to the obtaining of *initial* capital only, is not a satisfactory test. . . .[102]

It remains to be seen which of these views prevail. If the former view wins out, then the risk capital concept will not be available after the option company sells its first option.

99. In the latter case, the firm will go bankrupt if it suffers an adverse cash flow. This is of course what happened to many of the early option dealers who attempted to parrot the Goldstein Samuelson operation. It is this feature which has led many people to refer to the commodity option operation as merely an adaptation of the old Ponzi scheme.

100. A number of more recent option firms have attempted to avoid the risk capital classification by having the option money put into escrow until their repurchase obligations are satisfied. Such an arrangement would be proper, if the option grantor had sufficient permanent capital from sources other than the sale of options to meet all his obligations to customers. However, if these obligations were being met by short-term borrowing of a nonpermanent nature, then the risk capital classification cannot be avoided by the escrow device. The California Corporation Commission on a number of occasions has held that money which is placed in escrow is risk capital if it is to be used to repay temporary or interim financing. *See, e.g.*, 5 CAL. CORP. COMM'N OFFICIAL OP. 73/18C (Feb. 2, 1973); 5 CAL. CORP. COMM'N OFFICIAL OP. 73/49C (Mar. 21, 1973).

101. Jet Set Travel Club v. Corporation Comm'r, 3 BLUE SKY L. REP. ¶ 71,207 (Ore. Ct. App. May 12, 1975); Ackerson v. Jet Set Travel Club, Civ. App. No. 772,120 (Wash. Super. Ct., King County Feb. 22, 1974). In both these cases, the courts held that the risk capital concept could not be applied to membership money taken in by a travel club and admittedly used to provide the services that the club had promised its members in their memberships after the club conducted its first trip. Money received after that date was held not to be "initial" risk capital.

102. State *ex rel.* Park v. Glenn Turner Enterprises, Inc., 3 BLUE SKY L. REP. ¶ 71,023, at 67,201 (Idaho Dist. Ct., Ada County March 29, 1972).

The third test for investment contracts is really a combination of the first two. It first appeared in an article written by Professor Coffey[103] and received court approval in *State v. Hawaii Market Center, Inc.*[104] The court in *Hawaii Market Center* summarized the combined rule this way:

> [W]e hold that . . . an investment contract is created whenever: (1) An offeree furnishes initial value to an offeror, and (2) a portion of this initial value is subjected to the risks of the enterprise, and (3) the furnishing of the initial value is induced by the offeror's promises or representations which give rise to a reasonable understanding that a valuable benefit of some kind, over and above the initial value, will accrue to the offeree as a result of the operation of the enterprise, and (4) the offeree does not receive the right to exercise practical and actual control over the managerial decisions of the enterprise.[105]

Since its enunciation in the *Hawaii Market Center* case, this test has received wide-spread approval especially among the state courts.[106]

Applying this test to "naked" options, it is clear that the purchase of one of these options entails the transfer of capital from the purchaser or option customer to the option dealer. This investment is induced by the promise of the dealer that, if certain events occur, he will pay the purchaser a benefit in the form of money, measured by the difference between the option striking price and the current market price of the underlying futures contract. Again, because these dealers are inadequately capitalized, they must take this capital received and use it in such a way as to generate the funds necessary to satisfy their obligations to repurchase the profitable options. As a result, the purchaser is subject to two risks. First, he must suffer the risk that his investment will be dissipated in the process of the dealer attempting to generate funds to meet his commitments, and second, he suffers the risk that the dealer will be unsuccessful in generating these funds and will not be able to honor his repurchase obligation, thus denying the purchaser the profit to which he is entitled. Finally, since the dealers steadfastly maintain that this premium money is their money which they are free to invest as they will, it is clear that the option holder has no practical or actual control over the investment policies of the option dealer.

Thus the "naked" commodity option can be considered an investment

103. Coffey, *The Economic Realities of a "Security": Is There a More Meaningful Formula?*, 18 W. RES. L. REV. 367 (1967). *See also* Long, *An Attempt to Return "Investment Contracts" to the Mainstream of Securities Regulation*, 24 OKLA. L. REV. 135 (1971).

104. 52 Hawaii 642, 485 P.2d 105 (1971).

105. State v. Hawaii Mkt. Center, Inc., 52 Hawaii 642, —, 485 P.2d 105, 109 (1971) (footnotes omitted).

106. *See, e.g.*, SEC v. Glenn W. Turner Enterprises, Inc., 348 F. Supp. 766 (D. Ore. 1972), *aff'd on other grounds*, 474 F.2d 476 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973); Venture Inv. Co. v. Schaefer, 3 BLUE SKY L. REP. ¶ 71,031 (D. Colo. June 16, 1972), *aff'd on other grounds*, 478 F.2d 156 (10th Cir. 1973) (based on Colorado law); State *ex rel.* Park v. Glenn Turner Enterprises, Inc., 3 BLUE SKY L. REP. ¶ 71,023 (Idaho Dist. Ct., Ada County March 29, 1972); State *ex rel.* Fisher v. World Mkt. Centers, Inc., 3 BLUE SKY L. REP. ¶ 71,034 (Okla. Dist. Ct., Oklahoma County June 2, 1972), *aff'd*, 44 Okla. B.J. 2218 (Ct. App. 1973).

contract under the *Hawaii Market Center* test, and such a conclusion was reached in *In re Goldstein, Samuelson, Inc.*[107]

In summary, I submit that it makes no difference which of the three tests for investment contracts a court or agency elects to follow, if it will examine the economic realities of the transaction rather than the mere form in which it is cast, there should be little difficulty concluding that these "naked" options are investment contracts.[108]

### C. *Instruments Commonly Known as Securities*

The last general category within the standard definition of a security into which I think that the "naked" commodity option can be placed is that of "an instrument commonly known as a 'security.'" This phrase which has been in the definition of a security ever since the enactment of the Securities Act of 1933 appears to have largely been ignored by the courts and legal commentators alike until the trial court decision in *SEC v. Glenn W. Turner Enterprises, Inc.*[109] In the *Turner* case, Judge Skopil, seeking a way to avoid the straight jacket of the *Howey* test for investment contracts, hit upon the idea of using a risk capital test as the appropriate test for determining that the *Turner* pyramid sales contracts were "instruments commonly known as a 'security.'"[110]

Much the same motive induced a Maryland trial judge to conclude: "[The naked commodity options] sold by First Federated [were] within the definition of 'security' in the Maryland Securities Act, whether [they were] investment con-

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107. 3 BLUE SKY L. REP. ¶ 71,095 (Okla. Dept. of Sec. 1973). *See also* Ga. Sec. Comm'r, Release No. 1, 1A BLUE SKY L. REP. ¶ 14,612 (Sept. 18, 1973). This test is also couched in terms of "initial" risk capital, and therefore there exists the same problem as to its applicability to ongoing firms which are undercapitalized as was discussed in connection with the pure risk capital test. *See* text accompanying note 101, *supra.*

108. Basically, the same tests developed for investment contracts have been used for determining whether a particular instrument also involves a "certificate of interest or participation in any profit-sharing agreement," another one of the general terms within the definition of a security. See, *e.g., SEC v. Wickham,* 12 F. Supp. 245 (D. Minn. 1935), applying basically the *Howey* test, and *State ex rel. Fisher v. World Market Centers, Inc.*, 3 BLUE SKY L. REP. ¶ 71,034 (Okla. Dist. Ct., Okla. County June 2, 1972), *aff'd*, 44 Okla. B.J. 2218 (Ct. App. 1973), applying the *Hawaii Market Center* test. As a result, a number of administrative agencies have found that "naked" options involve also "profit-sharing plans." *In re* Secured Commodities, Inc., 3 BLUE SKY L. REP. ¶ 71,125 (Ark. Dept. of Commerce Jan. 22, 1974); OP. TENN. ATT'Y GEN. NO. 27, 3 BLUE SKY L. REP. ¶ 71,164 (Aug. 21, 1974); *Cf., In re* Meed Invs., Inc., 3 BLUE SKY L. REP. ¶ 71,171 (S.D. Sec. Comm'n Aug. 30, 1974); Clayton Brokerage Co. v. Mouer, 3 BLUE SKY L. REP. ¶ 71,132 (Tex. Sec. Comm'r Dec. 18, 1973), *aff'd*, 520 S.W.2d 802 (Tex. Civ. App. 1975).

109. 348 F. Supp. 766 (D. Ore. 1972), *aff'd on other grounds*, 474 F.2d 476 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973). The trial judge claimed that his opinion was the first to use this phrase. Subsequent research reveals that the judge was inaccurate in this claim as there are a number of decisions and attorneys general opinions in the 1930's which use this phrase as an alternative holding. However, it is clear that Judge Skopil's opinion is the first to attempt to give the term some concrete substance.

110. Unfortunately, it is impossible to tell whether Judge Skopil intended to adopt a pure risk capital test as outlined in the *Silver Hills* case or the combined *Howey*-risk capital test as developed in *Hawaii Market Center* as he cites both cases within the body of the opinion. However, it is not important for our purposes to attempt to distinguish here since we have seen in the last section, the naked commodity option can come within either of the tests.

tract[s] or [fall] within the catch-all phrase, 'in general, any interest or instrument commonly known as a 'security.' ' "[111]

More recently, the Arkansas Securities Commissioner used this category as an alternative holding in his decision in *In re Secured Commodities, Inc.*[112]

## II. Mocatta Options

The second group of options that we need to examine in some detail are those options sold in the United States by the Mocatta Metals Corporation. In theory these options differ little from the real estate option or the true non-"naked" commodity futures option to purchase real estate or a commodity futures contract: the option is to purchase a specified quantity of the actual commodity, usually gold or silver bullion.[113]

Again, as with the "naked" option, however, we cannot judge this option agreement by the way it is to operate in theory, but must determine its status under the securities laws from the way that the transaction actually is conducted. There is only a limited amount of information available about these options and most of it comes from a request by the Mocatta Metals Company for an SEC interpretive opinion.[114] The request letter indicates that the present "American" Mocatta Company, a Delaware corporation formed in

111. Shapiro v. First Federated Commodity Trust Co., 3 Blue Sky L. Rep. ¶ 71,071, at 67,336 (Md. Cir. Ct., Baltimore County May 30, 1973). In this case, however, the court appears to adopt the definition for investment contract found in *State v. Gopher Tire & Rubber Co.*, 146 Minn. 52, 177 N.W. 937 (1920), discussed *supra* at note 65, as the controlling definition for instruments commonly known as "securities" rather than the risk capital test.

112. 3 Blue Sky L. Rep. ¶ 71,125 (Ark. Dept. of Commerce Jan. 22, 1974). There is one other item, not found within the standard definition of a security, which has been relied on by two states, as an alternative ground for holding options to be securities. Some of the older definitions of a security contain language to the effect that "certificates representing or secured by an interest in any or all of the capital, property, assets, profits or earnings of any company" is a security. Similar language was included in the Securities Act of 1933 when it was first adopted. Act of May 27, 1933, ch. 38, § 2(1), 48 Stat. 74. However, this language was removed by the 1934 amendments "as possibly involving too broad and uncertain application." H.R. Rep. No. 1838, 73d Cong., 2d Sess. 9 (1934). The statutes in South Dakota and Texas still contain this language and it was used as an alternative holding in *In re Meed Investments, Inc.*, 3 Blue Sky L. Rep. ¶ 71,171 (S.D. Sec. Comm'n Aug. 30, 1974) and *Clayton Brokerage Co. v. Mouer*, 3 Blue Sky L. Rep. ¶ 71,132 (Tex. Sec. Comm'n Dec. 18, 1973), *aff'd on other grounds*, 520 S.W.2d 802 (Tex. Civ. App. 1975).

113. For the holder of a commodity futures option to receive the actual commodity a two step process must be followed. First, the holder must exercise his option by paying the option price. If he does this he is entitled to receive a standard commodity futures contract. This contract entitles the holder to receive delivery of the actual commodity at some time in the future as specified in the futures contract. If the contract is held until that date then he may demand actual delivery of the physical commodity. In the case of the Mocatta option, the intermediate step is eliminated. Upon exercise of the option the holder is entitled to immediate delivery of the physical commodity.

114. Mocatta Metals Corp., [1974-1975 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 79,940 (SEC NAL Aug. 1, 1974). Since this information comes from the company itself, it should be recognized that it is self-serving and attempts to show the transactions in their best light. Also, it outlines how the options are to work in theory, which may not be followed in actual practice. However, the company has the incentive to be accurate in its description since the SEC no-action position was based solely upon the information submitted and would not apply if the company deviates from the outlined practices.

