UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

Nos. 87-5581 and 86-6374
(Consolidated)

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COMMODITY FUTURES TRADING COMMISSION,

Plaintiff-Appellee,

-against-

P.I.E., INC. (d/b/a PARAGON INVESTMENTS)
and MARVIN D. BRANDON,

Defendants-Appellants,

-and-

JACK L. CHRISTIAN,

Defendant.

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# BRIEF OF PLAINTIFF-APPELLEE
# COMMODITY FUTURES TRADING COMMISSION

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## COUNTERSTATEMENT OF THE ISSUES PRESENTED FOR REVIEW

1. Whether the district court correctly concluded that Paragon's "Purchases For Delivery For A Later Date" contract was a contract of sale of a commodity for future delivery offered and sold in violation of section 4(a) of the Commodity Exchange Act, 7 U.S.C. § 6(a) (1982).

2. Whether the district court correctly concluded that Paragon's and Brandon's fraudulent activities in connection with off-exchange futures contracts violated section 4b of the Act, 7 U.S.C. § 6b (1982).

3. Whether the district court acted within its discretion in ordering Brandon to disgorge illegal profits.

## STATEMENT OF JURISDICTION

The Commission concurs in the statement of jurisdiction in appellants' opening brief.

## NATURE OF THE CASE, COURSE OF PROCEEDINGS, AND DISPOSITION BELOW

On June 23, 1986, the Commodity Futures Trading Commission ("Commission" or "CFTC") filed a three-count complaint in the United States District Court for the Central District of California against Marvin D. Brandon ("Brandon") and P.I.E., Inc., d/b/a Paragon Investments ("Paragon") (collectively "appellants").[1] The complaint alleged that Paragon and Brandon: (1) offered and sold commodity futures contracts that were not executed on a board of trade that had been designated by the Commission as a "contract market," in violation of section 4(a) of the Commodity Exchange Act (the "Act"), 7 U.S.C. § 6(a) (1982); (2) cheated or defrauded the public in connection with the offer and sale of those contracts, in violation of section 4b(A) of the Act; and (3) willfully deceived the public in connection with those contracts, in violation of section 4b(C) of the Act. 7 U.S.C. §§ 6b(A), 6b(C). The Commission sought an ex parte restraining order,[2] preliminary and permanent

[1] The complaint also named Jack L. Christian as a co-defendant. Mr. Christian reached a settlement with the Commission prior to the second phase of trial.

[2] Section 6c of the Act, 7 U.S.C. § 13a-1 (1982), authorizes the Commission to obtain ex parte restraining orders for the preservation of records and assets.

injunctions, appointment of a receiver, an accounting of assets and liabilities, and disgorgement of illegal profits.

That same day, the district court granted the Commission's request for a limited ex parte temporary restraining order to prevent removal or destruction of records and dissipation of assets, and issued an Order To Show Cause why the temporary restraining order should not be broadened to prohibit the unlawful conduct alleged by the complaint, and a temporary equity receiver should not be appointed. (C.R. 10.)[3] Following a hearing on July 30, 1986, District Judge William D. Keller granted the Commission's request for a temporary restraining order prohibiting any further business activity of Paragon, and appointed a temporary receiver of all Paragon's assets and records. (C.R. 11.)

Trial on the merits then proceeded in two phases. The district court ordered the trial of Count I of the complaint (illegal sales of off-exchange commodity futures contracts) to be consolidated with the hearing on the Commission's request for a permanent injunction. (C.R. 12.) On August 26, 1986, following completion of the first phase of the trial, the district court permanently enjoined Paragon and Brandon from marketing off-exchange futures contracts, appointed a permanent equity receiver of all Paragon's property

[3] "C.R." refers to the Clerk's Record that contains the docket entries of all documents filed in the proceeding below. The number following "C.R." denotes the document number for the cited material on the Clerk's docket sheet.

(C.R. 92), and entered findings of fact and conclusions of law. (C.R. 91.) Both Brandon and Paragon appeal this order (No. 86-6374). (C.R. 102.)[4]

Counts II and III of the Commission's complaint, relating to fraud and deception, were tried before the district court between November 14 and 19, 1986. On January 5, 1987, the court issued an order permanently enjoining Paragon and Brandon from cheating or defrauding, and from willfully deceiving the public in violation of sections 4b(A) and 4b(C) of the Act, and ordered Brandon to disgorge $496,495.39 in illegal profits. Only Brandon appealed from this order, which was docketed in this Court as No. 87-5581. (C.R. 192.)

On February 28, 1987, this Court granted the motion of Paragon and Brandon to consolidate the two appeals.

## COUNTERSTATEMENT OF THE CASE

### A. Statutory Background

In 1974, Congress substantially revised the Commodity Exchange Act to establish the CFTC as an independent agency with exclusive regulatory jurisdiction over, among other things, transactions involving "contracts of sale of a commodity for future delivery."[5] The Act's regulatory scheme is predicated

[4] Defendant Christian also appealed to this Court the entry of a preliminary injunction against him, which was assigned Docket No. 86-6554. That appeal was dismissed after settlement. See note 1, supra.

[5] The Commodity Futures Trading Commission Act of 1974 ("CFTC Act"), Pub. L. No. 93-403, 88 Stat. 1389 (1974); see also sections 2(a)(1) and 2(a)(2) of the Act, 7 U.S.C. §§ 2, 2a (Supp. V, 1975).

In 1974, Congress also vested the Commission with exclusive jurisdiction to regulate gold and silver "leverage" transactions referred to in what is now section 19 of the Act. 7 U.S.C. § 2 (Supp. V, 1975); see also section 217 of the CFTC Act. The regulatory scheme applicable to leverage transactions is discussed at pp. 22-32, infra.

on the purchase and sale of futures contracts exclusively on authorized exchanges. Thus, section 4(a) of the Act, 7 U.S.C. § 6(a) (1982), makes it unlawful to effect a commodity futures transaction unless it has been executed on or subject to the rules of a "board of trade"[6] that has been designated by the Commission as a "contract market." To obtain designation, a board of trade must apply to the Commission under section 6 of the Act, 7 U.S.C. § 8 (1982), and satisfy the conditions and requirements of section 5 of the Act, 7 U.S.C. § 7 (1982). Thereafter, a contract market must continue to comply with those conditions of designation and meet other requirements, such as the obligations to furnish the Commission with its trading rules, keep books and records of its proceedings, and require warehouse operators to follow certain rules. See Section 5a of the Act, 7 U.S.C. § 7a (1982).

