Commodity Futures Archive - Selected materials, Bank Activities Involving the Sale of Precious Metals., ¶22,673, Commodity Futures Trading Commission, (Aug. 6, 1985)

¶22,673. Commodity Futures Trading Commission, Office of the General Counsel. Interpretative Letter No. 85-2. August 6, 1985. Correspondence in full text.

Banks: Leverage Transactions: Precious Metals..– A bank transaction involving the purchase and sale of precious metals to be settled in two business days with the bank receiving payment in full from a dealer who would resell the metals to its own retail customer with direction for the bank to transfer ownership and title to the metals to the purchaser's name, would not be a leverage contract within the meaning of Commission Reg. §31.4(w). Under the rule, the duration of a leverage contract is of at least ten years during which time it is anticipated that the purchasing customer will be making periodic payments of carrying charges after an initial downpayment. In the opinion of the Commission's Office of the General Counsel, in the transactions between the bank and the dealer and the subsequent one between the dealer and purchaser, payment of the full purchase price to either the bank or the dealer would occur by the second business day after the execution of the transaction.

See ¶12,475, "Liabilities—Prohibitions" division, Volume 1.

Futures Contracts: Banks: Precious Metals Transactions..– Initial precious metals transactions between a bank and its dealers and subsequent transactions proposed to be effected between those dealers and purchasers of precious metals with financing by the bank in which full settlement is to be made within two business days could not be subject to Commission regulation as transactions in futures contracts.

See ¶4003, "Definitions" division, Volume 1.

This is in response to your April 30, 1985, letter to this Office requesting an interpretation of the applicability of the Commodity Exchange Act, as amended ("Act"), 7 U.S.C. §1, *et seq.* (1982), to a commodity transaction in which your client, X (the "Bank"), proposes to become involved. The purpose of this letter is to set forth this Office's views concerning the transaction described in your letter.

From your letter and subsequent telephone conversations with you, we understand the relevant facts concerning the first proposed type of transaction to be as follows: The Bank would maintain a "metals trading desk" that would quote "bid and ask" prices for gold and silver bullion and coins. Through this metals trading desk, the Bank would engage in large purchase and sale transactions with coin dealers and other professional metal traders ("Dealers"). These Dealers, who are not in any way affiliated with the Bank, generally are persons engaged in the buying and selling of coins and bullion to the public. Some of these Dealers may be registered with the Commission, the Securities and Exchange Commission, or with various state agencies.

The purchase and sale transactions between the Bank and the Dealer would be settled within two business days, with the Bank receiving payment in full from the Dealer within that time. The Bank would make delivery of the precious metals purchased by Dealers pursuant to these transactions either by delivering the physical metal to the Dealer, or by segregating the metal for the Dealer in its vaults or in the vaults of a third party.

After this initial transaction between the Bank and the Dealer, a second separate transaction would, in some cases, occur whereby the Dealer would resell the metals it had purchased from the Bank to its own retail customer ("Purchaser"). Pursuant to this transaction wherein the Dealer would resell to the Purchaser metals which the Bank had previously sold to and segregated for the Dealer, the Dealer would direct the Bank to transfer ownership of and title to the metals to the Purchaser's name. Pursuant to the subsequent transaction, the Purchaser would receive a written confirmation of his purchase from the Dealer, and the Bank would also notify the Purchaser in writing that it was holding metals for the Purchaser's account. In this subsequent transaction, the Purchaser could make payment in full for the metals, or would be permitted to finance his purchase of metals by entering into a financing arrangement with the Bank. In either event, the settlement period within which full payment of the purchase price to the Dealer would be made again would be two business days.