1973, is the successor to a 1969 New York corporation of the same name. This American corporation is an "affiliate" of the English company, Mocatta & Goldsmid Limited of London.[115] The American Mocatta Company, like its English "affiliate," is primarily a bullion dealer and as such is engaged in the refinement, processing, storing and trading of various precious metals throughout the world.[116] Its customers are primarily bullion users ranging from silver fabricators to government agencies, banks and other dealers.[117]

The letter states that prior to the fall of 1973, the company had engaged in selling "call" options only on silver bullion,[118] primarily to professional silver users. These sales were not geared to the speculator or individual customer, and the company provided no view as to the prospective change in the price of silver.[119] These options accounted for less than one-quarter of one percent of the company's gross revenues during 1972 and early 1973,[120] and were issued primarily to maintain the company's competitive position in the world bullion dealers' community.[121] The sale of these options was suspended in the Fall of 1973.

In August, 1974 the company wanted to resume the sale of these call options. It stated that it would sell these options only to business entities and not to individuals and that each option would cover a minimum purchase of $100,000 worth of silver. Further, it stated that all premiums received from the writing of these options would be placed in an escrow account and be released to Mocatta only after the option had been exercised or had expired. The premium upon the option was to be returned to the purchaser in the event that Mocatta did not fulfill its obligations under the option.[122]

In response to a request from the SEC, Mocatta made two additional representations concerning its proposed option offering. First, it represented that at all times Mocatta would actually own the necessary silver bullion to meet its option commitment, *or in the alternative, have the capacity to acquire*

115. The nature of the "affiliation" is not disclosed. However, it appears that it is not one of parent and subsidiary. The request letter indicates that the "American" firm is primarily owned by two parties, its current president and an English bank, Standard and Chartered Banking Group Limited of London. *Id.* at 84,426. It may be that the English Mocatta & Goldsmid is a subsidiary of the English banking group. In any event, the English firm of Mocatta & Goldsmid has been a bullion broker to the Bank of England for almost three centuries.

116. The letter claims that Mocatta maintains a large inventory of these precious metals. *Id.*

117. *Id.*

118. *I.e.*, the purchaser received the right to buy silver from Mocatta. Apparently the company did not engage in the sale of "put" options which would have required the company to buy the silver from the option holder.

119. Mocatta Metals Corp., [1974-1975 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,940, at 84,429 (SEC NAL Aug. 1, 1974).

120. The general period of the naked commodity option boom. The letter claims that Mocatta had a net worth of $3.5 million in September 1973, *id.* at 84,426, and a gross revenue of over $500 million for the fiscal year ending April 30, 1973. *Id.* at 84,429.

121. The letter indicates that such options are also sold by bullion dealers in London and Zurich and therefore the American firm felt obliged to sell these options to maintain its competitive position. *Id.* at 84,429.

122. *Id.*

*a sufficient quantity to do so.*[123] Second, it stated that the premiums charged for the options would be established in accordance with the procedures followed by it in connection with its other metal dealings and would be at such a level as "will assure the economic feasibility of Mocatta's option-dealing activities."[124]

There is one item notably absent from the Mocatta representations. While the request letter leaves the definite impression that all options, when exercised, will be satisfied by actual delivery of the underlying silver bullion, Mocatta is careful not to make any such representation to the SEC.

The Mocatta request letter was accompanied by an opinion from independent counsel to the effect that these options, as Mocatta was purportedly going to offer them, did not constitute securities under any of the categories of evidences of indebtedness, investment contracts, or "instruments commonly known as securities."[125]

In response to the request letter, the Division of Corporate Finance informed Mocatta that it would not recommend any enforcement action against Mocatta, if it proceeded to sell these options under the conditions outlined in its letter, without registration under the Securities Act of 1933. It indicated that this decision was based upon the representations of that letter and the attached opinion of counsel that the options were not securities. However, it closed the letter with the following statement:

> [T]his letter only expresses the Division's position on enforcement action and does not purport to express any legal conclusions on the questions presented as to the applicability of the federal securities laws.[126]

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123. *Id.* at 84,430 (emphasis supplied).

124. *Id.* The significance of this representation or the reason for the SEC's demand that it be made remains obscure. It may be that it was directed toward assuring the SEC that the option-dealing venture had a sound economic footing and was not merely a Ponzi scheme under which Mocatta hoped to collect a large amount of premium fee money up front with no intent or fiscal capacity to later fulfill its obligations to deliver. Harold Goldstein now freely admits that his naked option scheme was a fraud from the very beginning in that he never intended to meet his delivery obligations. By indicating that the premiums would be calculated in such a way as to bear a direct relationship with the risks undertaken by the firm and the services performed, and in such a manner as to provide Mocatta with a reasonable profit for assuming these obligations, this assurance tends to show that Mocatta wants to operate a legitimate option business. All too often in the case of the naked options, the premiums were arbitrarily or capriciously set by the option companies far below that which was commensurate with the risk undertaken in an effort to encourage additional business. As a result most of these firms could not economically continue in business and meet their obligations to their option customers. Most are now in bankruptcy. *See, e.g., In re* Puts and Calls, Inc., Civ. App. No. 73-02706 (C.D. Cal., filed May 3, 1973); *In re* King Commodity, Inc., Bankruptcy No. 73-H-446 (S.D. Tex., filed Oct. 1, 1973).

125. Mocatta Metals Corp., [1974-1975 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,940, at 84,427-28 (SEC NAL Aug. 1, 1974).

126. *Id.* at 84,425. Counsel pointed out that the broader interpretation would convert most executory contracts into evidences of indebtedness. Thus, the theater ticket which gives the holder the right to see a play at some time in the future would become a security. Further, under such a broad definition all futures contracts would have to be classified as securities. *See* United States v. Jones, 450 F.2d 523 (5th Cir. 1971) (holding that blank airline tickets were not securities within the federal Stolen Securities Act even though they could be filled in and create an obligation on the part of the airline to furnish services in the future).

Thus, the SEC Staff took the position that it would not try to inhibit the sale of these options by Mocatta without registration, but it clearly stopped short of saying that they were not securities.

Let us now consider the proposed selling scheme and the contentions of Mocatta's counsel in light of the various theories for securities developed in the previous section, *keeping in mind, however, that we are considering the plan as it is proposed which may or may not be the way that it operates in actual practice.*

Counsel first considered the evidence of indebtedness question. He argued that this concept should be limited to those obligations to pay *money* in the future and should not be broadly construed to include contractual duties to provide goods and services in the future.[127] He then concluded that the Mocatta options were not evidences of indebtedness because the company's obligation was to deliver the underlying precious metals not to pay money.

To the extent that Mocatta does not offer its option holders the alternative to settle their options by having Mocatta repurchase them, I would agree with counsel's analysis. While the Oregon Corporation Commission has shown some interest in attempting to expand the concept of evidence of indebtedness to cover the future delivery of precious metals,[128] I do not think that such an expanded definition will or should gain wide acceptance. However, if Mocatta does offer a repurchase alternative, then I think its options would become evidence of indebtedness in the same way that the naked options sold with a repurchase agreement have been held to be evidences of indebtedness. By offering the repurchase option, Mocatta would have transformed its obligation from one of future delivery of goods to one of future payment of *money*. Nor would it matter that none of the customers actually elected the repurchase alternative, it is sufficient that the alternative is offered since this would constitute the offering of a security which is as much a violation of both state and federal securities laws as is the actual sale of these securities.

Next, the Mocatta counsel addressed himself to the investment contract issue. He concluded that the Mocatta options were not investment contracts because neither the common enterprise nor the "profits solely through the efforts of others" element of the *Howey* test was present. Unfortunately, I cannot agree that this issue can be so glibly or easily disposed of. First, in

127. *See In re* Constitution Mint, Inc., Notice of Proposed Order to Cease and Desist (Ore Corp. Comm'n Aug. 1974); Oregon Corporations Commissioner, Internal opinion to International Precious Metals Corp. (May 20, 1974). This concept was rejected in State v. Coin Wholesalers, Inc., 3 BLUE SKY L. REP. ¶ ———, (Minn. Dist. Ct., 4th Jud. Dist. May 5, 1975).

128. Thus it indicates it will sell *primarily* to professionals and not to individuals or speculators. To further insure that sales will be to this group sales are made in only $100,000 lots. Further, the company does not *normally* offer investment advice concerning the price of silver nor does it appear that it will automatically exercise profitable options. While the company has carefully hedged each of these representations, if they are followed in practice, many of the abuses found in the Goldstein Samuelson-type option will be removed.

reaching this conclusion, it appears that counsel has looked only at the *form* of the transaction and not its substance or economic reality. Second, as we have seen in the section on naked options, the *Howey* test is not the only recognized test for investment contracts. There are at least two other tests which have been used as alternative tests. Mocatta's counsel does not address himself to either of these theories.

It appears from reading the request letter that Mocatta has made a very conscious effort in designing its program to remove many of the strongest objections found in the sale of the earlier naked options. However, I do not feel that the Mocatta request letter or the SEC's response adequately dealt with the two major points of the plan which have led to earlier option offerings with similar features being classified as investment contracts under both the risk capital and *Howey* tests.

First, as we have noted above, Mocatta makes no representation that it will in fact require the option holder to exercise his option by taking actual delivery of the underlying silver bullion.[129] Second, Mocatta has not made a representation that it is selling these options against an existing inventory of silver which it owns outright. Instead, it indicated that the options would be sold against existing inventory *or that Mocatta would have the capacity to acquire the necessary silver to satisfy its obligations.*[130]

To the extent that Mocatta offers both an option repurchase program and sells the options which are not backed by physical inventory owned outright by it, I submit that the company is selling "naked options" which are as much investment contracts as were the Goldstein Samuelson "naked options."[131]

Turning to the risk capital theories, the first point which we must consider is whether these option fees received by Mocatta should be considered risk capital at all. It should be obvious that not all situations where a person prepays for the right to receive goods or services in the future should be classified

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129. If Mocatta provides storage and resale facilities for the underlying silver once the option has been exercised, there is a strong possibility that such an agreement itself will be considered an investment contract. Again, the realities of the situation will have to be examined. If it appears from the facts that the investor is not really knowledgable in the metals market, but is merely investing money with the metals dealer with the expectation that he will buy the metal, store it and later dispose of it for the investor at a profit, I submit that this is an investment contract. Both California and Oklahoma have taken such a position. *See* 5 CAL. CORP. COMM'N OFFICIAL OP. 73/118C (Oct. 2, 1973); OKLA. SEC. COMM'N INT. OP., 2 BLUE SKY L. REP. ¶ 39,721, at 35,542 (Jan. 8, 1975). *See also* 7 CAL. CORP. COMM'N OFFICIAL OP., 75/21C (July 10, 1975). *But see* SEC Securities Act Release No. 5552, [1974-1975 Transfer Binder] CCH FED. SEC. L. REP. ¶ 80,037 (Dec. 26, 1974).

130. *Quaere* whether this means that Mocatta will have the necessary capital to insure the purchase of the silver or merely that it has sufficient sources of supply that it will be able to secure delivery of the actual metal.

131. *Cf.* Malamphy v. Real-Tex Enterprises, Inc., — F.2d — (4th Cir. Oct. 20, 1975), *summarized in* BNA SEC. REG. & L. REP. (No. 325) at A-15. In this case, the defendant was selling options on subdivided land in Texas with repurchase agreements. Prior to the present case, the SEC had obtained a consent decree to the effect that the options coupled with the repurchase agreement were securities. *See also* the discussion of the cases involving the sale of silver coins on the margin, *infra* note 145.

as involving the investment of risk capital. Thus, for example, no one would argue that a person who pre-pays for his new Ford automobile which must be custom built to his specifications involves an investment in the capital of the Ford Motor Company. On the other hand, I submit that the similar pre-payment for a new Tucker automobile would involve the investment of risk capital.[132] What distinguishes the two transactions? The present ability of Ford Motor Company to furnish the new car through the use of its present capital resources without resorting to the use of the customer's pre-payment. Thus Ford Motor Company is adequately capitalized to produce its products while Tucker was not.

