The Securitization of Commodities:

Crossing a Gold (or Silver) Line in the Sand

By Elizabeth L. Ritter

In recent months, Barclays and the World Gold Council have begun trading exchange-traded funds (ETFs) based on the rise or fall in the price of gold. From a marketing perspective, the marriage of ETFs and gold was made in heaven. ETFs have been publicized as an investor's dream: they can be bought or sold on margin; unlike mutual funds they can be traded throughout the day; and they benefit from certain tax advantages over mutual funds.[1] And gold is, well–gold. It glitters, it's glamorous, it's global. Gold prices skyrocketed through the fall of last year to reach a high of over $450 an ounce at the end of 2004, enticing virtually everyone to play the gold market. It's solid, reliable, and in a bear market it frequently becomes the investment of choice–as Jill Leyland, an economist at the World Gold Council states, "Bad news is good news for gold."[2] And commodity markets generally are hot, both on- and off-exchange, enjoying record volumes in recent years.[3]

iShares COMEX Gold Trust®, sponsored by Barclays and traded on the American Stock Exchange (AMEX), and StreetTracks Gold Shares®, sponsored by the Gold Council and traded on the New York Stock Exchange (NYSE), both enjoyed solid successes in trading volume at inception.[4] The StreetTracks contract has, since the beginning of the year, benefited from trading volumes averaging approximately 2 million contracts per day, even as its net asset value has declined. Other than portfolio diversification, what is the lure of such a seemingly quixotic investment?

Simply put, iShares Gold Trusts and StreetTracks Gold Shares are marketed to investors as an efficient method to access changes in the price of gold, without having to take actual possession of physical gold bullion. Rather, gold price risk is accessed through the trading of a security–a much more familiar, and therefore comfortable, investment option for many market participants. You can deal with your local securities broker, and trade the gold market just as you trade Intel or IBM stock. Sounds like a good deal, right?

There is an issue, however, as to the appropriate regulatory characterization of these products: are they securities, are they commodity futures, or are they cash market transactions? This article explores those questions, and provides some legal and policy background regarding the nature of these transactions. Specifically, we review the regulatory framework for commodity futures and options transactions, note some of the differences between the commodities and securities markets, and analyze gold ETFs in light of applicable securities and commodities case law and statutes. As a result of this analysis, we reach the conclusion that the gold ETFs as described herein are most appropriately viewed neither as futures nor as securities, but rather as cash market transactions, with the resulting regulatory ramifications that flow from such a determination.

Commodity Futures and Options Regulation

In 1974, Congress promulgated legislation to create the Commodity Futures Trading Commission (CFTC), an independent federal regulatory agency that oversees the trading of the commodity futures and options markets in the United States. While there once was a rather romanticized perception of the free-wheeling world of commodity futures trading, dominated by Chicago pork belly traders and Midwestern wheat and grain merchants, after the 1971 Bretton Woods decision to remove the dollar from the fixed gold standard, the word "commodity" took on a whole new meaning. Futures and options trading on underlying financial commodities soon began to develop and expand, so much so as eventually to overtake by large measure the trading volume of more "traditional" commodities, and to transform the futures and options markets into the global financial risk management markets they are today.

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The primary federal interest in regulation of this type of trading is two-fold: commodity markets are used 1) to shift or assume market risks; and 2) to discover and disseminate price information "through trading in liquid, fair and financially secure trading facilities."[5] Congress has long recognized a fundamental difference between these types of markets as opposed to capital formation markets, which are regulated by the Securities and Exchange Commission (SEC). (Indeed, federal regulation of the commodities markets under the Department of Agriculture was in place almost a decade prior to the 1933 enactment of federal securities regulation.)

Jurisdictional Issues Between Commodities and Securities Transactions

SINCE THE CREATION OF THE CFTC, numerous jurisdictional questions have arisen regarding precisely where the line should be drawn separating federal securities laws from federal commodities regulation.[6] The distinction is critically important: while there are several facial similarities between the two bodies of regulation, intrinsic differences between the commodities and securities markets require application of the appropriate regulatory structure in order to carry out Congressional intent regarding fundamental issues of market integrity and customer protection.