Pursuant to the financing arrangement alternative, the Purchaser would be permitted to borrow from the Bank up to 80 percent of the cash value of the metals purchased, and the Bank would acquire a lien against the metals purchased for the amount borrowed by the Purchaser, plus interest. The financing agreement between the Bank and the Purchaser would provide that the Bank would be entitled either to demand additional funds from the Purchaser, or sell the metals subject to the lien, in the event that the market value of the metals at any time during the term of the loan diminished to a value of less than 110 percent of the amount of the unpaid balance of the loan from the Bank to the Purchaser. Any such additional funds paid by the Purchaser to the Bank would be directly applied toward reducing that unpaid loan balance. While the Bank would enter into financing transactions with Purchasers and would hold Purchasers' metals in segregation in its vaults, the Bank would not be selling to or buying from the Purchasers any precious metals, nor would the Bank be engaged in advising prospective Purchasers regarding the advisability of buying metals from the Dealers.

As an altrnative to the foregoing, you have suggested in your letter that a settlement period longer than two days, *i.e.*, seven days, is being considered, as is the possibility that the Bank might hold the coins and bullion in unsegregated vaults, with book entries reflecting Dealer and Purchaser ownership.

In analyzing whether these transactions are subject to regulation under the Commodity Exchange Act, it is necessary to determine whether the transactions may be either leverage contracts of transactions involving contracts of sale of a commodity for future delivery within the meaning of the Act and applicable Commission regulations. Concerning whether these transactions constitute leverage contracts, Commission Rule 31.4(w) which was recently promulgated by the Commission pursuant to its authority in Section 19 of the Act, 7 U.S.C. §23 (*see* 50 F.R, 27 (January 2, 1985)), generally defines a leverage contract to mean a "contract, standardized as to terms and conditions, for the long-term (ten years or longer) purchase ("long leverage contract") or sale ("short leverage contract") by a leverage customer of a "leverage commodity" which contract meets certain additional specific criteria as set forth in the Rule.

In apply this definition of a leverage contract to the precious metals transactions in which the Bank is considering becoming involved as described above, it appears that these transactions can be distinguished from leverage contracts. Under Rule 31.4(w), the duration of a leverage contract is of a long-term nature of at least ten years during which time it is anticipated, at least when the contract is entered into, that the customer who is purchasing a precious metals leverage contract will be making periodic payments of carrying charges after an initial down payment, with payment of the full purchase price of and transfer of ownership to the underlying commodity occurring at the end of this period or earlier if the customer elects to take delivery. In both the initial precious metals transaction between the Bank and the Dealer, and in the subsequent transaction between the Dealer and Purchaser with financing possibly provided by the Bank as described above, payment of the full purchase price to either the Bank or the Dealer, respectively, and a resulting transfer of ownership from the Bank or Dealer occurs by the second (or, alternatively, the seventh) business day after the execution of the transaction. As a result, and based upon the facts as stated above, it is the opinion of this Office that the two precious metals transactions described above are not leverage contracts within the meaning of Commission Rule 31.4(w) and are thus not subject to Commission regulation as such.

Concerning whether these transactions involve futures contracts subject to the Commission's regulatory jurisdiction, Section 4(a) of the Act, 7 U.S.C. §6(a), generally makes it unlawful for any person to offer to enter into, enter into, execute, or confirm the execution of any futures contract, or to conduct any office or business in the United States for such purposes, unless the futures contract is traded on or subject to the rules of a board of trade which has been designated by the Commission as a "contract market" and the contract is executed or consummated through a member of that contract market.

While the Act does not define the term "contract of sale of a commodity for future delivery," its plain and literal meaning is clearly broad enough to encompass any and all contracts or agreements which contemplate that payment for and transfer of ownership of the commodity involved will occur at some time in the future. As such, futures contracts are agreements to later buy and sell a commodity—agreements calling for later performance and payment—rather than spot transactions. In addition, while futures contracts create rights and obligations in the parties thereto concerning the delivery of any payment for the underlying commodity, it is quite rare for the parties to the contract to fulfill those rights and obligations as called for in the contract. Rather, before the time for delivery and payment as set forth in the futures contract arrives, the parties thereto most often eliminate their particular obligations under the contract by entering into an off-setting futures contract transaction, thereby extinguishing their obligation under the initial contract either to make delivery of or make payment for the underlying commodity. [1]