Examining the information available on Mocatta, we find that the company was originally formed in 1969 and underwent a technical reorganization in 1973. Further, it has an established net worth as of September 1973 of $3.5 million.[133] Based upon this information in those jurisdictions which limit the risk capital concept to *initial* risk capital,[134] it should be clear that these fees are not risk capital because Mocatta is not in the formative stage and has substantial capital resources. However, I submit that the limitation of the risk capital to the raising of initial capital is inappropriate.[135] Instead, our attention should be directed toward determining whether any firm, new or old, well-capitalized or poorly financed, is using some type of a pre-payment arrangement to raise the additional capital it needs to meet its obligations to supply the goods and services provided.[136]

Examining Mocatta in this light, it is clear that Mocatta is an established metal dealer and has substantial financing. We are not, however, in a position (nor was the SEC) to determine whether this financing was adequate to finance Mocatta's existing dealer operations. Beyond this Mocatta now wants

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132. Such pre-payment contracts on Tuckers were held to be securities in *In re Tucker Corp.*, 26 S.E.C. 249 (1947).

133. Moccata Metals Corp., [1974-1975 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,940, at 84,426 (SEC NAL Aug. 1, 1974).

134. Jet Set Travel Club v. Corporation Comm'r, — Ore. —, 535 P.2d 109 (Ore. Ct. App. 1975); Ackerson v. Jet Set Travel Club, Civ. App. No. 772,120 (Wash. Super. Ct., King County Feb. 22, 1974). *See also* Silver Hills Country Club v. Sobieski, 55 Cal. 2d 811, 361 P.2d 906, 13 Cal. Rptr. 186 (1961); State v. Hawaii Mkt. Center, Inc., 52 Hawaii 642, 485 P.2d 105 (1971).

135. See *State ex rel. Park v. Glenn Turner Enterprises, Inc.*, 3 BLUE SKY L. REP. ¶ 71,023 (Idaho Dist. Ct., Ada County March 29, 1972), where this concept of *initial* risk capital was specifically rejected. *Cf. In re* Dept. of Commerce v. Spa Athletic Club, Inc., 3 BLUE SKY L. REP. ¶ 71,136 (Alas. Dept. of Commerce May 24, 1974).

136. I think the following illustration taken from *In re Spa Athletic Club, Inc.*, 3 BLUE SKY L. REP. ¶ 71,136 (Alas. Dept. of Commerce May 24, 1974) well illustrates this point. For several years a corporation has owned and operated a health club in a one-story building. It now decides to expand its facilities by adding an additional floor to the building. To do so, it wants to sell memberships. Memberships to use the new facilities would cost $200 more than the memberships to use the existing facilities only. Should there be any doubt that the memberships to use these new facilities are just as much investment contracts under the risk capital test as the original memberships in the newly formed Silver Hills Country Club? The fact that the issuer of the memberships is an established club seeking to expand its facilities does not alter the fact that the member must bear the risk that the second floor may never be built and as a result he does not receive the right to use the expanded facilities which is what induced him to purchase the membership in the first place.

to add a new area of operations, the sale of call options on silver. Obviously, this will involve the commitment of additional capital to insure that Mocatta has the necessary inventory or the ability to secure the necessary inventory to meet its obligations to deliver the silver upon exercise of the option. The question which must be asked—and which cannot be answered from the information available either to us or to the SEC—is from what source will this additional capital come? Is the admitted net worth of $3.5 million sufficiently great to support *both* the existing dealer operations *and* the new option or does Mocatta hope to secure the necessary capital for the new option trading enterprise from the option fees received? If the latter situation proves true, then I submit that the option fees received are risk capital and the options are investment contracts.[137]

Mocatta anticipated that a "risk capital" argument might be levied against its sales program and attempted to blunt this attack by including a provision that all option premiums received would be deposited with an independent escrow holder. Such holder would not release the fees to Mocatta until such time as Mocatta had performed its obligations under the option or the option was abandoned. In the event that Mocatta was unable to perform, then the escrow holder was to return the premium to the option purchaser. On the surface this procedure would seem to prevent the escrowed funds from being considered risk capital in that it is obvious that such funds could not be used to supply the silver necessary to satisfy a particular customer's option. However, the California Corporation Commission has had occasion to consider similar

137. This raises one of the most difficult and as yet unanswered questions concerning the risk capital test. When attempting to evaluate whether money received is to be classified as risk capital should we use a "need for capital" or a "used as capital" test? Thus, when we examine the Mocatta option operation, are we seeking to find out whether the company lacks sufficient capital to operate this portion of its business and is seeking to remedy the deficit through the collection of the option premiums, or is it sufficient that the premium money is actually used by Mocatta to pay some of the expenses involved in the option operation?

Often we will not need to distinguish which of these tests we are applying. If a company has a deficient capital structure, normally it will also be using the money taken in to defray its expenses. This was the pattern found in Goldstein Samuelson and the other naked option firms.

On the other hand, a well-capitalized firm which has the necessary surplus capital to finance its expansion from internal sources may make a conscious decision not to employ its own surplus capital but seek to finance the new option operation entirely out of the funds generated from premiums received. In this situation the fees would not constitute risk capital under the "need for capital" test, but if used to pay the expenses of the option business would come within the "used as capital" test. To my knowledge no court has yet addressed itself to this question, but I submit that while the "used as capital" test is obviously much broader, it is the more appropriate test.

Which test is used will make a significant difference as to what evidence the plaintiff needs to offer in order to establish a risk capital case. If the "used as capital" test is applied, then all the plaintiff must show is that the funds taken in are used to pay rent, salaries, utility bills or the like. On the other hand, the "need for capital" test would seem to require an economic evaluation of the enterprise to determine whether the firm was undercapitalized to conduct the business in which it was engaged. This would seem to require expert testimony similar to that used in the case where a plaintiff seeks to pierce the corporate veil on grounds of inadequate capitalization. *See, e.g.*, Wallace v. Tulsa Yellow Cab Taxi & Baggage Co., 178 Okla. 15, 61 P.2d 645 (1936).

escrow schemes,[138] and it has consistently taken the position that the mere escrowing of funds does not preclude their classification as risk capital. Instead, the financing of the operation and the eventual disposition of the escrowed funds must be considered. If the person offering the interest seeks to finance his enterprise through the use of temporary or borrowed funds which will be replaced in whole or in part by the funds in escrow once they become available, then the escrowing of the funds does not remove their character as risk capital.[139]

Again, because of the lack of adequate financial information about Mocatta or its plans as to how it hopes to finance its new option operation, it is impossible to determine whether the premium fees should be classified as risk capital and what effect the escrowing of these funds will have. Clearly these points should be examined before Mocatta is allowed to sell these options in those states which follow either of the risk capital approaches.

Further, I submit that Mocatta may not entirely solve its investment contract problems by inserting a provision requiring the option holder to take actual delivery of his silver upon exercise of his option. Such a provision may well allow it to escape the investment contract classification under the *Howey* test due to the recent Supreme Court holding that the "profit" element of that test envisions a monetary gain rather than a savings or some other non-monetary benefit.[140] However, it is clear that under neither the pure risk capital nor combined risk capital and *Howey* tests is it necessary that the benefit sought be purely monetary. As a result, the Georgia Securities Commissioner has taken the position that the sale of a futures contract or option wherein the seller of the contract does not possess the necessary physical commodity to fulfill his obligation, the necessary risk element is introduced so that the futures contract or option becomes an investment contract under Georgia law.[141]

The Commissioner begins by pointing out that there are two risks assumed by any purchaser of a futures contract or commodity option. The first risk is that the market will move against him. The presence of this risk, the

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138. *See, e.g.*, 5 CAL. CORP. COMM'N OFFICIAL OP. 73/49C (Mar. 21, 1973); 5 CAL. CORP. COMM'N OFFICIAL OP. 73/18C (Feb. 2, 1973); 4 CAL. CORP. COMM'N OFFICIAL OP. 72/99C (July 31, 1972).

139. Thus, in Policy Letter 158C, a limited partnership sought to establish a swimming and tennis club with facilities to cost $365,000. The bulk of the funds necessary to provide these facilities, some $340,000, was to come from loans obtained by the partnership from commercial lenders and advances made to the partnership by nonpartners. The partners through the partnership were only investing $25,000, a substantial part of which was to go for pre-organizational, architectural, engineering and general development expenses. The advance sale membership fees were to be escrowed and not released until the facilities were ready for use. The Commissioner held these fees to constitute risk capital. Policy Letter No. 158C [1969-1971], CAL. CORP. COMM'N OFFICIAL OP. (May 24, 1971).

140. United Housing Foundation, Inc. v. Forman, 421 U.S. 837 (1975). It might be argued, however, that the monetary nature of the "profit" under *Forman* is supplied by the fact that the option holder who receives the silver usually intends to sell it and realize a monetary gain.

141. Ga. Sec. Comm'r Release No. 1, 1A BLUE SKY L. REP. ¶ 14,612 (Sept. 18, 1973).

Commissioner properly concludes, does not make the contract a security. The second risk that the purchaser undertakes is the risk that the person selling the option or futures contract will be unable to perform. This risk the Commissioner labels as the "enterprise risk." He states that this risk is no greater in the case of an option or futures contract than in any other contractual relationship, if the writer of the option or the person contracting to make delivery, in the case of the futures contracts, actually owns the commodity against which he is selling the option or futures contract.[142] But then he goes on to say that the enterprise risk becomes critical in those situations where the person selling the contract does not own the underlying commodity.

In such a case, the commissioner felt that the seller's ability to perform his contractual obligation to the investor is solely dependent on the skill and ability with which he invests the money and hedges the contracts of his numerous investors whose funds he has received. Here the Commissioner concluded with a classic example of a case in which "the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others." In such a case, the Commissioner ruled that the sale of commodities contracts or options would be a security and subject to the provisions of the Georgia Securities Law.[143]

Viewing the proposed Mocatta sales plan in light of this position taken by the Georgia Securities Commissioner, it should be apparent that the sale of the Mocatta options would involve an investment contract. Mocatta does not propose to limit the sale of its options to options on actual silver in its inventory. Instead, it stated to the SEC that the options would be sold against silver actually owned *or which Mocatta had the capacity to acquire.*[144] By extending the coverage of its options to silver not actually owned by Mocatta, the company has introduced the very enterprise risk outlined by the Georgia Commissioner. The fact that Mocatta makes the assurance that it will maintain the capacity to acquire the necessary silver does not remove this inherent risk—at best it merely reduces it to an absolute minimum.

The primary purpose of the registration provisions of the securities acts with their disclosure requirements is to provide the investor with information sufficient for him to make an intelligent decision as to the degree of risk that he wishes to assume. Here, Mocatta has asked the SEC—and through it, the

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142. The Commissioner also makes the following observations concerning the risk involved when these contracts are traded on a recognized exchange:

> If the sale is to be executed on the floor of some established commodities exchange, where performance will be guaranteed by the exchange clearing house, the exchange members' margin agreements, and the exchange members personally, the enterprise risk is so reduced that, as a matter of economic reality, it is negligible.

*Id.* at 10,506. This statement will become extremely important in our consideration of the London options.

143. Id. The Commissioner goes on to discuss factors that he will consider in exercising his fair, just and equitable jurisdiction when such securities are offered for registration in Georgia.

144. Mocatta Metals Corp., [1974-1975 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,940, at 84,430 (SEC NAL Aug. 1, 1974).

investors—to be satisfied with an unsupported self-serving declaration of its ability to meet its obligations not only presently but for an indefinite period into the future. To allow Mocatta to escape registration on the basis of such a statement would be like allowing A T & T to sell its corporate bonds to the general public without registration upon its unsubstantiated representation that it presently had the capacity to pay both the principal and interest on the bonds and would continue to maintain such capacity for the life of the bonds. Hopefully the SEC and the state securities agencies would not be satisfied with such a statement from A T & T, and they should not be with a similar statement from Mocatta. While in both cases, the companies *may* enjoy a reputation for being strong, financially-sound enterprises, the enterprise risk identified by the Georgia Commissioner is present. Conditions may change and both companies *may* be unable to meet their obligations. The investor in the A T & T situation is clearly entitled to sufficient information through the registration process or a recognized substitute therefor to evaluate this enterprise risk for himself. I submit that the Mocatta option holder is entitled to the same right.[145]

## III. London Options

The last group of options which have been traded extensively in this country come under the generic heading of "London" options. Our consideration of this category must in turn be broken down into two sub-areas. First we must understand and evaluate the option trading process itself as it is carried on in London. Since for the first time we are dealing with organized exchanges our discussion of this process will necessarily involve at least a limited discussion of how the various London Exchanges and their clearing houses operate. After we have evaluated the foreign part of the option operation, we will then consider the way in which the London options are marketed in this country. In viewing this marketing operation, it is important to remember that something which is not a security in itself may become a part of a broader sales plan which viewed in its entirety would be considered to be a security. Let us first consider the London market process.