Risk management markets are sometimes referred to as a "zero-sum game." For every dollar lost, a dollar is gained–every time I win, you lose a corresponding amount, and vice versa. This is fundamentally different from the "rising tide raises all ships" concept of the capital formation markets. Accordingly, the two types of markets require two different types of regulation. And let's not forget cash and forwards transactions, which generally are neither securities nor futures, and which are specifically excluded from the jurisdiction of the CEA.[7] Each of these markets has different uses, and, while the same terminology may be utilized across markets, each is regulated by a different set of rules.

Here's an elementary example: the term "insider trading" means something very different in the securities world than it means in the commodities world (where it's actually desirable to have people with inside industry knowledge actively trading the marketplace–that's how prices are discovered). Consequently, application of securities insider trading laws to commodities trading is entirely inappropriate.[8] Another example: the term "margin" in the commodities world refers to a performance bond deposited to ensure performance on a futures contract (and is usually fairly low, often 5-7% of the value of the underlying contract), while the same term in the securities world refers to collateral deposited in partial payment of the security (and is generally not less than 50% of the underlying stock). Most importantly, as noted above capital formation markets and risk management markets are utilized by market participants to perform different identified functions, and therefore require regulatory oversight programs tailored to those specific uses.

Accordingly, given the importance of determining the character of a particular product in order to evaluate under what oversight system it is appropriately regulated, we turn to this question: Are gold investment products such as shares in the trust vehicles described above properly traded as securities? Or should they be characterized under an alternative product class?

Are Gold ETFs Securities?

TO ESTABLISH A REGULATORY CHARACTERIZATION for gold ETFs, it's helpful to provide a brief overview of how they are structured and traded. StreetTracks Gold Shares and iShares Gold Trust shares represent fractional, undivided beneficial ownership interests in investment trusts, the sole assets of which are gold bullion. (Occasionally, the trusts hold cash as well, used in redemptions and to pay trust expenses.) Shares are issued in the trusts, and the shares are listed and traded on the NYSE and on the AMEX.[9] A review of the trust prospectuses indicates that

there does not appear to be active, ongoing management of the trusts, other than making distributions and paying expenses. In other words, the value of the trust shares appears to be completely dependent upon the rise or fall in the price of gold. The prices of the gold ETF shares are set at 1/10 the price of the spot gold market.[10]

While this may constitute an investment contract, there is a colorable argument to be made that such an investment contract may not be a security. In *SEC v. W.J. Howey Co.,* the Supreme Court said that an investment contract under federal securities laws is "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[.]"[11] With regard to gold ETFs, it would appear that the first two parts of the test are met (investors commit assets, and they are part of a common enterprise), but there remains a question as to whether the third prong of *Howey* is satisfied.

What does it mean to profit "solely from the efforts of the promoter or a third party?" Courts have interpreted this language with a fair degree of elasticity, and have held that profits must derive "primarily" or "substantially" from the efforts of others.[12] In addition, *de minimus* management does not rise to the level of administrative activity required to affect investors' profits under *Howey.*[13] In response to a query whether the iShares Gold Trust utilizes the services of a portfolio manager, the product website states "[n]o, the trust will only hold gold . . . [t]he trust will not be actively managed, and the trustee and the custodian will oversee the deposits of gold."[14] The Gold Trust Prospectus indicates that the trustee is responsible for day-to-day administration of the trust, including "processing orders," "coordinating with the custodian" for gold delivery and receipt, "calculating net asset value and adjusted net asset value," and "selling the trust's gold as needed to cover the trust's expenses."[15] The custodian's responsibility can be generally characterized as "safekeeping the gold."[16] StreetTracks Gold Trusts appear to be managed in a similar fashion, and the custodian and trustee responsibilities identified in its prospectus are quite comparable to those in the iShares Gold Trust prospectus.[17] Accordingly, inasmuch as the identified conduct would appear to rise to the level only of *de minimus* management activity (and, indeed, iShares affirmatively states that its trust is not "actively managed"), it is reasonable to speculate as to whether the third element of the *Howey* test is met as to ETFs for the StreetTracks Gold Shares and the iShares Gold Trust shares, and accordingly, whether these products are appropriately regulated and traded as securities on national securities exchanges.