In addition, the Act creates a registration scheme for brokers. Individuals or firms that solicit, accept and execute orders for futures contracts, and accept money, securities, or property, to margin or secure those contracts, must register with the Commission as "futures commission merchants" (FCM). An FCM must satisfy rigid minimum financial requirements and comply with other reporting and recordkeeping requirements. See, e.g., sections 4d, 4e, 4f, 4g, 4i and 4k of the Act, 7 U.S.C. §§ 6d, 6e, 6f, 6g, 6i and 6k (1982).

[6] In section 2(a)(1)(A) of the Act, 7 U.S.C. § 2 (1982), the term "board of trade" is defined as "any exchange or association, whether incorporated or unincorporated of, persons who shall be engaged in the business of buying or selling any commodity or receiving the same for sale on consignment."

To enforce this statutory scheme, the Commission is authorized to conduct investigations and bring actions in federal district court to enjoin violations of the Act, and the regulations and orders issued thereunder. See Sections 6c, 8(a) and 16 of the Act, 7 U.S.C. §§ 13a-1, 12(a) and 20 (1982). Upon a proper showing, a district court may grant injunctive relief and otherwise enforce compliance with the Act's provisions. Section 6c of the Act, 7 U.S.C. § 13a-1 (1982). As the Second Circuit observed, "the Commission, like the SEC in the securities area, is the 'statutory guardian' entrusted with the enforcement of the congressional scheme for safeguarding the public interest in the commodity futures markets." CFTC v. British American Commodity Options Corp., 560 F.2d 135, 142 (2d Cir. 1977).

B. The Nature of Appellants' Activities

The factual record developed regarding the nature of Paragon's business, and Brandon's involvement in it, is not in dispute.[7]

Paragon was incorporated in October 1984, and commenced doing business in January 1985 by offering so-called "Purchases For Delivery At A Later Date" contract (hereafter "Paragon contract") for sale to the public. Paragon, through Brandon and others, solicited orders for the purchase of the Paragon

[7] The following factual recitation is taken directly from: 1) the pretrial statement of "Stipulated Facts" filed by the parties in the proceeding below (C.R. 79); 2) Paragon's customer agreement, its risk disclosure statement, or its "360 Credit Program Agreement" (C.R. 79, Exhs. 1-1 through 1-14) and 3) Brandon's August 7, 1986 deposition (references to which are made in C.R. 158).

contract through advertising in nationally circulated newspapers, through the mails, and through other means and instrumentalities of interstate commerce. (C.R. 79 at p.7). Paragon continued marketing these contracts until at least July 24, 1986, when the Commission served the district court's ex parte restraining order upon Paragon and Brandon. (C.R. 79 at p.5).

As the parties stipulated (C.R. 79), appellants offered and sold the Paragon contract to the public subject to the following terms and conditions, and in the following manner:

> A. The customer placed a predetermined 15% deposit on purchases of precious metals for delivery at a later date of the type and quantity offered by Paragon and selected by the customer. The contract price and delivery date were determined at the time of the purchase and the customer would be required to pay the remaining balance prior to taking possession of the precious metals (C.R. 79 at p.4);
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> B. The customer could choose a contract term of 90 days, 180 days or 360 days from the date of purchase to the date of delivery (C.R. 79 at p. 4);
>
> C. The customer could either take delivery of the precious metals upon payment of the full price or require Paragon to repurchase the customer's right to obtain precious metals under the Paragon contract at any time prior to the delivery date (C.R. 79 at p.4);
>
> D. The purchase price was determined by Paragon by adding a 3% commission and a surcharge over the spot price[8/] on the date the customer placed the order; the surcharge varied according to the 90-day, the 180-day, or the 360-day, duration of the contract (C.R. 79 at p.4);
>
> E. The price, type and quantity of a particular transaction was agreed upon at the time of the purchase and was documented by a written confirmation statement sent by Paragon to the customer (C.R. 79 at p.4);

[8/] The term "spot price," as used throughout this brief, means the current market price (that is, cash price) of the precious metal for immediate delivery.

> F. If the spot price of the precious metals declined and if Paragon determined that the customer's equity in the account was "insufficient" the customer would be required to deliver additional funds to Paragon to reflect the difference between the current spot price and the spot price on the date of the customer's initial transaction (C.R. 79 at pp. 4-5);
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> G. Customers were informed that the precious metals they purchased for later delivery in all likelihood would not be held in inventory until the agreed date of delivery. Customers were informed that, instead, Paragon may acquire the precious metals for delivery to them through the purchase of futures contracts (C.R. 79, Exh. 1-8);
>
> H. In solicitations by Brandon and other employees of Paragon, the Paragon contract was offered as an opportunity to speculate and to profit from fluctuations in the market value of precious metals, and customers were informed that they could require Paragon to repurchase their contracts, thereby eliminating the customer's obligation to take delivery of the metals (C.R. 79 at p. 5);
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> I. Most customers who purchased Paragon contracts may not have had any expectation that they would take delivery of the metals pursuant to the contract (C.R. 79 at p. 5). In actuality, less than 3% of Paragon's customers took delivery of the metals pursuant to Paragon's contract (C.R. 158, August 1986 Reporter's Transcript ["A.R.T."] at 49.);
>
> J. Nothing in Paragon's promotional literature, the Paragon contract itself, or its risk disclosure statement referred to the Paragon contract as a "leverage" contract, agreement, or instrument (C.R. 79, at p.6); and
>
> K. The Paragon contract is not for a duration of ten years or longer (C.R. 79 at p.6).

It is also undisputed that Paragon had never been designated by the Commission as a contract market pursuant to section 5 of the Act, id., and that Paragon had never been registered with the Commission in any capacity. Id. at 3. Moreover, the Paragon contract was not executed on or subject to the rules of a contract market, and was not executed through a member of a contract market. (Id.) From January 1985 until July 24, 1986, Paragon accepted money from customers for the purchase or sale of various precious metals pursuant to the terms of the Paragon contract.

Brandon was Paragon's president, chief financial officer, sole shareholder, and one of its two directors. (C.R. 79, at p.2). (His wife was the other director.) Id. Brandon's responsibilities included the design and direction of Paragon's sales program, formulation of contract documents, bookkeeping, and general supervision of business operations. Id. During the time relevant to the complaint (January 1985 through June 1986), Brandon had not been registered with the Commission in any capacity. (C.R. 79, at p.3.)