### A. *The London Trading Markets*

As I indicated in the previous paragraph the term London option is merely a generic term. There is no such thing as a "London" option. Instead there are a number of different exchanges located in London on which commodity options are traded. Unfortunately each of these exchanges has its own standard contract, trading procedures and customer safeguards. Therefore

145. The already extended length of this article prohibits a detailed discussion of a number of other investment schemes involving the sale of coins, precious metals, and gems whose form differs widely from the Mocatta option, but whose economic substance are strikingly similar.

when we attempt to discuss whether a particular option is a security it is first necessary to determine what type of "London" option we are dealing with as the safeguards for the investor differ widely between the issuing exchanges. There are at least seven different exchanges in London on which option trading is conducted. These exchanges are: (1) the London Wool Terminal Market Association; (2) the London Cocoa Terminal Market Association; (3) the United Sugar Terminal Market Association; (4) the Coffee Terminal Market Association in London; (5) the London Vegetable Oil Terminal Market Association; (6) the London Metals Exchange; and (7) the London Rubber Exchange. Fortunately for our purposes we can treat the first five of these exchanges together as they all use a common clearing house which provides essentially the same investor safeguards for options purchased on all the exchanges.[146]

This common clearing house is the International Commodity Clearing House,[147] which is an independent privately-owned subsidiary corporation of an English banking group. International Commodity Clearing House or more simply ICCH is capitalized at about $8.5 million.[148] In addition to serving as the clearing house for the five terminal market associations in London handling wool, cocoa, sugar, coffee, and vegetable oil, often collectively referred to as the "soft commodities," ICCH also serves as the clearing house for a number of similar groups in Australia.[149]

By regulation of the five exchanges and the clearing house, the members of both agree that no futures or option contracts dealing with these commodities can be traded by them and referred to as an exchange contract unless that contract or option has been sold on the open exchange by public outcry.[150] As a

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146. Each exchange, however, has its own set of trading rules and standard contract.

147. The information included here concerning the International Commodity Clearing House is taken from the verbatim testimony of Maurice Stockdale, one of the managing directors of that Clearing House, given before the Texas Securities Commissioner in his hearing in the case of *In re Clayton Brokerage*, 3 BLUE SKY L. REP. ¶ 71,132 (Tex. Sec. Comm'r Dec. 18, 1973), *aff'd* 520 S.W.2d 802 (Tex. Civ. App. 1975). This hearing was held from November 1 through November 7, 1973. Mr. Stockdale's testimony hereinafter will be cited as Stockdale.

148. Stockdale, *supra* note 147, at 64-66. The parent is United Dominion Trust Ltd.

149. *Id.* at 116. The term "futures contract" is not used in England, instead each of these terminal market associations issues its own standard terminal market contract which is the equivalent of a futures contract traded on an American commodity exchange such as the Chicago Board of Trade. To avoid confusion for the reader, I will refer to the London terminal contracts as futures contracts in this article.

150. *Id.* at 74, 155. This would not appear to prevent the exchange members or clearing house members from dealing in other contracts covering these commodities; it would merely prohibit them from referring to the off-the-exchange contract as an exchange contract. Thus the off-the-exchange contract would not have the investor safeguards that the clearing house provides as the clearing house will not register such contracts. Such an off-the-exchange contract would appear to be a forward contract rather than a futures contract since the usually recognized difference between these contracts, which both contemplate future delivery, is that a futures contract refers to the standard contract as traded on an exchange while a forward contract is merely any contract negotiated between two parties to sell forward contracts in silver to the general public. See *Texas Arizona Mining Co.*, [1971-1972 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,626 (SEC NAL Feb. 18, 1972) for a typical forward contract on silver.

result of this rule there are no off-the-exchange options on these commodities traded by exchange or clearing house members.[151]

After the terms of the option contract have been determined on the floor of the exchange, the exchange forwards a record of the transaction which has been verified by both parties to the clearing house for processing. The clearing house first collects the option premium from the purchaser and the required initial margin from the grantor. The premium, which was determined through the bargaining process on the floor of the exchange, is placed by the clearing house in a separate account on which interest is paid. This premium is not released to the grantor of the option until the option is exercised or abandoned.[152] The initial margin on the option is determined by the clearing house and amounts to approximately 10 percent of the price of the underlying futures contract.[153]

When these funds have been received, the clearing house will then register two contracts: One, a taker's contract, goes to the member purchasing the option; the other, a seller's contract, goes to the grantor of the option. At this point the face to face nature of the transaction ceases. A single contract between the parties has now been replaced by two separate contracts, one running between the clearing house and the grantor and another between the clearing house and the option purchaser. Hence the grantor now owes his obligation to perform to the clearing house, and the purchaser looks to the clearing house, not to the grantor, for the performance of the contract.

This process is often referred to as the Clearing House "guaranteeing" the option.[154] In fact, however, it is not a guarantee, but rather a substitution of

151. It would however be possible for a person who is not a member, but owns a futures contract issued on the exchange and registered by the clearing house to sell an option against it. Such an option would not be a clearing house registered option. Likewise it is possible for a non-member to issue his own commodity option which will be backed by an exchange traded option which he has purchased. We will see in the second part of our discussion that this is what is being done by the American dealer purporting to sell London options. They are not selling the option traded on the Exchange, but rather are issuing to their customer an option of their own making, supposedly backed by an exchange option.

152. Stockdale, *supra* note 147, at 88.

153. *Id.* at 152.

154. *Id.* at 66. While in the past this guarantee would appear on each option contract, the Clearing House has ceased issuing individual contracts and now the guarantee appears only upon each member's daily registration statement which summarizes all the contracts registered for him on a particular day. It is important to note that these exchange contracts only run between members of the exchange, and therefore the "guarantee" of the clearing house runs only to the exchange member who purchases it.

There are some members of the terminal markets who are not "trading members." These members must do business on the floor of the exchange through brokers who are trading members. The contracts are, however, issued in the non-trading member's name rather than that of his broker. Thus this member does not have to suffer the risk of the broker's bankruptcy as he will look directly to the clearing house for performance of his contract, not to the broker.

However, in the case of a non-member, as is the case of virtually all of the purchasers of London options in this country, the option is not registered in the purchaser's name but rather in the name of the broker member who purchased it on his behalf. This broker in many cases is not the broker who sold the contract to the customer but rather the broker of that broker, since the original broker himself is not a member of the exchange or clearing house. The result is that the "guarantee" of the clearing house only runs to the member an obligation by the clearing house for that of the original option grantor. Therefore we need to consider what assurances there are that the ICCH will be in a position to meet its obligations to the purchaser.

The basic resources of the clearing house can be divided into two categories. First there is its own permanent capitalization which we have seen presently stands at $8.5 million. Second there are the contractual rights which the clearing house has against the writer of the option. As we have seen at the time of registration, the grantor is required to make an initial margin deposit. Beyond this each day, if the market moves against his position, *i.e.*, the option becomes more profitable, the grantor is required to deposit additional margin with the clearing house equal to the difference between the option striking price and the current market price of the underlying futures contract.[155] While the clearing house also provides certain loan or financial services to its members, it *never* loans them the necessary margin money.[156] Instead it insists that the margin money be in cash or in the form of a bank guarantee.[157]

These financial safeguards are significant in view of those who are allowed to grant options. An option grantor must be a member of the Clearing House.[158] However, there are no fixed net capital requirements for this membership or for option grantors.[159] Further, the grantor is not required to own either the physical commodity or the futures contract on such commodity necessary to back the options he sells.[160] Thus these options can be written "naked" in the same way that the American options have been.

It is also important to understand the procedure the option holder must follow in order to obtain his profit. First he must exercise his option, which he does by notifying the Clearing House.[161] Upon notification, the Clearing House replaces the option with an appropriate futures contract. At the same

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broker and all persons down the chain must bear the risk of his or any intermediate broker's insolvency. This Clearing House "guarantee" reads:

> The International Commodity Clearing House, Ltd., subject to its regulations and conditions, guarantees *to the member whose name appears at the head of the statement*, the due fulfillment of the duly registered contract listed above in accordance with the rules, regulations, articles, or bylaws of the terminal market association above. *Id.* at 81 (*emphasis added*).

155. Stockdale, *supra* note 147, at 92. This, however, is not done on an individual option basis, but rather on an aggregate basis for the member's entire option and futures position. *Id.* at 94. Further once having paid additional margin, the grantor is entitled to have any excess margin returned to him should the market move back in a favorable direction. *Id.* at 95.

156. *Id.* at 96.

157. *Id.* at 70. In the case of foreign members the Clearing House requires the bank guarantee method be used, and the minimum guarantee for foreign members is $250,000. *Id.* at 70, 136. The Clearing House does not call on the bank for the money pursuant to this guarantee unless the member firm goes into liquidation. *Id.* at 136.

158. He does not however have to be a member of the exchange on which the option is sold, but may deal there through a dealer. Id. at 131, 134.

159. *Id.* at 131.

160. *Id.* at 136-37.

161. The Clearing House does not follow the practice found among most of the American "naked" option dealers of automatically exercising profitable options on the last day of the option period if no instructions are received from the holder. Thus it is possible through neglect that a profitable Clearing House option will expire.

time, the Clearing House issues an identical but opposite futures contract to the option grantor.[162] Both the grantor and the purchaser are required to make the original margin deposit and any additional margin due against their contract.[163]

From this point on, the parties completely part ways, each taking his futures contract and doing with it what he will. The grantor may wish to dispose of his contract immediately and recognize the loss, or hold on to it in hopes that the market will later move so that he can recognize a profit. Likewise the purchaser may want to take his immediate profit, or hold on, hoping that the market will advance even further.

Assuming our purchaser does not want to retain the contract until the due date in which case he will receive delivery of the actual commodity,[164] he does not look to the original grantor to liquidate his position. Instead he goes onto the market and sells a futures contract, at the current market price, opposite to the present contract he holds.[165] Then both the new and the old contracts are tendered to the Clearing House. If these contracts are taken together they represent the purchase and sale of the same amount of commodity due to be delivered upon the same date in the future. Thus the two represent opposite sides of a wash transaction. The Clearing House cancels both contracts, paying over to the option purchaser the difference between the purchase and sale prices.[166]

Turning to the London Rubber Exchange,[167] we find that the mechanics of trading on this exchange are quite similar to the procedure outlined above in connection with the trading of the "soft commodities." There is, however, one very important difference. Trading on the Rubber Exchange is not carried on by open outcry. All dealings are done by negotiation between the member

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162. The price of these futures contracts will be the striking price established in the option contract. Stockdale, *supra* note 147, at 143, 147. Also at this time, the grantor is entitled to receive the option premium which the Clearing House has escrowed. *Id.* at 130.

163. The grantor normally would have done this by his original deposit in connection with the option and his deposits of additional margin as the market fluctuated. While the purchaser will have to make the initial margin deposit, there should be no additional margin to deposit since he will not exercise the option unless it is favorable to him. *Id.* at 130.

164. Stockdale estimates only one or two percent of futures contracts traded through the Clearing House are held until the delivery of the actual commodity is made. *Id.* at 118.

165. *Id.* at 137-38.

166. Keep in mind of course, that there are two other future contracts still outstanding. One is the contract issued to the original grantor and the other is the opposite contract issued when the purchaser sold the new contract to obtain his pair. Eventually these contracts, if not paired in the same way as the purchaser did, will have to be settled by the original grantor delivering the actual commodity to the holder of the new contract. However, as we noted in note 164, *supra*, this happens in only a very small minority of cases.