As discussed above, we understand that, unlike futures contracts, both the initial transaction between the Bank and the Dealer and the subsequent transaction between the Dealer and the Purchaser either with or without financing by the Bank, unequivocally would require payment and transfer of ownership of the precious metals to occur in all cases on or before the second business day after the transaction date. By that time, the precious metals which are the subject of the transaction actually would have been purchased from the selling party who would have transferred ownership and received full payment for the metals. In this context and in response to our inquiry, you have indicated that you are unsure whether, prior to the settlement date of a purchase of metals by a Purchaser from a Dealer, the Dealer will stand ready to repurchase the metals from the Purchaser. If such repurchases, which would serve to offset the original purchases, were to be permitted, we have indicated that we would view these transactions to be futures contracts. Alternatively, in this situation, should both the initial purchase by the Purchaser and the subsequent repurchase by the Dealer be closed out through full payment and transfer of ownership of the metal involved by the second business day after the date of each transaction, this Office would be of the view that these transactions would lack that element of futurity which is an essential characteristic of a futures contract, and would, in all material aspects, be more in the nature of spot transactions with delivery of and payment for the underlying commodity occurring essentially contemporaneously with the execution of the transaction, *albeit* for two business days for purposes of administrative convenience or necessity. [2] Accordingly, this Office is of the view that the initial precious metals transactions proposed to be effected between the Bank and the Dealers, and the subsequent precious metals transactions proposed to be effected between the Dealers and the Purchasers with financing by the Bank, where full settlement is made within two (or, alternatively, seven) business are not subject to regulation by the Commission as "transactions involving contracts of sale of a commodity for future delivery" as that term is used in Section 2(a)(1)(A) of the Act.

In addition to the applicability of the Commodity Exchange Act to the transactions described above, you should also consider whether the Model State Commodity Code recently adopted by the North American Securities Administrators Association, Inc. ("NASAA") (a copy of which is enclosed) may also apply. *See* 2 Comm. Fut. L. Rep. (CCH) ¶22,568. The views set forth below regarding the Model Code are the views of this Office and do not necessarily reflect the views of NASAA or any individual state that may adopt the Code.

Pursuant to Section 1.02 of the Model Code, it is generally unlawful for any person to sell or offer for sale any "commodity contract" of any kind or to offer or sell any commodity under any "commodity contract." (Sections 1.01(d) and (m) of the Code define commodities to include gold and silver.) The term "commodity contract" is defined in Section 1.01(e) of the Code so as not to include any contract under which the purchaser receives, within 28 calendar days from the payment of any portion of the purchase price, physical delivery of the total amount of the commodity to be purchased under the contract. As a result, the initial transaction described above wherein the Bank would sell and deliver precious metals to Dealers with settlement within two (or seven) days may not constitute a commodity contract within the meaning of the Model Code. In the situation where the Bank, rather than delivering the precious metal to the Dealer, segregates the metal for the Dealer in its vaults or in the vaults of a third party, it may be that a state official would not deem "physical delivery" to have occurred for purposes of the exclusion from the term "commodity contract." *But see* note 4, *infra*. In any event, even if the initial transaction between the Bank and the Dealer as described above should be determined to be a "commodity contract," Section 1.08(e) of the Code exempts from the prohibitions of Section 1.02 any transaction offered by and in which a "financial institution" is the purchaser or seller. As a result, the initial transaction between the Bank and the Dealer could be found to be exempt from the proscriptions of Section 1.02 because of the involvement of the Bank as the seller in the transaction.