### C. The Proceedings Below

#### 1. The Trial and Decision on Count I of the Complaint

On August 13-15, 1986, a bench trial was held on Count I of the Commission's complaint charging defendants with violating section 4(a) of the Act by offering and selling futures contracts other than on a Commission-designated contract market. The Commission's affirmative case was presented through Dr. Betsey Kuhn, who testified as an expert witness on the subject of the economic purposes and the essential elements of a futures contract.[9]

[9] At the time of the trial, Dr. Kuhn was a senior research economist in the Commission's Division of Economic Analysis. She holds a Ph.D. in Economics from Stanford University (where she wrote her dissertation on futures contract margin requirements), received a graduate fellowship from the Chicago Mercantile Exchange, and had been a scholar in residence at the Rockefeller Foundation in Bellagio, Italy (where she wrote a research paper on the hedging effectiveness of domestic versus international futures markets for developing countries). Since joining the Commission's staff in 1977, Dr. Kuhn's responsibilities included analysis of commodity contracts. Specifically, she had been responsible for determining whether particular instruments, regardless of labels by those who market tnem, are in the economic sense futures contracts, commodity options, leverage contracts, or cash forward contracts. (C.R. 158, A.R.T. at 23-30.)

Dr. Kuhn established at the outset that the principal economic purposes of a futures contract are to enable participants to assume or to shift the price risk of commodities (C.R. 158, A.R.T. 30). Dr. Kuhn explained that in order to achieve either result, the contract must have three essential elements: the price must be fixed at the time of initiation; the contract must call for deferred delivery of the commodity; and the contract must allow the participants the opportunity to settle their obligations either by making or taking delivery of the commodity, or by "offset," e.g., via cash settlement, resale of the contract to the company, or any other procedure that allows the customer to settle his obligations under the contract without making or taking delivery. (C.R. 158, A.R.T. at pp. 32-42, 46.) Dr. Kuhn further testified that the right to offset one's obligation under a deferred contract is what distinguishes a futures contract from a cash forward contract, which is excluded from the Commission's jurisdiction by section 2(a)(1)(A) of the Act. Id. at 34.[10] The offset feature is also what allows the contract to be used either for speculating (assumption of price risk) or for hedging (shifting of price risk to another person). Id.

In addition to describing the essential elements set forth above, Dr. Kuhn testified that futures contracts also commonly have certain non-essential characteristics which facilitate their trading and reduce the risk of default among participants. These "facilitating characteristics" include: a centralized marketplace; competitive trading (e.g., by open outcry

[10] Because the appellants do not assert that the Paragon contract is a cash forward contact, we have omitted discussion of the characteristics of cash forward contracts. For such a discussion, see CFTC v. CoPetro Marketing Group, 680 F.2d 573 (9th Cir. 1982).

in a trading ring or pit on the floor of a commodity exchange); a clearinghouse (a separate organization established within the exchange to assure the daily settlement and clearance of all trades); standardized contract terms and conditions; and margin deposits tied to the price movements in the underlying commodity. (C.R. 158; A.R.T. at 63.)

Against this background, Dr. Kuhn analyzed the Paragon contract and found that it possessed all of the essential economic elements of a futures contract: deferred delivery, establishment of a price set at initiation, and the opportunity for settlement by offset. (C.R. 158, A.R.T. 34-38).[11/] She also observed out that the Paragon contract, like an exchange-traded futures contract, had facilitating characteristics such as margin requirements and standardized terms concerning quantities of precious metals and duration of contracts. (C.R. 158, A.R.T. at 63-65.) Accordingly, she concluded that Paragon's contract was a futures contract. (C.R. 158, A.R.T. at 67.)

Based on the evidence, the district court's August 26, 1986 opinion found that:

> [T]he Paragon contract has the essential characteristics of a futures contract and that the contract is standardized and has a margin requirement. See also, [CFTC v.] CoPetro, supra, at 579-81. Both Dr. Kuhn and defendants' expert, Dr. Teweles, testified that the trading of a futures contract on a designated contract market is what makes a contract legal and not what makes it a futures contract. See also, In re Stovall [1977-80 Transfer Binder] (CCH) ¶ 20,941 at 23,779. Only 2% to 3% of the purchasers of the Paragon contract took delivery of the precious metals. The Paragon contract was undertaken primarily to assume the risk of price changes in

[11/] Specifically, Dr. Kuhn found that the "offset" element of a futures contract was fulfilled by paragraph IV(B) of the Paragon contract which provided that, in lieu of taking delivery, a customer could satisfy his obligation under the contract by requiring Paragon to repurchase the contract at any time prior to the delivery date (C.R. 158, A.R.T. at 46).

> the underlying metal, and not to make or take delivery of the precious metals. The Paragon contract contains standardized terms. The contract offered and sold by defendants meets the Ninth Circuit's definition of a futures contract as set forth in Commodity Futures Trading Commission v. CoPetro Marketing Group, Inc., 680 F.2d 573 (9th Cir. 1982).

(C.R. 91 at p. 10). Moreover, because it was not traded on a Commission-designated contract market, the court concluded that Paragon's contract was an off-exchange futures contract offered and sold in violation of section 4(a) of the Act. Id.

The district court also rejected appellants' defense that Paragon's contract was a "short-term leverage contract" beyond the Commission's regulatory jurisdiction. The court found that Paragon's contract did not meet the Commission's definition of a "leverage contract" in 17 C.F.R. § 31.4(w) because the Paragon contract was for a duration of less than ten years, and did not provide for periodic payments by the customer or accrual by Paragon of a variable carrying charge or fee on the unpaid balance of the contract. Recognizing that Congress mandated CFTC regulation of leverage, and that the Commission was charged with the responsibility to define leverage, the court ruled that "[c]ontracts which do not meet the Commission's definition of leverage contracts as set forth in 17 C.F.R. § 31.4(w) are not leverage contracts." (C.R. 91, at pp. 13-14.) Concomitantly, the court recognized the Commission's clear authority to take enforcement action under the Act against off-exchange commodity futures transactions "masquerading as 'leverage' contracts." (C.R. 91, at p.14.) Accordingly, the district court concluded that "[t]here is no basis in fact or law for defendants' defense that they are offering and selling a 'short term leverage contract' which is unregulated by the Commission." Id.

The district court then turned to the issue of remedy. In this regard, it found that Paragon's and Brandon's business operation was "carefully organized, large-scale, long-term, and systematically carried out." (C.R. 91 at p.11.) Finding a likelihood of future violations, the district court permanently enjoined Paragon and Brandon from violating section 4(a) of the Act, and appointed a permanent equity receiver to administer Paragon's estate. (C.R. 92.)