167. The information included on the London Rubber Exchange is taken from the verbatim testimony of Roy Windsor, a director of the London Rubber Exchange, given before the Texas Securities Commissioner in his hearing in *In re Clayton Brokerage*, 3 BLUE SKY L. REP. ¶ 71,132 (Tex. Sec. Comm'n Dec. 18, 1973), *aff'd* 520 S.W.2d 802 (Tex. Civ. App. 1975). This hearing was held from November 1 through November 7, 1973. Mr. Windsor's testimony hereinafter will be cited as Windsor.

brokers. Thus, the Exchange is little more than a meeting place where the Exchange members can come to negotiate their trades.[168] Further, Exchange regulations do not prohibit members from making off-the-exchange contracts.[169] These off-the-exchange contracts may be made on standard Exchange forms or they may be simple forward contracts with all provisions reached by negotiation between the parties.[170]

The settlement process used by the London Rubber Exchange, however, differs widely from that followed by the "soft commodity" exchanges. The Exchange does maintain a settlement house, but its function is extremely limited as compared to that served by ICCH. The settlement house does not issue the actual futures or option contract. Instead the initial grantor of the futures or option contract issues the agreement directly to the taker.[171] Nor does the settlement house guarantee the Exchange contract in any way as we saw that ICCH did for the "soft commodities."[172] Further, the settlement house does not escrow the premium on option contracts granted; instead the funds are immediately turned over to the grantor, who may do what he will with them.[173] The settlement house does register those contracts tendered to it; however, as we noted earlier,[174] there is no requirement that off-exchange contracts using the London Rubber Association form be registered with the settlement house.[175] The settlement house does require the grantor on all contracts registered with it to make an initial margin payment and requires the depositing of additional margin money as the market advances in much the same way as ICCH requires grantors of "soft commodity" contracts to do.[176] Those Exchange form contracts which are not registered with the settlement house, however, are not subject to this margining requirement.[177] There appear to be some eight to ten Exchange dealers who are willing to offer unregistered off-the-exchange options directly to the public.[178]

As with options in the "soft commodities" in order for the option taker to realize his profit he must first exercise his option. He does this by notifying the original grantor who then is obligated to issue a futures or terminal contract to

168. Windsor, *supra* note 167, at 163, 172-73.

169. In view of the fact that all contracts are reached by private negotiation rather than open outcry, it is probably not significant where the contract is made.

170. Thus, the purchaser is not assured of receiving a standard exchange contract merely because he deals with an Exchange member.

171. Windsor, *supra* note 167, at 168, 213-14. This contract may not even be registered with the settlement house as there is no Exchange rule requiring that off-exchange contracts using the standard Exchange form be registered. *Id.* at 172.

172. *Id.* at 167.

173. *Id.* Apparently some of the companies internally account for the premium money separately as unearned income. There is, however, no physical segregation of these funds, and this internal accounting is not required by exchange regulations. *Id.* at 172, 176.

174. *Supra* note 171.

175. Such contracts are covered by London Rubber Exchange Delivery Contracts No. 5 & 6. Windsor, *supra* note 167, at 182.

176. *Id.* at 166.

177. *Id.* at 174.

178. *Id.* at 183, 213.

him.[179] The taker then goes into the market and sells a futures contract opposite to the contract received. These two contracts are then tendered to the taker's broker who offsets them and pays the taker his profit.[180]

All persons selling options using the London Rubber Exchange form option must be members of the Exchange, but these sellers need not be members of the settlement house.[181] As a result it would be possible for there to be a member firm which would specialize in selling only off-the-exchange options which would not be a member of the settlement house nor register its contract there. Further, there appear to be no stated financial requirements for membership in the exchange or financial limitations upon those who can grant options through the exchange. While it appears that the larger firms sell options only against futures or forward contracts actually owned, there would appear to be no exchange requirements that options be so backed.[182] Finally, it is important to note that, as in the case of the "soft commodities," the Rubber Exchange contracts run not to the actual customer who has bought the option, but rather run only to an Exchange member who normally will be the actual purchaser's dealer or that dealer's dealer. Thus the grantor's obligation does not run to the ultimate customer in the United States, but merely to another member firm.

The last of our three major option trading groups is the London Metals Exchange.[183] This exchange specializes in the trading of futures contracts in copper, lead, zinc, tin, silver, copper wire, and copper cathodes.[184] In addition to futures contracts, both put and call options on each of these commodities are also traded on the exchange.[185] While the exchange has a large membership list,[186] the majority of the business on the exchange is conducted by thirty-six principal firms known as "ring dealers."[187] These thirty-six firms participate

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179. In the case of the "soft commodities" this futures contract is issued not by the grantor, but by the clearing house. *See* text accompanying note 162 *supra*.

180. Again in the case of the "soft commodities" this offsetting function is performed by the clearing house, not the customer's dealer. *See* text accompanying note 165 *supra*.

181. Windsor, *supra* note 167, at 218.

182. *Id.* at 230.

183. The information included here about the London Metals Exchange is taken from the verbatim testimony of Dermot Butler, a director of C.C. Douglas Metals, Ltd., and an option trader for Rudolph Wolff & Co. This testimony was given before the Texas Securities Commissioner in his hearing in *In re Clayton Brokerage*, 3 BLUE SKY L. REP. ¶ 71,132 (Tex. Sec. Comm'n Dec. 18, 1973), *aff'd* 520 S.W.2d 802 (Tex. Civ. App. 1975). This hearing was held from November 1 through November 7, 1973. Mr. Butler's testimony hereinafter will be cited as Butler.

184. Butler, *supra* note 183, at 240, 242.

185. *Id.* at 251. Most American business in these options involve the purchase of call rather than put options. *Id.* at 318.

186. Again only members can trade futures or options contracts upon the exchange. *Id.* at 317. A non-member would have to sell an option to a member dealer who in turn would then have to sell his own option on the exchange based upon the option he received from his customer. In this situation the taker of the Exchange option would be able to look only to the other Exchange member for satisfaction of his option. He would not be able to seek performance by the original non-member grantor. *Id.*

187. *Id.* at 243. These firms are known as ring dealers because they are the only firms to be allowed on the floor of the exchange and to participate directly in the auction market

in an open auction market upon the floor of the exchange.[188] In addition to this auction market, the exchange regulations recognize the right of member firms to make off-exchange privately negotiated deals between members which are concluded at curb sessions which precede and follow the authorized auction market.[189] It is at these sanctioned curb markets that most of the option trading is done, due to the need to privately negotiate the premium which will be paid for the option.[190]

Unlike the other two groups, while the London Metals Exchange specifies the form of its standard contracts, the Exchange does not maintain a settlement house or register its contracts.[191] Nor does it in any way guarantee performance of its contract[192] or place any margin requirements upon those persons purchasing or selling on the exchange.[193] It does suggest that the various ring dealers escrow premiums received on option contracts and requires their customers to meet certain margin requirements.[194] It appears that some dealer firms have imposed escrow and margin requirements,[195] but the imposition and policing of these requirements is purely discretionary with the member firm.

The London Metals Exchange appears to have several other unique features. Its futures contracts are made for specific forward date delivery which is up to three months from the date of sale in the case of all metals, but silver, where the contract delivery date may be as much as seven months in the future.[196] The same applies to an option.[197] The individual who exercises his option will receive a futures contract from the grantor of his option, but no money can be realized directly upon this futures contract until the settlement date.[198] As a result most traders feel that it is not sound business to exercise the option until the declaration date of the option even though the option can be declared earlier.[199]

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conducted there. Other member firms must conduct their floor dealings through one of these 36 ring dealers. A similar system is employed on the Chicago Board of Trade.

188. *Id.* at 241.
189. *Id.* at 242-43.
190. *Id.* at 314.
191. *Id.* at 244.
192. *Id.* at 310.
193. *Id.* at 293.
194. *Id.* at 253, 276.
195. Mr. Butler's firm, for example, appears to escrow the premium received for a grantor client under certain circumstances. *Id.* at 253. His firm also imposes a 10 percent initial margin requirement for futures contracts for traders in the manufacturing process, but a 20 percent margin requirement for speculative traders. *Id.* at 256. The firm also requires an initial margin of 20 percent for grantors of options. *Id.* at 277. The firm also appears to require that all options and futures contracts be marked to market each day. *Id.* at 276.
196. *Id.* at 241.
197. *Id.* at 257.
198. *Id.* at 320.
199. The declaration date is established by allowing one day for each month the option runs and subtracting this from the settlement date of the underlying futures contract. Thus, if it is a seven month option, the maximum on silver, the declaration date would be one week before the settlement date of the underlying silver futures contract. *Id.* at 262.

Further, options issued on the London Metals Exchange are not transferable.[200] Thus, an American buyer cannot go on the market and simply "sell" the option that he bought a month ago in the same way that he could sell 100 shares of A T & T. Instead, what he must do is sell an option at a higher price covering the same futures contract as the option that he has purchased.[201] His profit then would be the difference between the premium he had to pay for his option and the premium that he received when he sold his option. However, it is important to note that in doing so he is creating a new *obligation*. The purchaser of his option cannot look to the grantor of the original option for performance but is limited to demanding performance from his own grantor which in our example is the American speculator.[202]

As a result of this practice it is not unusual for a dealer to "job options." To do this, he goes on the exchange and purchases an option issued by another member (which in turn may have been written on the basis of an option purchased from a non-member client). He then uses this option as the basis for issuing his own option to another member or a non-member client, such as an American broker, who in turn uses this option as the basis for issuing his own option to the American customer.[203]

It should be obvious from this practice that the vast majority of options are written "naked" in the sense that the person writing the option does not have the actual inventory or even the futures contract to support the option he has sold. Instead, he merely has the option to acquire that futures contract. Thus the "London Metal" option which reaches the hands of the individual American client is nothing more than an option on an option to acquire a "London Metals" option which in turn may be based upon a non-member's option. It should be obvious that there is no way that a person acquiring this option can determine for himself whether the option is backed by an existing physical supply of the commodity.[204] The exchange appears to have no financial requirements for membership in the exchange or financial restrictions upon who can offer options. As a result, a large number of options which are traded on the London Metals Exchange are sold totally naked in that the person who originates the option chain does not have the physical inventory or futures contract to support his option.[205] Thus, the entire system is built upon the good faith and ability to perform of the next higher person in the option chain—a typical English idea based upon trust of a man's word. Such a system outside England, however, leaves much to be desired.

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200. *Id.* at 296, 331.
201. *Id.* at 297.
202. Our example is not totally correct in that our American speculator cannot sell an option on the exchange since he is not a member. Instead, he can only sell an option to a dealer who in turn sells his own option based upon the customer's option on the exchange. *See* note 186 *supra*.
203. Butler, *supra* note 183, at 254-55.
204. *Id.* at 312.
205. *Id.* at 328-29.

With this background as to how the three major London trading groups are organized and operate, we are now in a position to consider whether the options sold on those exchanges *as they are traded* should be classified as securities. There is one point in common which emerges from our discussion of each of the major trading groups: This is the fact that it is possible in each group to sell options "naked." None of the exchanges or their clearing or settlement houses have any regulations which require that a person who offers an option have the physical inventory necessary to meet his contractual obligation to deliver. Further, there is no system in any of these markets whereby an interested person can determine whether the option he purchased is a covered or "naked" option.

To the extent that the London options are sold "naked" and contain the same risks to the investor as do the "naked" American options, outlined in Section I, above, there would seem little justification for treating them differently than the American options. A number of state commissions have so concluded and held the London options to be securities on the same theories outlined in Section I.[206] Likewise, to the extent that the options are merely covered by commodity futures contracts purchased on the margin and not fully paid for, these options are subject to the same criticism raised in Section II concerning Mocatta options.

The Georgia Commissioner however has suggested that the enterprise risk inherent in all "naked" option contracts can be reduced by the introduction of certain other investor safeguards. Thus he concluded:

> If the sale [of the option] is to be executed on the floor of some established commodities exchange, where performance will be guaranteed by the exchange clearing house, the exchange members' margin agreements, and the exchange members personally, the enterprise risk is so reduced that, as a matter of economic reality, it is negligible.[207]

Since none of the American "naked" options discussed in Section I were traded on a recognized exchange, we did not have to consider the presence of exchange safeguards on the classification of these options.[208] However, the

206. *See In re* Secured Commodities, Inc., 3 BLUE SKY L. REP. ¶ 71,125 (Ark. Dept. of Commerce Jan. 22, 1974); *In re* Meed Invs., Inc., 3 BLUE SKY L. REP. ¶ 71,171 (S.D. Sec. Comm'n Aug. 30, 1974). *See also* Commodities Int'l, Inc. v. Eure, 22 N.C. App. 723, 207 S.E.2d 777 (1974).