Concerning the application of the Model Code to the second transaction described above wherein Dealers would subsequently resell precious metals to Purchasers, it would appear that even if the transaction were viewed as a "commodity contract," an exemption from Section 1.02 would be available by operation Section 1.04(a)(2). [3] Specifically, Section 1.04(a)(2) exempts from the prohibitions of Section 1.02 any commodity contract for the purchase of precious metals which requires, and under which the purchaser receives, within seven calendar days from the payment of any portion of the purchaser price, physical delivery of the quantity of precious metals purchased by the payment. For purposes of this exemptive provision, physical delivery is deemed to have occurred if, within the seven day period, the precious metals purchased are delivered, in segregated or fungible bulk form, into the possession of a depository (other than the seller) which is either a financial institution or other specified entity. Since the transaction would be concluded within seven days and the Bank, a financial institution, would be holding the commodity rather than the Dealer, the exemption in Section 1.04(a)(2) would apply, assuming the Bank issues the requisite certificate or documents of title contemplated by that exemptive provision. [4]

Of course, any specific determination of the applicability of the provisions of the Model State Commodity Code to the transactions described above would need to be made by the appropriate state officials of the states in which the transactions were to be marketed and wherein the Code may have been adopted. We note also that the Code's antifraud provisions would apply to any transaction involving a commodity contract, even if the transactions were exempt by virtue of Section 1.03 or 1.04(a)(2) of the Code. *See* Section 1.06.

As I am sure you can appreciate, because the above-stated positions are based upon the facts and representations contained in your April 30, 1985 letter, and upon subsequent representations made by you, any different, omitted or changed facts or conditions from those set forth above might well affect our analysis and resulting conclusions concerning the lawfulness of the transactions in which your client proposes to become involved, and instead could result in this Office reaching differing conclusions on this issue. You should also be aware that this letter expresses views concerning only the involvement of your client, the Bank, in the transactions described above and, therefore, does not express any opinion concerning the lawfulness of the activities of the Dealers in offering to sell and selling those transactions to Purchasers. Furthermore, you should know that it has often been our experience in matters of this kind that the public marketing and oral sales presentations made to prospective purchasers of transactions similar to those described above often differ markedly from written offering material describing such transactions which may be employed in that marketing effort. In this regard, you should be mindful of the fact that the Commission and the courts have consistently looked beyond the appearance of legitimacy created by such written materials to the underlying economic reality of the transaction itself as reflected in the actual day-to-day operations of those engaged in the business of marketing such transactions. Finally, we wish to make clear that the analysis set forth above is not necessarily that of the Commission and concerns only the applicability of the Commodity Exchange Act and the Model State Commodity Code to the transactions you have described and, as such, does not reflect any determinations concerning the applicability of other federal or state statutes to those transactions.

Footnotes

1 The indicia of what may constitute a futures contract were recently set forth in an interpretation published by this Office. 50 F.R. 11656 (March 25, 1985).

2 Should the settlement period be extended to seven days which, as noted above, you suggest is, an alternative under consideration, our view of these transactions would be unchanged assuming, of course, that the subsequent repurchase transaction would not he used simply to offset the original purchase transaction, as described above.

3 Because the Bank is involved neither as the purchaser nor the seller in the subsequent transaction but merely provides storage and financing, the exemptive provision of Section 1.03(e) from the proscriptions of Section 1.02 for commodity transactions in which "financial institutions" are purchasers or sellers, would not appear to apply. However, you have indicated that certain Dealers may be registered with the Commission, the Securities and Exchange Commission or various state agencies. Depending on the category of registration, other exemptions may be available under the Code with respect to transactions between the Dealer and a Purchaser. *See* Section 1.03.

4 Moreover, we note that a state official may not view the transaction between the Dealer and the Purchaser as constituting a "commodity contract" for purposes of the Code. Since the entire quantity of the metals to be purchased would be delivered to and held by a depository other than the seller within seven days, a state official might determine that "physical delivery" to the Purchaser has occurred under Section 1.01(e) within 28 days by analogy to the "physical delivery" provision of Section 1.04(a)(2).