### 2. The Trial and Decision On Counts II And III Of The Complaint

As noted, Counts II and III of the Commission's complaint, alleging fraud and deception, were the focus of a separate bench trial held on November 14, 17 and 19, 1986.

At these hearings, the Commission presented the testimony of seven individuals who had purchased Paragon contracts. Some of the witnesses testified that they were told by Paragon salesmen that when customers purchased a Paragon contract, Paragon immediately acquired or held the precious metals in storage. (C.R. 209, November 1986 Reporter's Transcript ["N.R.T."] at pp. 46, 124-26). Another witness, Lloyd Franklin Wilson, testified that he was told by a Paragon salesman that, upon executing customer orders for the Paragon contract, Paragon would acquire "COMEX" silver on his behalf.[12/] (C.R. 209, N.R.T. at pp. 165-166.) Another former Paragon customer, Loring Chapman, testified that a Paragon salesman represented that Paragon would keep

[12/] "COMEX" is an acronym for the Commodity Exchange, Inc., a Commission-designated contract market for gold, silver and other precious metals located in New York.

his funds segregated from Paragon's general funds bank account. (C.R. 209, N.R.T. at 180.)

The Commission also presented the testimony of James Andreozzi, a CFTC supervisory futures trading investigator, an expert in the customary business practices of precious metals dealers and, in particular, the extent to which those companies "covered" (i.e. hedged) their exposure to price risk by taking positions in the futures markets. (C.R. 209, N.R.T. at 217-18.) Andreozzi explained that precious metals merchandisers who have committed to deliver metals to customers would be subject to disproportionate risk of adverse price changes in the metals unless they covered their obligations by acquiring the physical commodity or by taking equivalent positions in the futures markets. See id. at 214-15. Andreozzi further testified that precious metals dealers, processors, and merchandisers, like Paragon, normally covered at least 90% of their metals commitments to customers. Id. at 219.

The parties agreed, however, that Paragon held no metals in storage for purposes of cover. Id. at 246. Moreover, based on his examination of Paragon's records, Andreozzi testified that to the extent Paragon ever covered its obligations to customers, it did so by means of exchange-traded futures contracts executed through Commission-licensed brokerage firms. Id. at 247-257. Andreozzi's analysis showed that the most cover Paragon had ever achieved was 27.08%, and that, on at least two days, Paragon had absolutely no cover. Id. at 257. And on some occasions, Andreozzi found, Paragon was actually taking positions in the futures markets opposite to its customer positions. Id. at 265. By not adequately covering its commitments to customers, Andreozzi concluded that Paragon was betting against its customers that the price of metals would not rise, id. at 262, and that Paragon was paying off some customers with monies received from other customers. Id. at 294.

Finally, the Commission presented the expert testimony of Bob H. Agnew, a CFTC supervisory auditor, on the subject of accounting methods and practices of futures professionals. Agnew testified that, after October 1985, Paragon failed to maintain a general ledger to keep track of revenues and expenses. Id. at 305. Moreover, based on his examination of Paragon's records, Agnew determined that Paragon failed to segregate customer funds from the general funds of the firm. Id. at 328-29. Agnew also testified that Paragon commingled customer funds with Brandon's personal funds, id. at 330, and that Brandon had received disbursements from Paragon in excess of $600,000 between January 1985 and October 1986. Id. at 312-13.

Based on all the evidence presented, the district court found that Paragon and Brandon failed to cover customer obligations adequately. (C.R. 189, at p.3) Specifically, the district court found that:

> Brandon conducted Paragon's cover program. Brandon did not cover customer obligations in an appropriate manner. In some metals and currencies Brandon purchased no cover. Brandon covered silver, the principle [sic] metal sold to Paragon customers, at most 27% during 1986. In the case of the British pounds, Brandon actually took positions opposite to those of his customers.

(C.R. 189 at p.3.) The lower court further found that Paragon and Brandon cheated or defrauded, and willfully deceived, the public by misrepresenting that customers were purchasing precious metals, that customer monies would be segregated from company funds, and that Paragon had the financial ability to meet customer obligations. Id. at p.4. Finally, the court found that Paragon and Brandon defrauded the public by failing to disclose material facts. These material facts included:

> 1) that the defendants did not purchase sufficient metals on behalf of customers and did not sufficiently cover customers' purchases through purchases of futures contracts;
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> 2) that defendants did not, for most of the time, segregate customer funds from their own funds;
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> 3) that defendants did not keep adequate books and records; and
>
> 4) that defendants did not have the financial ability to meet their customer obligations, and Brandon misappropriated customer funds for his personal use at a time when Paragon was unable to meet its customer obligations.

Id. at 4-5.

Finding a likelihood of future violations, the district court permanently enjoined Paragon and Brandon from making or engaging in fraudulent misrepresentations and willful deceptions. (C.R. 188.) In addition, after allowing Brandon to keep $96,720 as a reasonable salary for managing the firm from January 1985 through June 1986, the court ordered Brandon to disgorge the sum of $496,495.39 to the trustee in bankruptcy for Paragon's estate. Id.[13/]

## SUMMARY OF ARGUMENT

The district court properly exercised its equitable powers to enjoin Paragon and Brandon from continuing to sell illegal off-exchange futures contracts, and from continuing to engage in fraud and deception. Concerning Count I of the complaint, the district court correctly determined that Paragon and Brandon unlawfully offered and sold contracts of sale of a commodity for future delivery in violation of section 4(a) of the Commodity Exchange Act.

[13/] On August 4, 1986, Brandon filed a voluntary petition to place Paragon in bankruptcy under Chapter 11 of the United States Bankruptcy Code. The Chapter 11 trustee is the same individual who already served as the permanent equity receiver.

The record established that the Paragon contract had all the essential elements of a futures contract: price set at initiation; deferred delivery; and the opportunity for offset. It also had standardized terms and conditions and margin requirements. Like the contracts found to be "futures contracts" in the seminal case of CFTC v. CoPetro Marketing Group, 680 F.2d 573 (9th Cir. 1982), the Paragon contract was offered as an opportunity to speculate and profit from fluctuations in the market value of a commodity, without any expectation of taking delivery.

The lower court also properly rejected the defense that the Paragon contract was a "leverage" contract. As will be explained, the Commission possesses exclusive regulatory jurisdiction over a "leverage contract," including the authority to define the elements of such a contract. Since the Commission has defined "leverage contract" to be a standardized contract for the long-term (ten years or longer) purchases or sales by a customer of a commodity which meets other specifications, see 17 C.F.R. § 31.4(w) (1987), the district court was unquestionably correct in concluding that future delivery-type commodity contracts that do not meet the durational requirements (ten-years or longer) of 17 C.F.R. § 31.4(w) are not leverage contracts. The Commission remains empowered to take enforcement action against any such contracts "masquerading" as leverage contracts by having them declared "off-exchange futures contracts" prohibited by section 4(a) of the Act.