207. Ga. Sec. Comm'r Release No. 1, 1A BLUE SKY L. REP. ¶ 14,612, at 10,506 (Sept. 18, 1973). *Quaere* whether the presence of these investor safeguards should be considered in determining whether these "naked" option contracts are securities or merely whether a special exemption from registration should be created for these "naked" options. It could be argued that the matter of degree of the risk is a factor to be considered in formulating public policy to exempt a security from registration. Thus, most state statutes exempt those securities which are traded on a national stock exchange. *See, e.g.*, UNIFORM SECURITIES ACT § 402(a)(8). On the other hand, following the lead of the Supreme Court in *United Housing Foundation Inc. v. Forman*, 421 U.S. 837 (1975), it could be argued that the absence of a substantial investor risk creates an economic reality where the item should be considered a security at all. This argument has apparently been rejected by the Texas Commissioner in the London option context. *See* Clayton Brokerage Co. v. Mouer, 3 BLUE SKY L. REP. ¶ 71,132 (Tex. Sec. Comm'n Dec. 18, 1973), *aff'd*, 520 S.W.2d 802 (Tex. Civ. App. 1975). *See also* note 208 *infra*.

208. Two states, Oklahoma and Alaska, however, anticipated that the question of

vast majority of London options appear to be traded on an organized exchange, and therefore we must consider the investor safeguards provided by each of the

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"naked" options traded on an exchange might be raised at some point in the future. Both states modified their statutory definition of a "security" to specifically cover both commodity futures and commodity option contracts. ALAS. STAT. § 45.55.138 (1975 Cum. Supp.), *reproduced in* 1 BLUE SKY L. REP. ¶ 6013; 71 OKLA. STAT. § 2(20)(O) (1974 Supp.). Under these statutes, while all commodity futures and option contracts which were not regulated by the old Commodity Exchange Authority are considered securities, those futures or options which were traded "on the floor of a bona fide exchange or board of trade" and through the offices of a locally registered broker-dealer are excused from the registration provisions of the statute.

This approach has one major drawback. The statutes do not define what constitutes a bona fide exchange. The absence of any statutory guidance in the Oklahoma statute has led to a second commodity option scandal which is discussed below. This scandal is directly linked to the refusal of the Oklahoma Administrator or the Securities Commission itself to adopt an administrative rule implementing the statute. After some nine months of operation under the amended statute, the former Administrator, in a series of unpublished advisory opinions, finally indicated what he felt was a "bona fide" exchange based upon his historical understanding of the development of these markets in the United States. He said:

> The older and well-known exchanges appear to be association or non-profit corporations organized for the purposes of providing their membership with facilities for open and orderly trading between themselves. An inseparable counterpart, however, appears to be what is commonly known as a clearing association. The primary usefulness of the clearing house from the regulatory standpoint is that transaction is with the clearing house, and the clearing house stands behind each trade, and the entire membership of the clearing house is obligated in the guarantee of trade. In addition, the rules of the exchange and clearing house normally provide for the creation and maintenance of a reserve fund to meet any contingencies which might arise as a result of the failure of an exchange member.

Oklahoma Securities Administrator, Internal Opinion to Universal Options, Inc., at 1 (Jan. 14, 1974). The Administrator also concluded that, while some of the London Exchanges would meet this definition, they could not qualify under Oklahoma law because a provision of the state "bucket shop" act, 15 OKLA. STAT. § 561 (1970), which requires all contracts sold in Oklahoma to have been traded on the floor of an exchange organized under the laws of the state or a sister state. This letter was followed by another on January 30, 1974 indicating that as of February 15, 1974, the Oklahoma Securities Commission would not recognize as exempt from registration any option not sold through a domestic exchange or by an exchange which operated a clearing house maintaining an appropriate reserve fund for the protection of investors. Oklahoma Securities Administrator, Internal Opinion to Gibson Options, Inc. (Jan. 30, 1974).

While the CFTC Staff Memo, Appendix II, at 3-4, confirms the Oklahoma Administrator's statement that all present American exchanges operate clearing houses which "guarantee" the investor's contract and maintain reserve funds, we have seen that this is not the case with the London Metals Exchange (*see* text accompanying notes 191 and 192, *supra*), nor is there any apparent reason why a domestic exchange could not be organized without these features.

Finally, some 15 months after the adoption of the amended statute and the resulting scandal described in the next paragraph, the Oklahoma Securities Commission adopted a comprehensive definition of a "bona fide exchange" in its Rule R-2(20)(O), 2 BLUE SKY L. REP. ¶ 39,601 (Sept. 19, 1974, *modified*, Dec. 19, 1974). Three of the most important features of this Rule are, first, no bona fide exchange can sell options "naked." The exchange or its clearing house must either purchase the underlying commodity represented by warehouse receipts or a futures contract or it must require that the writer of the option deposit the warehouse receipts or futures contracts with the clearing house to be held in trust for the option grantor and released only upon the exercise or expiration of the option. Okla. Sec. Comm'n Rule R-2(20)(O), § 6(c). Further, the exchange or its clearing house has an obligation to investigate the validity of the underlying warehouse receipts or futures contracts to determine whether the issuer has the ability to perform, and may require the posting of a performance bond in questionable cases. *Id.* Second, an exchange member who sells an option granted by a non-member must guarantee that option when it offers the option for sale on the exchange. *Id.* § 6(d). Finally, the exchange or clearing house must set up a trust fund under the control of a bank for the benefit of exchange customers three major trading groups in light of the Georgia Commissioner's suggested criteria.[209] These critera are: (1) that the exchange clearing house "guarantees" the performance of the option contract; (2) that the exchange requires the issuer to margin the contract (this should include both the initial margin and subsequent margins daily); and (3) that there is a mutual guarantee of all exchange contracts by the members of the exchange. While the Georgia Commissioner seems to suggest that all three criteria should be present, I submit that the risk may well be sufficiently reduced if any one of the three elements is present.[210]

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to protect them against loss resulting from the default of any exchange member. Each exchange member must make an initial contribution of $10,000 to this fund and an additional contribution of $10 per option contract sold. *Id.* § 6(e). The Rule became effective April 21, 1975, almost two years after the amendment of the Oklahoma statute. The continued effectiveness of the Oklahoma and Alaska amendments and the Oklahoma Rule, by virtue of the amendments to the Commodities Exchange Act, discussed at the conclusion of this paper, is in some doubt. The Oklahoma Commission has taken the position that any futures or options contracts which are under the regulation and jurisdiction of the CFTC are not securities under the Oklahoma Act. OKLA. SEC. COMM'N INT. OP., 2 BLUE SKY L. REP. ¶ 39,723 (June 25, 1975). The problem of course is the extent of the CFTC jurisdiction in these areas.

As we indicated above, the Oklahoma experience prior to the adoption of Rule R-2(20)(O) was singularly unfortunate. Not only did the Administrator allow the continued sale of these London options for almost a year before rendering his opinion that they would not meet the exclusion from registration, but it appears that he allowed several dealers to continue to use the services of registered agents whose blanket bonds had been cancelled. This was a violation of his own Administrative Rule R-204(G), § 3, 2 BLUE SKY L. REP. ¶ 39,605. *See* OKLA. SEC. COMM'N, REPORT OF INVESTIGATION, PREFERRED COMMODITY OPTION CORPORATION 1 (May 3, 1974). Further, after he finally indicated that the London options *per se* could not be sold in Oklahoma, he allowed the continued sale of these options when the option dealers joined the newly organized American Commodity Exchange, Inc., located in Tulsa and Oklahoma City. This exchange did not conduct trading upon its floor, but merely charged the London option firms a 5 percent commission for the use of its name. *Id.* at 2. This exchange had been organized by several state legislatures who had been influential in passing the amendment to the securities act.

In the Spring of 1974, the Commission finally undertook a lengthy investigation of the commodity option business in Oklahoma. As a result of this investigation and before it was complete, the Administrator was forced to resign for his alleged association with the new exchange. Upon completion of the investigation, the Commission forwarded a criminal reference report to several of the local district attorneys as it is authorized to do under 71 OKLA. STAT. § 407(b) (1971). To date no action has been taken on this report nor has the report itself been made public. The Commission has also taken administrative action against a number of option firms and their principals. *See, e.g., In re* Eugene E. Anderson, 3 BLUE SKY L. REP. ¶ —— (Jan. 8, 1976).

Meanwhile, most of the dealers and the American Commodity Exchange and its clearing house went into bankruptcy after a substantial amount of customer money was transferred to banks in the West Indies and then disappeared under mysterious circumstances. Conditions became so bad that the SEC was forced to file civil injunctive proceedings against the Exchange, its principals, some of the option companies and their principals, and the former Oklahoma Securities Administrator. *See* SEC v. American Commodity Exchange Inc., Civ. App. No. 75-0436-C (W.D. Okla., filed May 27, 1975). While some of the defendants have entered consent decrees, this case still remains unresolved.

209. While most options appear to be traded under the sanction of one of the London exchanges if not actually on the floor of the exchange, it is possible to have non-sanctioned off-exchange options sold by exchange members.

210. The CFTC indicates that at least the first two are present in trading on all existing American exchanges. CFTC Staff Memo, Appendix II, at 3-4. The third normally would be used only as an alternative to the clearing house guarantee. *See* Okla. Sec. Comm'n Rule R-2(20)(O), 2 BLUE SKY L. REP. ¶ 39,601 (Sept. 19, 1974, *modified*, Dec. 19, 1974).

Examining the practices of the International Commodity Clearing House outlined above in light of these three criteria, we see that there are substantial investor safeguards for purchasers of options cleared through that house. The first of the investor safeguards suggested by the Georgia Commissioner is present in that ICCH "guarantees" the investor's option by becoming the opposite party to that option.[211] Likewise the second of the Georgia Commissioner's safeguards is present in that the Clearing House requires the deposit of an initial margin by the option grantor and requires him to make further margin deposits daily, if the market moves against his position.[212] These funds are paid to the Clearing House and escrowed by it. The presence of these two safeguards would seem to be sufficient to reduce the enterprise risk incurred by a purchaser of a "naked" option cleared through ICCH so that these "naked" options should be excluded from the definition of a security or there should be an exemption created for them.[213]

Turning to options traded on the London Rubber Exchange, we find that the first of the Georgia Commissioner's safeguards is not present. While the exchange does maintain a settlement house, this house is not a clearing house in the sense that it "guarantees" the options. It merely registers them.[214] However, the settlement house does require the grantor to deposit an initial margin and meet additional margin calls daily as the market moves against his position.[215] Thus, while the investor protection for options traded on the London Rubber Exchange and registered by its settlement house[216] are not as great as those available for options cleared through ICCH, they would still seem sufficient to exclude or exempt these options.

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211. Of course, the major problem with this investor safeguard is that it is only as good as the clearing house which makes the guarantee. There would seem to be no problem with ICCH since it is capitalized at approximately $8.5 million. *See* note 148, *supra* and accompanying text. However, it would be possible to have a clearing house which was inadequately capitalized in which case the "guarantee" would be worthless. Such a situation occurred in Oklahoma with the formation of the American Commodity Exchange and its clearing house, Commodity Clearing House, Inc. *See also* King Commodity, Inc. v. State, 508 S.W.2d 439 (Tex. Civ. App. 1974) (no writ). Any court asked to exclude a "naked" option on the basis of such a safeguard should examine the substance of such "guarantee." Likewise, state administrators should by rule establish certain standards for clearing houses in the same way that the SEC sets up standards for broker-dealers. Oklahoma has done this to a limited extent in its Rule R-2(20)(O), 2 BLUE SKY L. REP. ¶ 39,601 (Sept. 19, 1974, *modified*, Dec. 19, 1974).

212. *See* note 155, *supra* and accompanying text.

213. The Oklahoma Administrator held that these options would be excluded under the Oklahoma Act except they were not sold on a domestic exchange. Oklahoma Securities Administrator, Internal Opinion to Universal Options Inc. (Jan. 14, 1974). This domestic exchange requirement was carried forward into the Commission's Rule. Okla. Sec. Comm'n Rule R-2(20)(O), § 2, 2 BLUE SKY L. REP. ¶ 39,601 (Sept. 19, 1974, *modified*, Dec. 19, 1974). See note 207, *supra* as to whether the diminution of this risk should cause the "naked" options to be excluded from the definition of a security or whether it should merely provide the basis for creating an exemption from the registration provisions of the act.

214. *See* notes 171 and 172, *supra* and accompanying text.

215. *See* note 176, *supra* and accompanying text.

216. Keep in mind that it is possible to have an option traded off the Rubber Exchange which complies with the Exchange requirements, but which is not registered with the settlement house. *See* notes 174 and 175, *supra* and accompanying text. The safeguards provided by the settlement house are not therefore available and these "naked" options should be treated as securities.