Another basis on which to query whether these products are properly viewed as securities is that, while securitization of certain commodities has received regulatory approval in the past, it has been permitted only in specific circumstances. The rationale for this limitation is found in the CEA's grant of exclusive jurisdiction to the CFTC over transactions involving the offer and sale of a commodity for future delivery. In certain circumstances, however, futures and options transactions, in particular commodities–foreign currencies are one example,–are excluded from CFTC's exclusive jurisdiction, and the SEC is free to, and has, exercised some jurisdiction in this area. For example, the SEC noted in its January 19, 2005, approval of the AMEX iShares filing that, "[t]he [SEC] has previously approved the listing of products for which the underlying was a commodity or otherwise was not a security trading on a regulated market."[18] However, each of the examples listed to support this contention involves transactions that would not implicate contracts within the exclusive jurisdiction of the CFTC due to an explicit Congressional exclusion of the underlying commodity.[19] Accordingly, allowing the securitization of other types of commodities that do not fall under such a statutory exclusion–gold bullion, for example–would appear to be an act of first impression.[20] The obvious concern is that, if the transaction were deemed to be the nature of future or option, it would fall under the exclusive jurisdiction of the CFTC and the attempted securitization would transgress the jurisdictional boundaries limned by Congress.

Are Gold ETFs Futures?

THERE IS NO PRECISE STATUTORY DEFINITION of a futures contract in the CEA; the definition has been open to interpretation by the Commission and by courts, and varying iterations of what constitutes a futures contract have been posited over the years. Indeed, that issue usually is a favorite topic of debate during the Commission's cyclical reauthorizations, and is also a recurring theme on the Commission's litigation agenda.[21] There are, however, certain long-standing definitions that have been relied upon over time, and are useful to review in this context.

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In the *Co-Petro* case,[22] the Ninth Circuit Court of Appeals instructed that, when determining whether transactions are futures contracts, "[t]he transaction must be viewed as a whole with a critical eye toward its underlying purpose."[23] The Commission cited to that directive in its *Statement of Policy Concerning Swap Transactions*,[24] and noted that despite the absence of a bright-line test, there are three necessary elements common to futures contracts:

- First, futures contracts are contracts for the purchase or sale of a commodity for delivery in the future at a price that is established at the time the contract is initiated (the element of futurity);

- Second, the ability to form offsetting contracts is a necessary characteristic of futures contracts, inasmuch as market participants generally do not take delivery on futures contracts;

- Third, the purpose of the transactions is to assume or shift risk.[25]

In addition, the Commission noted that other characteristics may be indicative of futures contracts, including: standardized commodity units, margin requirements related to price movements, clearing organizations that guarantee counterparty

performance, open and competitive trading in centralized markets, and public price dissemination.[26] The CFTC stated that "[t]hese additional elements facilitate the trading of futures contracts on exchanges and historically have developed in conjunction with the growth of organized markets. The presence or absence of these additional elements, however, is not dispositive of whether a transaction is a futures contract."[27]

Utilizing this framework to determine whether gold ETFs are futures, it would appear that these products do not satisfy all required elements listed in the Swap Transaction Policy Statement. First, gold ETFs shares are not contracts "for the purchase or sale of a commodity for delivery in the future at a price that is established at the time the contract is initiated"; on the contrary, the value of the shares at any given time reflects the price of gold owned by the trust at that time. For that reason alone–the failure to include an element of futurity–these contracts would probably not be deemed to be futures contracts. Secondly, gold ETFs do not appear to satisfy the definitional element relating to delivery in that the trust underlying the ETFs shares actually owns the underlying gold This distinguishes gold ETFs from futures contracts, which do not represent actual ownership of underlying commodities, but rather are contracts for potential delivery of a commodity. With regard to the third definitional element, gold ETFs–like gold futures contracts–may be used to shift or assume risk; in addition, some of the secondary definitional characteristics of futures contracts may be present.[28] However, failure to meet the first two required elements noted above would appear to be fatal to a characterization of these products as futures. Accordingly, while gold ETFs may have apparent similarities to gold futures transactions, as these products are currently structured gold ETFs do not appear to be appropriately traded as futures under the jurisdiction of the CFTC.