With respect to Counts II and III of the complaint, the district court correctly determined that section 4b of the Act proscribed Paragon's and Brandon's fraudulent and deceptive activities even though the Paragon contract itself was not executed on any Commission-designated contract market. Although appellants claim that former section 4b of the Act (in effect when the complaint was brought) was not broad enough to reach off-exchange futures contracts, it is clear from the legislative history of the 1986 amendments to that provision that Congress understood that former section 4b applied to fraud in connection with such off-exchange futures.

As will further be shown, Paragon and Brandon violated former section 4b even under the terms of their own narrow construction. Appellants represented that Paragon would most likely cover its commitments to customers through purchases of futures contracts, in lieu of purchasing the metals outright. By failing either to cover those positions through the acquisition of futures contracts, or to disclose that Paragon would not cover those commitments by taking an adequate number of positions in the futures markets, Paragon and Brandon committed fraud "in connection with" orders to be made on or subject to the rules of any contract market on behalf of others. This was a violation of section 4b(A) and 4b(C) of the Act, 7 U.S.C. § 6b(A) and 6b(C)(1982). In any case, assuming arguendo that "former" section 4b did not reach appellants' fraudulent activities, "current" section 4b should be applied in this case. Thus, under any reading of section 4b, the district court's determination should stand.

Finally, the district court acted well within its discretion in ordering Brandon to disgorge $496,495.39 to Paragon's trustee in bankruptcy. Because Brandon was allowed to retain $96,720 as a reasonable salary for managing Paragon, the disgorgement order cannot be characterized as punitive. In addition, the lower court's grant of authority to Paragon's bankruptcy trustee to enforce the disgorgement order as a judgment creditor was a reasonable exercise of its equitable powers to provide complete relief in light of the customer protection purposes of the Act.

## ARGUMENT

### I. THE DISTRICT COURT CORRECTLY DETERMINED THAT THE APPELLANTS UNLAWFULLY OFFERED AND SOLD CONTRACTS OF SALE OF A COMMODITY FOR FUTURE DELIVERY SUBJECT TO REGULATION UNDER THE COMMODITY EXCHANGE ACT.

### A. The District Court Correctly Concluded That The Paragon Contract Was An Off-Exchange Futures Contract.

The district court determined that the Paragon contract was a contract of sale of a commodity for future delivery, and that Paragon's and Brandon's off-exchange offer and sale of that instrument violated section 4(a) of the Act. This determination was correctly based on the reasoning of this Court's decision in CFTC v. CoPetro Marketing Group, 680 F.2d 573 (9th Cir. 1982) ("CoPetro"), and should be affirmed.

CoPetro addressed whether a contract for deferred delivery of gasoline that enabled purchasers to speculate in the fluctuating market price, without any expectation of taking delivery, was a futures contract. The Court in CoPetro initially observed that

> in determining whether a particular contract is a contract of sale of a commodity for future delivery over which the Commission has regulatory jurisdiction by virtue of 7 U.S.C. § 2 (1976), no bright-line definition or list of characterizing elements is determinative. The transaction must be viewed as a whole with a critical eye toward its underlying purpose.

680 F.2d at 581. Upon analysis, the Court determined that the CoPetro contracts were futures because they possessed many of the same characteristics of lawful exchange-traded contracts: they were promoted and used as a vehicle for speculation, they had relatively standardized contract terms, and they provided the opportunity for offset. Moreover, the fact that CoPetro unilaterally set the contract prices did not dissuade the Court from its holding that

CoPetro's contracts were futures. As the Court stated, "the fact that public auction did not determine CoPetro's prices is merely a result of CoPetro's failure to seek Commission licensing for organized exchange trading in petroleum futures." Id.[14/]

Based on the stipulated facts and Paragon's promotional and contractual materials, there is ample support for the district court's findings that Paragon marketed and sold off-exchange futures contracts in violation of the Act. As the district court correctly determined on the basis of expert testimony, the Paragon contract had all of the essential characteristics of a futures contract: price set at initiation; deferred delivery; and the opportunity for offset. (C.R. 158, A.R.T. at pp. 34-48.) It had also had

[14/] Appellants argue (App. Br. 13) that the Paragon contract was, like most leverage transactions, a principal-to-principal transaction, and not a broker-to-broker transaction as are most exchange-traded futures contracts. But, in her testimony in this case, Dr. Kuhn established that it was immaterial whether the Paragon contract was a principal-to-principal transaction or a broker-to-broker transaction. As she explained, there is no economic distinction between a "principal" transaction, traded off an exchange, and a "broker" transaction executed on an exchange. Id. at 211. In her view, trading on an exchange is what makes a futures contract legal, not what makes it a futures contract. (C.R. 158, A.R.T. at p. 181.) See also In re Stovall, [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,941 at p. 23,779 (Dec. 6, 1979) ("Stovall").

In an attempt to show that the Paragon contract was a leverage contract, notwithstanding its failure to meet the minimum ten-year durational requirement of 17 C.F.R. § 31.4(w), appellants (App. Br. 17) cite Dr. Kuhn's testimony that there were no economic differences between the Paragon contract and leverage transactions regulated by the Commission. In fact, however, Dr. Kuhn testified that there is no economic distinction between leverage contracts and futures contracts. In other words, leverage contracts are, economically speaking, futures contracts that become legally distinguishable from off-exchange futures contracts if and only if they have a duration of ten years or longer and otherwise meet the definition of leverage in Commission regulation 31.4(w), 17 C.F.R. § 31.4(w) (1984). (See C.R. 158, A.R.T. at pp. 67-68, 216.)

standardized terms and conditions and margin requirements. Id. at 63-64. As in the case of the gasoline futures contracts sold in CoPetro, "the contracts here represent speculative ventures in commodity futures which were marketed to those for whom delivery was not an expectation." 680 F.2d at 581. Accordingly, this Court should affirm the district court's determination that Paragon and Brandon violated section 4(a) of the Act through off-exchange sales of futures contracts.