Such is not the case for options traded on the London Metals Exchange. This Exchange does not operate a settlement or clearing house,[217] and therefore the Commissioner's first safeguard is not present. Likewise the Exchange does not require any margins, initial or additional, to be deposited with it. Instead it allows margining to be optional with its member dealers.[218] Thus safeguard number two is also lacking. Finally there is no indication that the Exchange has any type of scheme where the dealers collectively are obligated to make good an exchange option. Therefore, London Metals Exchange options possess no investor safeguards which would suggest that they should be treated differently than the "naked" American option offered by people like Harold Goldstein.[219] In fact there are indications that the London Metals Exchange is presently having the same type of problems with certain "naked" option dealers that the various securities authorities in this country had with the Goldstein Samuelson and other naked option firms.[220]

### B. *London Options as They Are Sold in This Country*

Unfortunately our discussion of the London options cannot stop at this point. Instead we must consider how the London options are actually traded in this country. The key here is to remember that, in the case of all three London trading groups, exchange contracts, including option contracts, run only between members of the exchange. Since most option contracts do not originate with an exchange member, this means that a non-member must decide to grant an option. To do so, he contacts a member firm and "sells" him an option. This option was not negotiated upon an exchange and does not have the exchange safeguards discussed in the last section.

Turning then to the customer who wishes to buy an option, if he is not an exchange member, he must go to an exchange member and buy an option. The exchange member then goes on the exchange seeking an option for its customer. The member who purchased the option from its customer will then sell to the buyer's broker-member an exchange option based upon its off-the-exchange option purchased from the original grantor. This exchange option by exchange regulation runs between the selling member and the buying member. As a result, if the ultimate customer is not also an exchange or clearing house member, then the option contract and the exchange and clearing house safeguards do not run directly to him, but rather to the member-broker who purchased on his behalf.[221] Since the exchange contract is owned by, and

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217. *See* note 191, *supra* and accompanying text.

218. *See* note 194, *supra* and accompanying text.

219. The Oklahoma Securities Administrator so concluded in Oklahoma Securities Administrator, Internal Opinion to Universal Options, Inc. (Jan. 14, 1974).

220. *The Wall Street Journal* (S.W. ed.), June 23, 1975, at 1, col. 6, contains a lengthy story outlining the bankruptcy of the ABI Commodity Options, Ltd., a member firm of the London Metals Exchange. The article also indicates that the Law Society, the governing body of the English Barristers, has urged the British government to create a regulatory body similar to our Securities and Exchange Commission.

221. If the ultimate purchaser is a clearing house member, then the contract will be

registered in the name of, the customer's broker-member, this broker then must issue his customer a new off-the-exchange option written by it. Thus the customer gets an option written by his immediate broker which in turn is backed by an exchange option which in turn is usually backed by another off-the-exchange option written to the grantor of the exchange option by its customer.

Let's now put this in the context of a typical purchase by an American customer. Our customer is a client of the London House Brokerage Firm of Oklahoma City.[222] He goes into the offices of London House and buys a London coffee call option, one of the options which will be cleared through ICCH. London House is a small brokerage firm which like most of the American brokerage firms is not a member of any of the London exchanges or their clearing house.[223] Therefore, it is merely jobbing options and must "acquire" the option from a member firm. Normally it would do this by opening an account with a member firm, not in the customer's name, but rather in its own name. Through this one account it will purchase all the options for its customers. These options will be listed on the books of the member firm in the name of the option company, and there will be no indentification as to from which of the dealer's customers a particular option was acquired.

London House, however, is a very small option jobber which does not have a sufficient volume of option trades to merit a trading account with a London exchange firm, so it in turn buys the necessary options from a larger jobber, Gibson Commodity Options, Inc. located in Tulsa.[224] Gibson, it appears, is sufficiently large to buy its options directly from the London broker.[225] However, it would not be uncommon to have some four or five other option jobbers in the chain between the customer and the member firm which actually buys the option on the exchange,[226] each of which would charge a mark-up or a commission for participating in the transaction. As a result it is not uncommon for the customer to pay as much as 40 percent more for a

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registered in his name rather than the broker who bought it for him. In this case, the obligations of the clearing house run directly to the customer and he is protected from the effects of the bankruptcy of the broker who is buying on his behalf.

222. The mechanics of this trade are taken from Oklahoma Securities Commission, Report of Examination, London House Brokerage Firm, Inc. (Mar. 15, 1974), hereinafter referred to as Report.

223. The one exception to this known to me is Clayton Brokerage which became a member of ICCH in 1973. Stockdale, *supra* note 147, at 73. Clayton, however, is not a member of any of the exchanges and must purchase its options on the exchange through a member-broker. Its contracts are, however, registered by the clearing house in its name rather than the broker's and it has the protection discussed in note 221, *supra*.

224. Report, *supra* note 222, at 1.

225. *Id.*

226. Thus we have a system not dissimilar to that used by many small banks who rely upon their corresponding banks as a source of the bonds and commercial paper needed to service their customers, or the small over-the-counter brokerage house which depends upon the larger brokerage firms to handle their on-the-exchange trades. There is, however, one important difference between both these systems and the option system. In both the bank and brokerage system, the customer is supposed to eventually receive the product in the form of separate securities. In the option situation, the customer never receives the London option. Instead he merely receives the broker's option *based* upon a London option.

London option than he would have had to pay had he bought the option directly from the London exchange member.[227] While it was a violation of the Oklahoma regulations not to disclose this mark-up to the customer, since London House is acting as an agent in the transaction,[228] no disclosure was normally made.[229]

Thus, while the American customer thinks he has purchased a London option at approximately the market price in London, in fact nothing could be further from the truth. What he has actually acquired, at best, is an option contract issued by London House Brokerage, based upon an option issued to it in its name by Gibson Commodity Options, based upon an option issued to it, in its own name, by the London option dealer. The London dealer's option is backed by the London exchange option which is registered in the dealer's name, and he alone is entitled to performance under it or to the clearing house safeguards described in the last section. At worst, the customer has an option issued by London House, his immediate broker, which is not backed by any London Exchange option because his broker did not buy the option from the jobber above.[230] Further he is being forced to pay an unknown premium of up to 40 percent or more over the London market for these vastly inferior options.

Leaving aside then the question of whether the underlying London option held by the London member-broker is itself a security, the question examined in the first half of this section, it should be apparent to the reader that the marketing of these options in the United States closely parallels the sales

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227. In the case of London House options, London House was marking up their options 20 percent above their cost from Gibson. This excess mark-up was itself a violation of Oklahoma Securities Commission Rule R-204(G), §§ 3(a) and (d), 2 BLUE SKY L. REP. ¶ 39,605, which establishes a five percent guideline for commissions and mark-up. See *Selig v. Novak*, 506 S.W.2d 825 (Ark. 1974) and *In re Hunt & Fitzgerald, Inc.*, 3 BLUE SKY L. REP. ¶ 71,004 (Okla. Sec. Comm'n June 9, 1971) for cases involving disciplinary proceedings for the violation of this and similar rules. Beyond this, Gibson Options marked up the options sold to London House 8 percent over its cost from the London broker. Of this 3 percent was Gibson's profit, and 5 percent went to the Commodity Clearing House, the clearing house for the American Commodity Exchange for registering the option contract even though the contract was not traded on the American Exchange. This last was an attempt to meet the domestic trading requirement established by the Oklahoma Administrator under the Oklahoma law. *See* note 208, *supra*. Thus, the customer was paying 31 percent more for the option than it would have cost had it come directly from the London dealer. Report, *supra* note 222, at 1-2. Each additional company in the jobber would add a minimum of 3 percent to this cost.

228. Okla. Sec. Comm'n Rule R-204(G), § 3(j), 2 BLUE SKY L. REP. ¶ 39,605.

229. Report, *supra* note 222, at 2.

230. In the case of one Oklahoma option dealer it was discovered that the dealer was heavily in debt to the London exchange member. As a result it was not clear whether this exchange member was actually buying exchange options to support the dealer options or merely taking the $162,100 in transmitted funds as a set-off against the dealer's pre-existing debts. The dealer was so afraid that the proceeds from the sale of any exercised options would be seized by the London exchange member that it did not request the member to exercise any of the outstanding option positions when the customer elected to exercise his option. Instead, the firm was using newly taken in premium money to satisfy the claims of the older option holders. Okla. Sec. Comm'n, Report of Investigation, Preferred Commodity Option Corp. at 3 (May 3, 1974). This, of course, is exactly the abuse that lead to problems in the Goldstein Samuelson sales of "naked" options discussed in Section I.

pattern used in marketing the earlier "naked" options discussed in Section I. The investor does not receive a London option in the same way that he would receive 100 shares of A T & T if he went to his broker and ordered the 100 shares. Rather, he receives an option of the broker's creation. This is the broker's promise backed solely by the broker's assets. The broker takes the investor's money, uses part of it to pay his salesmen their commissions and his other overhead expenses, and hopefully invests the remainder in options issued by another jobber or a London member-broker. There is no obligation on his part to make such re-investment and the options purchased are general assets of the broker with no attempt made to identify a particular option to a particular client's account. At each level in the jobber chain, the process is repeated. Even the London member-broker does not give the first jobber a "London" option, but merely his own based on an exchange option. Therefore, in a very real sense the brokerage client is making an investment in the general assets of the broker with the expectation that the broker will use that money in such a way as to generate sufficient income so that he will be able to pay the client his profit as determined by an independent factor, the London market, upon exercise of his option. Nor should it come as any great surprise to the reader that the only court to consider this trading pattern has concluded that the sale of these options in the manner outlined constituted the sale of a security.

In *Clayton Brokerage Co. v. Mouer*,[231] the court was called on to consider the Clayton Brokerage London option marketing plan. The court first outlined the plan, pointing out that it contained most of the features found in our London House example. The court indicated that Clayton pooled the premium money received from the various clients and used the money according to its sole discretion. Part of the money was used to pay administrative expenses, including commissions and overhead. The remainder was used to buy London options through Drexel-Burham, a London member-broker. These options, however, were not purchased by Clayton in the name of the customer, but rather in its own name. Drexel-Burham did not know the names of Clayton's clients and considered Clayton its only client. The Clayton clients were not informed of this practice. When they elected to exercise their options, Clayton would not immediately exercise one of its options with Drexel-Burham, but would simply compute the customer's profit and pay it out of its corporate funds. It would continue to retain the Drexel-Burham option which would be disposed of in accordance with its investment needs and decisions. On these facts, the court found that there was a definite interweaving of the financial fortunes of the option client and Clayton whereby Clayton's ability to meet its obligations to the client were dependent upon its own success and efforts in managing its option trading account.[232] Therefore relying upon the earlier *King Commodity Co. v. State*,[233] a naked option case, the court concluded:

231. 520 S.W.2d 802 (Tex. Civ. App. 1975), *aff'g* 3 BLUE SKY L. REP. ¶ 71,132 (Tex. Sec. Comm'n Dec. 18, 1973).
232. Clayton Brokerage Co. v. Mouer, 520 S.W.2d 802, 807 (Tex. Civ. App. 1975).
233. 508 S.W.2d 439 (Tex. Civ. App. 1974) (no writ).

"under the facts of this case London options may be dealt with in such a manner that they become securities."[234]

I think that it is significant to note that the court specifically did not rule that the London option contracts per se were securities but merely that they could be combined in a marketing program in such a way that the *program* became an investment contract. Thus, the court merely added London options to the long list of other items of real and personal property which are not securities in and of themselves but which can be combined with other features so that the combined package or marketing device constitutes a security.[235]

In summary then, I think that we can make two observations about London options. First to the extent that they are sold "naked" and the exchange upon which they are traded does not provide investor safeguards which off-set the investor risk inherent in dealing in "naked" options, the London options are *per se* securities. Second, those London options which are *per se* securities along with those which are not, can be combined into a marketing program in such a way that the combined program constitutes an investment contract separate and apart from the underlying London options. My investigation suggests that all the marketing programs presently in use in the United States for these options are subject to such classification. It would seem extremely difficult due to the concept found on all London exchanges that the option contracts do not run in favor of the ultimate purchaser but only to the purchasing exchange member to design a sales program which would not involve the elements of an investment contract.

## IV. Conclusion

Having established that it is possible to bring most of the marketing programs for commodity options and in some cases the options themselves, within the purview of the state and federal securities laws, there remains the question of whether it is desirable to do so. And second, assuming that we conclude that it is desirable to do so, then we must further deal with the question whether the amendments to the Commodity Exchange Act creating the new Commodity Futures Trading Commission have specifically pre-empted such regulation under the securities laws. The first question I think is easier to solve than the latter.