Gold ETFs – Cash Market Transactions

After all of this extended analysis, the most reasonable approach may be to characterize gold ETFs neither as securities nor as futures. As discussed, the *Howey* test presents a problem in attempting to define these transactions as securities; similarly, the definition of a futures contract under the various commodities case law and agency interpretations does not appear to accommodate these products. However, the gold ETFs described in this article do seem to fit squarely within one market sector briefly noted above: specifically, the most appropriate characterization of these products appears to be as cash market transactions. The earlier-cited comparison of ETF gold prices as against the LME spot price and the NYMEX gold spot-month futures contract price reveals a striking consonance–so much so as to provide a convincing argument that gold ETFs are, in essence, nothing more than cash gold transactions effected through shares in a trust vehicle.[29] And while such a determination would appear to be elementary, the effect of this characterization is anything but insignificant: if gold ETFs are viewed as cash market transactions, then options on such transactions unquestionably lie within the exclusive jurisdiction of the CFTC.[30]

The jurisdictional issue is notable because efforts to securitize commodities are increasing, both in number and in kind. Barclays recently filed a registration statement with the SEC to trade silver ETFs, which are similar in design to Barclays' gold ETF products.[31] A currency ETF–based on the Euro–also has been developed in which Euros are deposited in exchange for trust shares; the registration statement for that product was filed with the SEC on June 7, 2005.[32] Ameristock Funds, a small California fund, has filed for regulatory approval of an oil ETF that it intends to organize as a limited partnership, operate as a commodity pool, and trade on NYMEX. (Interestingly, regulatory approval for this fund, even though it plans to organize as a commodity pool and trade on a commodity exchange, was filed solely with the SEC.)[33]

In yet another commodity securitization scenario, inventors associated with NYMEX and the Philadelphia Stock Exchange have recently filed with the U.S. Patent and Trademark Office a patent to "securitiz[e] contracts valued on an index."[34] A review of the filing indicates that it would provide for trusts, entitled "Special Purpose Entities" (SPEs) to issue securities, the value of which are derived from underlying commodities held in the trust. The patent filing states that the SPE trust would be traded by a contract dealer, most likely a futures commission merchant (the commodities world equivalent of a securities broker/dealer). Like the ETFs discussed above, the SPE trust assets could be gold, silver or oil (or presumably any other commodity), and trading would occur on securities exchanges rather than on futures exchanges. In a similar patent application, inventors are attempting to obtain exclusive rights on a process for linking stock directly to the value of physical commodities.[35] Given the interest in commodities trading and the benefits of offering products through the securities marketing network, there is every reason to believe that efforts to securitize commodities will become increasingly common.

> "One thing is clear: given the increasing interest in these products, this is an issue deserving of additional attention by regulators and market participants. "

Conclusion

As has occurred numerous times in the past, certain financial market transactions are developed that are challenging, at first blush, to characterize. Gold ETFs, like many other innovative products, appear to fall into this category. Attempts to securitize commodities through the use of ETFs (or other, even more creative methods), raise interesting questions regarding longstanding interpretations of securities laws as well as with regard to statutory provisions of the CEA providing for exclusive jurisdiction of the CFTC over the offer and sale of commodities for future delivery.

While the jurisdictional lines of demarcation between the securities world and the commodities world can become more and more indistinct as products become more and more sophisticated, there are certain legal and policy benchmarks that may prove useful in divining under what regulatory system a product should be traded. With regard to the ETFs discussed in this article, the cases and statutes noted above, particularly those relating to the Howey test and exclusive jurisdiction provisions of the CEA, may afford some guidance in this area.