Appellants attempt to challenge the lower court's conclusion that the Paragon contract was a futures contract by claiming that the Paragon contract was not suitable for hedging--i.e., risk shifting by commercial dealers, processors, and other handlers of the commodity. (App. Br. at 15-16.) The suggestion that the Paragon contract could not be used for hedging is flatly contradicted by the record evidence. Although Dr. Kuhn observed that the standardized quantity terms of Paragon's contract are probably too small to attract much interest by large commercial firms interested in hedging, she explained that the Paragon contract could nevertheless be used for hedging. (C.R. 158, A.R.T. 32-33, 210.) Moreover, Dr. Teweles, appellants' own expert witness, testified that even leverage contracts could be used for hedging. Id. at 243.

In any event, there is no legal basis for appellants' claim that there is a requirement that a contract be used significantly by hedgers before it may qualify as a futures contract.[15] In CoPetro, this Court found that the

[15] Demonstrating that a contract may be used for hedging is one of the two alternative methods for satisfying the "economic purpose" test, which is a legal prerequisite for obtaining contract market designation. See Commodity
(Footnote Continued)

contracts at issue there were off-exchange futures contracts where they were used almost exclusively by speculators, without finding that the contracts were suitable for hedging.[16] Thus, on this separate basis, appellants' "hedging" argument must be rejected.

B. The Legislative History And Commiss on's Leverage Regulations Support The District Court's Conclu ion That The Paragon Contract Was Not A Leverage Contrac .

As stated above, the lower court rejected appellants' "leverage" defense to the charge of offering and selling unlawful off-exchange futures contracts. Notwithstanding Paragon's and Brandon's claim that they were marketing a "short-term leverage contract" assertedly beyond the Commission's regulatory jurisdiction, the court found that the Paragon contract was not a leverage contract because it did not meet the definitional requirements of CFTC regulation 31.4(w), 17 C.F.R. § 31.4(w). Specifically, it found that the Paragon contract did not meet the definition of "leverage contract" because, *inter alia*, it was for a duration of less than ten years. Recognizing that Congress required the Commission to regulate leverage transactions, and delegated to the Commission the responsibility for defining leverage, the court concluded that "[t]here is no basis in fact or law for defendants' defense that they are

(Footnote Continued)
Futures Trading Commission Guideline No. 1, Comm. Fut. L. Rep. (CCH) ¶ 6045 at p. 6070. Thus, a finding that a futures contract may be used for hedging, as a prerequisite for contract market designation, is what qualifies the futures contract for *legal* status, not what makes it a futures contract.

[16] *See also Stovall*, *supra*, where the Commission concluded that off-exchange futures violations had occurred without any express or implied finding that the contracts at issue could be used for hedging. [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,941.

offering and selling a 'short-term leverage contract' which is unregulated by the Commission." (C.R. 91, at p.14.)

Appellants nonetheless maintain that the Paragon contract cannot be a futures contract because it is a leverage contract. Specifically, they take issue with the district court's conclusion (C.R. 91, at 14) that "[c]ontracts which do not meet the Commission's definition of leverage contracts as set forth in 17 C.F.R. § 31.4(w) are not leverage contracts." This conclusion is asserted to be inconsistent with the CFTC's own official explanation of its leverage regulations, as well as the legislative intent. (App. Br. 16.) As a corollary, appellants contend that the Commission regulates only those leverage contracts with durations of ten or more years, and has left it to the states to regulate less than ten-year leverage contracts. (App. Br. 17.)

These assertions are at odds with express language of the Commodity Exchange Act, its legislative history, the Commission's regulations, and agency statements interpreting those regulations. As will be demonstrated, since the Commission defined "leverage contract" in 1984 as an instrument of a duration of ten years or more, there is no such thing in law as a "leverage" contract that is less than ten years. Rather, all future delivery-type commodity instruments that have the same elements as the Paragon contract and are less than ten years in duration are futures contracts.

### 1. Legislative Enactments Affecting Leverage Regulation From 1974 Through 1982.

Leverage-type contracts were first developed in the late 1960s and early 1970s as a means for permitting individuals to make long-term "installment" purchases of gold or silver coins and bullion from coin dealers. The customer initially paid a percentage of the purchase price, was charged for interest, commissions and other "carrying charges" on a periodic basis and was subject to margin calls if the price of the commodity declined in the commercial markets.[17/] Leverage contracts were promoted as a hedge against inflation for the individual customers who found futures markets unsuitable, purportedly because of the larger quantities traded, and the high volatility and the short-term nature of futures contracts.[18/]

The 1974 amendments to the Commodity Exchange Act vested the CFTC with exclusive jurisdiction over leverage transactions in gold and silver bullion and bulk coins. Section 2(a)(1) of the Act and 217 of the CFTC Act, 7 U.S.C. §§ 2, 15a (1976). In granting this jurisdiction to the Commission, Congress did not define the term "leverage contract," but instead, provided a general description of leverage as "a standardized contract commonly known to the trade as a margin account, margin contract, leverage account, or leverage contract." Section 217 of the CFTC Act, 7 U.S.C. § 15a (1976). In addition to granting the Commission general regulatory authority over leverage, section 217 also provided that if the Commission determined that any leverage transaction constituted a contract for future delivery, such transactions should be regulated as futures contracts. Id.

[17/] See Hearings on S. 2485, S. 2837 and H.R. 13113 Be ore the Senate Comm. on Agriculture, Nutrition, and Forestry, 93rd Cong. 2d Sess., pt. 3, at 748 (1974) (statement of M. Martin Rom, Chairman, International Precious Metals Corporation).

[18/] Hearings on S. 2391 Before Subcomm. on Agricultura Research and General Legislation of the Senate Comm. on Agriculture, Nutrition, and Forestry, 95th Cong., 2d Sess. 625 (1978) (statement of International Precious Metals Corporation); Hearings on H.R. 10285 Before the Subcomm. on Conservation and Credit of the House Comm. on Agriculture, 95th Cong., 2d Sess. 719 (1978) (statement of the International Precious Metals Corporation).

In 1978, Congress replaced section 217 of the CFTC Act with a new section 19 of the Act, 7 U.S.C. § 23.[19] Section 19 extended the Commission's exclusive jurisdiction and comprehensive regulatory authority over gold and silver leverage transactions to those involving all other commodities (except those agricultural commodities regulated prior to 1974, for which leverage transactions were prohibited). In the 1978 legislation, Congress left the term "leverage contract" undefined, and expanded the CFTC's exclusive regulatory authority to include any contract that the Commission determines "serves the same function," or is "marketed or managed in the same manner" as a leverage contract. The 1978 legislation also preserved the Commission's authority to regulate as futures any leverage transactions it determined to be futures. Section 19(d) of the Act, 7 U.S.C. § 23(d).