It is the basic premise of this article that not all commodity option contracts are *per se* securities, and that securities status attaches to the option contract itself only when the contract is sold "naked" so that a substantial undisclosed investor enterprise risk is introduced into the transaction and when this risk is not substantially reduced by other factors surrounding the sale. This

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234. Clayton Brokerage Co. v. Mouer, 520 S.W.2d 802, 809 (Tex. Civ. App. 1975).

235. *See, e.g.*, SEC v. Haffenden-Rimar Int'l, Inc., 496 F.2d 1192 (4th Cir. 1974) (scotch whiskey); SEC v. Brigadoon Scotch Distribs., Ltd., 388 F. Supp. 1288 (S.D.N.Y. 1975) (coins with collector value).

leaves us with the awkward situation where some commodity option contracts are clearly securities and should be regulated as such, while others are not and cannot be regulated.

This is basically the same situation that the states found themselves in the regulation of franchises.[236] A number of states concluded that many of the abuses found in the franchising area applied equally to those franchises which came within the classification of an investment contract as to those which did not. Therefore, it made sense to regulate all franchises uniformly through special franchising legislation which would specifically exclude franchises from the definition of a security. Such special regulatory statutes have been enacted in a growing number of states.[237]

The same argument can be made for the regulation of commodity option contracts. The problem, however, is that to date only two states, California and Michigan,[238] have attempted to enact comprehensive legislation dealing with commodities and commodity options. Thus on the state level the only effective way to control at least some of these problems is through the use of the state securities acts.

This brings us to the second more difficult question. Has state and federal regulation of those commodity option contracts which are *per se* securities and those schemes using commodity option contracts as the underlying investment vehicle been pre-empted by the recent amendments to the Commodity Exchange Act creating the Commodity Futures Trading Commission?[239] This question is being hotly contested presently. The CFTC has on a number of occasions taken an adamant stand that the amendments pre-empt both the SEC and the state securities administrators.[240] The SEC and the state administra-

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236. See *Stanley v. Commercial Courier Service, Inc.*, Civ. App. No. 72-931 (D. Ore. Apr. 29, 1975), holding that a franchise is not an investment contract under federal law, but is an investment contract under Oregon state law. The federal courts have consistently refused to recognize franchises as investment contracts. *See, e.g.*, Nash & Associates, Inc. v. Lum's of Ohio Inc., 484 F.2d 392 (6th Cir. 1973); The Plum Tree, Inc. v. Seligson, 383 F. Supp. 307 (E.D. Pa. 1974). On the other hand, the states have consistently held that certain franchises can be securities. *See, e.g.* State *ex rel.* Healy v. Consumer Business System, Inc., 482 P.2d 549 (Ore. Ct. App. 1971); 49 OP. CAL. ATT'Y GEN. 124 (1967).

237. *See, e.g.*, CAL. CORP. CODE §§ 31000-31513 (West 1974 Supp.); MICH. COMP. LAWS §§ 445.1501-445.1545 (1974 Supp.). For a discussion of the California statute, see Comment, *Federal Legislation for Commodity Option Trading: A Proposal*, 47 S. CAL. L. REV. 1418, 1444-45 (1974).

238. CAL. CORP. CODE §§ 29500-29590 (West 1974 Supp.); Mich. Pub. Act No. 31, 1 West's Mich. Leg. Serv. 62 (May 1, 1975).

239. 7 U.S.C. §§ 4a-22 (Supp. IV 1974), *amending* 7 U.S.C. §§ 1-22 (1970). I will not discuss these amendments in any detail as that has been done elsewhere in this symposium. For a brief general discussion of commodity regulation under federal law including the new amendment, see CFTC Staff Memo, Appendix I. *See also* Jones & Cook, *The Commodity Futures Trading Commission Act of 1974*, 5 MEMPHIS ST. L. REV. 457 (1975); Note, *The Role of the Commodity Futures Trading Commission Under the Commodity Futures Trading Commission Act of 1974*, 73 MICH. L. REV. 710 (1975).

240. *See, e.g.*, CFTC Staff Memo reproduced in part in Current CCH FED. SEC. L. REP. ¶ 80,336 (1975); CFTC Amicus Curiae Brief, SEC v. American Commodity Exchange, Inc., Civ. App. No. 75-0436-C (W.D. Okla., filed July 14, 1975). Brief for CFTC as Amicus Curiae, People v. Monex Int'l, Ltd., Index No. 41439/74 (N.Y. Sup. Ct., New York County, filed Oct. 1975).

tors on the other hand have indicated that they do not feel that they have been completely pre-empted.[241] The two courts which have considered the question appear to favor the CFTC position.[242] I interject my brief comments on the subject only because they differ substantially from those expressed by other authors in the symposium.

Before turning to the actual language of the amendments which the CFTC claims pre-empts the SEC and the state administrators, I would like to offer two practical reasons why pre-emption should not take place. First, the regulatory approach of the Commodity Exchange Act is vastly different than that of the securities acts. This alone might suggest that pre-emption is necessary in order to avoid interference by the securities agencies with the comprehensive pattern of the commodities business. I would argue to the contrary. The type of transactions that we are dealing with are on the very fringe of commodity regulation. The Commodity Exchange Authority has long banned the sale of options on domestic commodities. This ban was carried forward into the amendments. Therefore, we are dealing only with commodity options on previously unregulated commodities and the sale of gold and silver coins and bullion.

Further it has been demonstrated throughout this paper that the people who are investing in this type of contract are not the normal commodity trader who has a reasonable knowledge of the commodity market and its operation. Instead the people drawn to the commodity option schemes are the totally unsophisticated investor who is merely seeking an investment for his money and has no knowledge of the commodity market. Likewise most of the commodity option dealers are not normally commodity traders. Most of the firms, which sprung up in the wake of the apparent success of Goldstein Samuelson and their employees, came from other branches of the securities business because of the easy pickings in a new and virtually unregulated area of investment. The regulatory scheme of the Commodity Exchange Act while it does have an anti-fraud section similar to that found in the securities acts,[243] which has been construed to give rise to a private cause of action,[244] is not designed to provide this class of unskilled investors with the information that they need to make an intelligent investment decision in this area.

Second, the new CFTC is a new and very small agency with approximately 500 employees. It is extremely doubtful that an agency of this size can adequately police this area along with the more important areas of its jurisdiction. The Securities and Exchange Commission, a much larger and more

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241. *See, e.g.*, Letter from Roderick M. Hills, Chairman, Securities and Exchange Commission to William Bagley, Chairman, Commodity Futures Trading Commission, Current CCH FED. SEC. L. REP. ¶ 80,336 (Nov. 13, 1975).

242. SEC v. Univest, Inc., Current CCH FED. SEC. L. REP. ¶ 95,369 (N.D. Ill. Nov. 18, 1975), *appeal pending*; State v. Monex Int'l, Ltd., 527 S.W.2d 804 (Tex. Civ. App. 1975), application for writ of error filed.

243. 7 U.S.C. § 6b (1970).

244. *See, e.g.*, Goodman v. H. Hentz & Co., 265 F. Supp. 440 (N.D. Ill. 1967).

experienced agency, has had difficulty keeping abreast of the commodity option operations and similar gold and silver bullion schemes even with the help of the state securities administrators who have been extremely active in the area. At the time of the passage of the Commodity Act amendments through the efforts of the SEC and the state securities agencies, the trading in American "naked" options had all but ceased and the trading in London options was well under control. However, it is my understanding that since the effective date of the Commodity Act amendment option dealers have again begun to peddle their wares. Yet the new CFTC has by its own admission proceeded against only two operations in the nine months since it began operation.[245] The state securities administrators are loath to stand by and allow their citizens to be victimized by these commodity option operators waiting for the new CFTC to act when they have been totally successful in controlling these schemes through state securities enforcement actions.

Both of these points suggest that the jurisdiction of the CFTC and the state and federal securities agencies should be concurrent and not exclusive. Yet obviously such arguments would be unavailing if the jurisdictional language of the statute was clearly unambigious. Unfortunately it is not. The language which gives rise to the dispute is found in section 2 of the Commodity Exchange Act as amended and reads:

> That the Commission shall have exclusive jurisdiction 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 15a of this title: *And provided further*: That, 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 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 the courts of the United States or any state.[246]

Rather than attempting to justify or refute the pre-emption argument by looking to the legislative history of the Act and the statements of members of Congress,[247] let me simply suggest some of the problems that a claim of total pre-emption causes. First, a fair reading of the exclusive jurisdiction provision suggests that the CFTC has exclusive jurisdiction over all United States trading

245. CFTC Staff Memo, Appendix I, at 7 n.17, *listing* CFTC v. American Options Corp., Civ. App. No. 75-3355 (C.D. Cal., no date given); CFTC v. American-Overseas Trading Corp., Civ. App. No. 75-1970A (N.D. Ga., no date given). The former was settled by a consent decree on November 22, 1975. BNA SEC. REG. & L. REP. (No. 325), ¶ A-13.

246. 7 U.S.C.A. § 2 (1975).

247. This was done in CFTC Staff Memo, reprinted in part in Current CCH FED. SEC. L. REP. ¶ 80,336 (1975).

of bare options on future contracts traded on any market.[248] This is without regard to whether the option itself is traded on any exchange or whether the underlying futures contracts are traded in London, Tokyo or Timbuktu. Thus the CFTC has jurisdiction over the options even when it does not have control over the underlying futures—a unique and awkward arrangement at best. But it is clear that the CFTC does not have exclusive jurisdiction over options traded on actual commodities,[249] or forward contracts.

This, however, should not end the matter. Admitting that the CFTC has exclusive control over bare option trading, I would submit that its exclusive jurisdiction does not extend to situations where the bare option is combined with other factors to make the entire package into an investment contract. Nor would I agree that the selling of "naked" options where there is no underlying dealing in the commodities merely by the use of the word "commodity" comes within this exclusive jurisdiction.

Probably the single biggest problem that I find with the exclusive jurisdiction argument is this. The provisions clearly do not remove the jurisdiction of the state and federal courts; at best merely the jurisdiction of the SEC and the state securities agencies. As we have seen then, it would appear possible for a defrauded option purchaser to go into either state or federal court and sue on the anti-fraud provisions of the securities acts on the basis of the precedents discussed earlier that the options in certain cases and the schemes in others involve the sale of a security.[250] If this is possible, what is there to prevent the same purchaser for suing not on the basis of fraud, but simply on the basis that the option sold him was an *unregistered* security?[251] Yet the state securities commission or the SEC would be powerless to accept registration.

My point here is the same as that made by Chairman Hills of the SEC in his letter to Chairman Bagley of the CFTC.[252] The pre-emptive language is not as clear as the CFTC would have one believe and the state and federal securities agencies and the CFTC should be working together to provide the American investor with the greatest possible protection, not haggling among themselves as to who has control over a particular transaction. There are enough would-be con artists in the commodity option area to require the attention of all the agencies.

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248. Bromberg, *Commodities and Securities Law—Overlaps and Pre-emptions*, 1 JOUR. CORP. LAW 217, 313 (1976). The CFTC has claimed such exclusive jurisdiction. CFTC proposed regulation on Commodity Option Transactions, Fraud, *reprinted in* SEC. REG. & L. REP. (No. 341) at E-1 (Feb. 25, 1976).

249. This would seem to place the Mocatta options outside the exclusive jurisdiction provisions, since the options do not come within the gold and silver provisions of 7 U.S.C. section 15a (Supp. IV, 1974). The California Corporation Commissioner recently concluded under similar language in his statute that coins marketed for the numismatic value; diamonds marked by an expert as to weight, clarity, size and value; fine silver products; and dried food evidenced by "food certificates" were not commodities because these items were not sold on the basis of public marketing quotations or prices made on any exchange or board of trade. *See* CAL. CORP. COMM'N INT. OP. Nos. 74/2CCL, 75/5CCL, 74/14CCL, and 74/15CCL, *discussed in* BNA SEC. REG. & L. REP. (No. 334), at A-15-A-16 (Jan. 7, 1976).

250. *See* Schroeder & Pollack, *Commodities Regulation*, 8 REV. OF SEC. REG. 935, 936 (Apr. 9, 1975); Bromberg, *Commodities and Securities Law—Overlaps and Pre-emptions*, 1 JOUR. CORP. LAW 217, 313 (1976).

251. *But see* Bromberg, *Commodities and Securities Law—Overlaps and Pre-emptions*, 1 JOUR. CORP. LAW 217, 313 (1976).

252. Current CCH FED. SEC. L. REP. ¶ 80,336 (1975).