One thing is clear: given the increasing interest in these products, this is an issue deserving of additional attention by regulators and market participants. And as to one of the novel patent filings regarding securitization of commodities, press reports indicate that "[t]he patent holders believe they would hold a patent on 'the entire concept of creating a security from a commodity.'"[36] One wonders what Barclays, Ameristock, and the World Gold Council have to say about that . . . . BLB

Elizabeth L. Ritter is Assistant General Counsel at the United States Commodity Futures Trading Commission. She is also an adjunct professor at the Washington College of Law. The author wishes to thank Michael Penick, Industry Economist, Office of the Chief Economist, Commodity Futures Trading Commission, for providing data for this article. The opinions expressed in this article are solely those of the author, and are not intended in any way to represent the views of the Commission.

ENDNOTES: *Elizabeth L. Ritter*

[1] Generally, investors can pay capital gains tax at the final sale of ETFs, making them somewhat more efficient than standard mutual funds, and much more efficient than mutual funds that are actively managed.

[2] "Future Is Still Bright For Gold Investors," December 11, 2004, at http://www.infinitytrading.com/gold_futures_options_trading.html (last visited July 17, 2005).

[3] *See e.g.*, Chicago Mercantile Exchange press report, April 1, 2005 (first quarter 2005 average daily trading volume reached record 3.9 million contracts, representing a 39% increase from 2004), at http://www.cme.com/about/press/cn/05-43March2005Volume12714.html (last visited July 17, 2005); Chicago Board of Trade press report, June 1, 2005 (May 2005 average daily trading volume was over 3 million contracts, an increase of almost 12 % over 2004, and the year-to-date average daily trading volume increased 22%), at http://www.cbot.com/cbot/pub/cont_detail/0,3206,1036+28650,00.html (last visited July 17, 2005).

[4] StreetTracks Gold Shares began trading in November 2004, with over 10 million contracts traded daily at the start of trading, and in the first month averaged approximately a half-million contracts in daily trading volume. iShares Gold Trusts, the smaller contract, began trading in January 2005, and averaged approximately 2 million contracts in daily contract trading volume during the first two weeks; in the past two months, daily trading volume has generally averaged approximately 30,000 contracts.

[5] Commodity Exchange Act ("CEA"), 7 U.S.C. § 5 (2003).

[6] *See e.g.*, *Board of Trade of the City of Chicago v. SEC*, 677 F. 2d 1137 (7th Cir. 1982), vacated as moot, 459 U.S. 1026 (1982)(Seventh Circuit Court of Appeals held that the CFTC had exclusive jurisdiction over options on mortgage-backed certificates, and that the SEC had no power to authorize their trading, later vacated as moot when Congress codified the Shad/Johnson jurisdictional agreement); *Chicago Mercantile Exchange v. SEC*, 883 F.2d 537 (7th Cir. 1989)(Seventh Circuit Court of Appeals held that CFTC had exclusive jurisdiction over stock index participation instruments); *Board of Trade of the City of Chicago v. SEC*, 187 F.3d 713 (7th Cir. 1999)(Seventh Circuit Court of Appeals affirmed the CFTC's exclusive jurisdiction over futures contracts on Dow Jones Utility and Transportation Indexes).

[7] CEA Section 1a(19), 7 U.S.C. §1a(19).

[8] It should be noted that the CEA does include provisions regarding insider trading that are specific to the commodities world. CEA §§ 9(c), (d), (f), 7 U.S.C. §§ 13(c), (d), (f).

[9] Both gold ETFs discussed in this article are created in a similar fashion: the trusts issue and redeem "baskets" equivalent to either 100,000 shares (in the case of StreetTracks Gold Shares) or 50,000 shares (in the case of iShares Gold Trust) in exchange for the delivery to the trust of the amount of gold represented by the basket being created.

[10] Regression analyses comparing the London Metals Exchange spot gold price and the New York Mercantile Exchange ("NYMEX") spot-month gold futures price with the ETF gold prices over a six-month period show virtually identical pricing alignments in these markets.

[11] 328 U.S. 293, 298-299 (1946).

[12] *See e.g.* SEC v. Glenn W. Turner Enterprises, Inc., 474 F.2d 476, 482 (9th Cir. 1973).