### 2. The Commission's Activities In Leverage Regulation From 1975 Through 1982.

In the meantime, from 1975 through 1979, the Commission studied the offer and sale of leverage contracts in the United States.[20] The studies revealed that leverage customers were inadequately protected, primarily due to the fact that many of the advantages of futures contracts traded on Commission-

[19] The Futures Trading Act of 1978, Pub. L. No. 95-405, § 23, 92 Stat. 865, 876-77 (1978).

[20] The Commission commenced operations as a fully independent regulatory agency on April 21, 1975. In February 1976, the Commission adopted a rule prohibiting fraud in connection with the offer and sale of gold and silver leverage contracts. *See* 41 Fed. Reg. 3191 (1976) (originally codified at 17 C.F.R. § 30.01 (1976)).

designated exchanges were not present in the sale of leverage contracts. In addition, it found that leverage transactions required a substantial initial investment by the customer, a large percentage of which went immediately to the leverage merchant in the form of commissions, mark-ups, and other fees. Moreover, because of a lack of public understanding concerning leverage transactions, the broad discretion held by the merchants in setting prices and all other contract terms, and the widely advertised promise by the leverage merchants of large potential profits to be gained by customers, the Commission determined that the marketing of leverage transactions was highly susceptible to overreaching and fraudulent activities.[21]

[21] See, e.g., 44 Fed. Reg. 6737, 6739 (1979) (customer complaints and preliminary investigations indicated a likelihood that "cold-canvas telephone calls and misrepresentations were being employed to sell leverage contracts"); 44 Fed. Reg. 55820, 55822 (1979) (preliminary Commission investigations had indicated likelihood that "high pressure 'boiler-room' sales techniques were being employed"). See also 43 Fed. Reg. 23729, 23730 (1978).

Furthermore, the Commission found that the offer and sale of leverage transactions in the U.S. was fraught with unsound, if not fraudulent practices. At least eleven firms purporting to engage in the marketing of leverage contracts had experienced financial failure from 1973 to 1977, involving a total loss in excess of $17.5 million to at least 3,500 customers. Commission Advisory to the Media, released April 27, 1978, at 2. Many of these firms' customers had made allegations of fraud. During 1979 and 1980, three additional firms claiming to market leverage contracts went bankrupt or experienced serious financial difficulty. In these instances, there were allegations of fraud, undercapitalization, or failure to segregate customers funds or to cover obligations. See, e.g., CFTC v. Trending Cycles for Commodities, Inc., [1980-1982 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,013 (S.D. Fla. 1980); CFTC v. Premex, Inc., C.A. 78-C-115 (N.D. Ill. 1978); Minnesota v. Federal Gold and Silver, Inc., [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,919 (Sept. 20, 1979). The Commission also found that as similar firms expanded their businesses into the sale of not only gold and silver but also of other commodities, fraud and abusive practices continued to spread in the marketing of these additional commodities. 44 Fed. Reg. 6737, 6739 (1979).

On the strength of this information, the Commission proposed temporary moratorium rules to protect the public until the Commission could resolve the issue of the appropriate approach to take in regulating this field. 43 Fed. Reg. 23729 (1978); 44 Fed. Reg. 6737 (1979). After receipt and analysis of public comments, the Commission adopted rules imposing temporary moratoria on the entry of new firms into the business of marketing leverage contracts involving gold, silver and any other commodities. See 17 C.F.R. §§ 31.01, 31.02 (1979) (currently, 17 C.F.R. §§ 31.1, 31.2 (1987)).

In September 1978, the Commission's Office of General Counsel prepared a memorandum for the Commission (published at 44 Fed. Reg. 13498 (1979)) which concluded that the form of leverage transactions then being offered to the public were in fact futures contracts and, accordingly, were required to be effected through the facilities of a designated contract market in accordance with the predecessor of what is now Section 4(a) of the Act, 7 U.S.C. § 6(a) (1982).[22] On the basis of this memorandum, the Commission initiated a rulemaking proceeding to solicit comments on the appropriate approach to the regulation of leverage transactions. 44 Fed. Reg. 13494 (1979). After analysis of the comments, the Commission announced a proposal to determine, effective January 1, 1980, that leverage transactions for the delivery of gold and silver bullion or bulk coins "of the type presently being offered to the public" were futures contracts. 44 Fed. Reg. 44177 (1979).

On November 20, 1979, the Commission postponed until June 30, 1980 the effective date of its determination to treat these leverage contracts as

[22] See 7 U.S.C. §§ 6, 6h (1976).

futures contracts. 44 Fed. Reg. 69304 (1979). Thereafter, on May 28, 1980, the Commission again extended the effective date until October 1, 1982, in order to allow Congress an opportunity to enact legislation regarding the appropriate regulatory framework for leverage transactions. Comm. Fut. L. Rep. (CCH) Newsletter No. 125, p. 1 (June 4, 1980).

### 3. Legislative And Regulatory Developments Affecting Leverage From 1982 Through the Present.

In 1982, Congress amended section 19 of the Act. These amendments continued the ban on agricultural leverage transactions but also required the Commission to regulate leverage involving all other commodities as an entirely separate class of transactions, as distinct from futures.[23] Congress again did not provide a statutory definition of leverage. Rather, the House and Senate conferees explicitly stated that nothing in the 1982 legislation "affect[s] in any way the Commission's authority under existing law to define the terms . . . leverage contract, leverage transaction, or leverage . . . ."[24]

In enacting the 1982 amendment to section 19, Congress specifically rejected a bill that would have granted the states registration authority over leverage merchants as well as the authority to proceed against leverage

[23] The Futures Trading Act of 1982, Pub. L. No. 97-444, § 234, 96 Stat. 2294, 2322 (1982), reprinted in 1982 U.S. Code Cong. & Ad. News [96 Stat.] 2322.