[13] *See e.g.* Noa v. Key Futures, Inc. 638 F.2d 77, 80 (9th Cir. 1980).

[14] iShares COMEX Gold Trust, "Frequently Asked Questions," at http://www.ishares.com/material_download.jhtml?relativePath=/repository/material/downloads/gold_faq.pdf&, at 2 (last visited July 17, 2005).

[15] iShares COMEX® Gold Trust Prospectus, March 11, 2005, http://www.ishares.com/material_download.jhtml?relativePath=/repository/material/downloads/prospectus/gold.pdf&, at 32.

[16] *Id.*

[17] StreetTracks Gold Shares Prospectus, January 21, 2005, at 37, 38.

[18] SEC Release No. 34-51058, File No. SR-Amex-2004-38, at http://www.sec.gov/rules/sro/amex.shtml (last visited July 17, 2005).

[19] *See* CEA § 2(c), 7 U.S.C. §2(c)(provides that nothing in the CEA shall apply to transactions in foreign currency, government securities, security warrants, security rights, resales of installment loan contracts, repurchase transactions in an excluded commodity, or mortgages or mortgage purchase commitments; that the CEA applies to futures and options transactions involving these commodities executed on a organized exchange and to foreign currency options not executed on a national securities exchange; that the antifraud provisions of the CEA apply to futures and options transactions in foreign currency between a non-eligible contract participant and a futures commission merchant or its affiliate).

[20] Some would argue that products are already trading–AMEXs "SPDRS"® ETF, for example–representing the securitization of a commodity not subject to a statutory exclusion. This type of product, however, reflecting securities prices as opposed to physical commodity prices, represents a difference in kind as opposed to the contracts discussed herein, and will be analyzed in the context of other issues relating to SEC/CFTC jurisdictional boundaries in a future article related to the definitions of narrow- and broad-based securities indexes under the securities and commodities laws, as well as to definitions proposed by the CFTC in its current Congressional reauthorization.

[21] *See e.g. Commodity Futures Trading Commission v. Zelener*, 387 F.3d 624 (7th Cir. 2004)(petition for rehearing and rehearing *en banc*, denied).

[22] *CFTC v. Co Petro Marketing Group, Inc.*, 680 F2d 573 (9th Cir. 1982).

[23] *Id.* at 581.

[24] Commodity Futures Trading Commission Policy Statement Concerning Swap Transactions, 54 Fed. Reg. 30694 (July 21, 1989).

[25] *Id.* at 30695.

[26] *Id.*

[27] *Id.*

[28] Gold ETFs are traded in standardized units, are cleared through a clearing-house, are traded in open and competitive markets, and have public dissemination of prices.

[29] *See* discussion *infra*, note 11.

[30] CEA § 2(a)(1)(A), 7 U.S.C. § 2(a)(1)(A).

[31] iShares Silver Trust, Sponsored by Barclays Global Investors International, Inc., Form S-1, Registration Statement, June 17, 2005, at http://www.sec.gov/Archives/edgar/data/1330568/000119312505127244/ds1.htm (last visited July 17, 2005).

[32] Euro Currency Trust, Sponsored by PADCO Advisors II, Inc., Form S-1, Registration Statement, June 7, 2005, at http://www.sec.gov/Archives/edgar/data/1328598/000095013605003315/file001.htm (last visited July 17, 2005).

[33] New York Oil ETF, LP, S-1, Registration Statement, May 16, 2005, at http://www.sec.gov/Archives/edgar/data/1327068/000095013305002254/w09130sv1.htm (last visited July 17, 2005); See Morningstar, "Fund Times: Oil ETF Tries to Strike it Rich," June 15, 2005, at http://news.morningstar.com/doc/news/0,2,135048,00.html (last visited July 17, 2005).

[34] United States Patent Application # 20050119962, Kind Code A1, Bowen, Christopher, et al., June 2, 2005.

[35] United States Patent Application # 20050086153, Kind Code A1, Scott, Aaron Edward, April 21, 2005.

[36] "NYMEX and PHLX Get Together on Patent for Securitizing Commodities," SECURITIES WEEK, Vol. 32, no. 24, June 13, 2005.