[24] H.R. Conf. Rep. No. 964, 97th Cong., 2d Sess. 51 (1982) ("1982 Conference Report"), reprinted in 1982 U.S. Code Cong. & Ad. News 4055, 4068-69.

sellers on the basis of state securities or commodities antifraud statutes.[25/] Instead, it reaffirmed the Commission's exclusive jurisdiction over leverage contracts, including any contract that serves the same function or is marketed in substantially the same manner as a leverage contract. And, although Congress repealed the Commission's authority to regulate leverage transactions as futures contracts, the House and Senate conferees stated explicitly that the repeal "is in no way to be construed as limiting or circumscribing the Commission's authority to take appropriate action under any provision of the Commodity Exchange Act against transactions masquerading as leverage contracts."[26/]

At the same time that Congress preserved the Commission's exclusive regulatory jurisdiction over leverage transactions and rejected proposals that would have granted states any regulatory authority over leverage, Congress also enacted a new section 12(e) of the Act to declare "open season" on illegal, off-exchange commodity enterprises. 7 U.S.C. § 16(e). There, Congress specifically provided that other federal and state officials were free to take appropriate action under their own laws "against persons selling certain off-exchange commodity investments and against persons engaged in activities

[25/] See S. Rep. No. 384, 97th Cong. 2d Sess. 51-53 (1982) ("1982 Senate Report"). There, the Senate Committee on Agriculture, Nutrition, and Forestry stated: "The Committee did not adopt S. 2210 and NASAA [North American Securities Administrators Association] proposals for the same reasons Congress placed exclusive jurisdiction over leverage transactions under the Commission in 1974. In order to avoid regulatory inconsistencies and unnecessary duplication of both governmental and industry effort, the Committee intends for the current exclusive jurisdiction of the Commission over leverage transactions to continue."

[26/] 1982 Conference Report at 51.

requiring registration or designation by the Commission who have not been so registered or designated."[27] Thus, section 12(e) made it possible for both the Commission pursuant to section 4(a) of the Act and state authorities under their own laws to proceed against the same violator for the unlawful offer and sale of off-exchange futures contracts.[28]

With the 1982 legislative changes in mind, the Commission in June 1983 initiated a comprehensive rulemaking to regulate offer and sale of leverage contracts. 48 Fed. Reg. 28668 (1983) (notice of availability of proposed rules). The Commission proposed to define the term "leverage contract" as:

> a standardized contract for the long-term (ten years or longer) purchase by a customer of a commodity which provided for (1) the initial and maintenance payments of a percentage of the spot-price value of the commodity, (2) periodic payment of a carrying charge or a fee on the unpaid balance, (3) delivery of a commodity in an amount and form which can be readily resold in normal commercial or retail channels, (4) delivery of the underlying commodity after satisfaction of the balance due on the contract by the customer, (5) repurchase of the contract by the person or firm who sold the contract to the customer upon demand by the customer, and (6) determination of the contract purchase and repurchase price by the person or firm who sold the contract and who acts as a principal in every contract.

Id. at 28668-69. (Proposed Rule 31.4(w).)

After an analysis of the data, comments and recommendations received, the Commission on January 16, 1984 adopted final rules establishing a comprehensive regulatory scheme designed to govern leverage transactions involving gold

[27] 1982 Senate Report at 27-28. Excepted from this state authority were leverage transactions subject to regulation under section 19 of the Act. See 7 U.S.C. § 16(e)(2)(1982).

[28] See id.; H.R. Rep. No. 565 (pt. 1), 97th Cong., 2d Sess. 103-04 (1982), reprinted in 1982 U.S. Code Cong. & Ad. News 3871, 3952.

or silver bullion or bulk coins, copper, platinum, deutsche marks, Japanese yen, Swiss francs and British pounds. 49 Fed. Reg. 5498 (1984). In the final rules, the Commission adopted the definition of "leverage contract" exactly as proposed.[29] In doing so, the Commission stated that:

> [t]hrough its definition in these interim final rules of a leverage contract, the Commission is exercising its exclusive regulatory jurisdiction over transactions that fall within the scope of Section 19 of the Act. In adopting that definition, the Commission has exercised its authority to specify the standardized contracts that Congress expected to be regulated under Section 19 of the Act. H. Rep. No. 964, 97th Cong. 2d Sess. 51 (1982). . . . In contrast, those transactions that do not meet the Commission's definition of a leverage contract are not within the Commission's regulatory jurisdiction under Section 19 of the Act and are not subject to Commission registration and regulation pursuant to Part 31. This "bright line" distinction between transactions subject to exclusive Commission jurisdiction under Section 19 and those not subject to Commission regulation thereunder is one of the salutary effects of the comprehensive definition adopted by the Commission. Those transactions not subject to exclusive Commission jurisdiction under Section 19 are open to regulation and enforcement by the states. See Section 12(e)(2)(C) of the Act.

49 Fed. Reg. 5498-99 (1984).

Any remaining doubt about the legal status of less than ten-year instruments (including those that might otherwise fit the Commission's definition of leverage contract) would have been dispelled by a March 1985 interpretive statement published by the Commission's Office of General Counsel:

[29] On February 1, 1985, the Commission amended the definition of "leverage contract" in regulation 31.4(w), which had theretofore been limited to standardized, long-term (ten-year or longer) purchases of a commodity, to include standardized long-term (ten-year or longer) sales of a commodity. See 50 Fed. Reg. 22 (1985). Because the Paragon contract was not a standardized ten-year (or longer) contract to sell a commodity, this February 1985 amendment to the definition of leverage contract has no bearing on any of the issues in this appeal.

> Various instruments which call for the future delivery of commodities and which do not meet the definition of a "leverage contract" as contained in the Commission's interim final leverage regulations, are commodity futures contracts. As such, the off-exchange offer or sale of these instruments is unlawful under section 4(a) of the Commodity Exchange Act, as amended ("Act"), 7 U.S.C. § 6(a) (1982), and may also properly be prohibited under the laws enacted by the states.

50 Fed. Reg. 11656 (1985).

In late 1986, more than two years after the Commission defined the term "leverage contract," Congress reviewed the Commission's regulation of leverage and again revised section 19 of the Act. At that time, Congress banned leverage transactions in all commodities except gold and silver bullion and bulk coins, and platinum.[30/] The 1986 revisions to section 19 also required the Commission, after a study and report to Congress, to, in effect, lift the existing moratoria and thus to permit the entry of new firms into the leverage business. Significantly, in the legislative history of these revisions, Congress expressed no dissatisfaction with the Commission's definition of leverage contract as a ten-year or longer instrument in 17 C.F.R. § 31.4(w), and left that definition undisturbed.[31/]

[30/] The Futures Trading Act of 1986, Pub. L. No. 99-641, § 109, 100 Stat. 3556, 3560-61 (1986), reprinted in 1986 U.S. Code Cong. & Ad. News [100 Stat. 3560-61].

[31/] See H.R. Rep. No. 624, 99th Cong., 2d Sess. 36-37 (1986) reprinted in 1986 U.S. Code Cong. & Ad. News 6005, 6037-38 ("currently leverage trading by the two registered firms takes place under a set of Federal regulations that are as strong, if not stronger, than futures regulations"); S. Rep. No. 291, 99th Cong., 2d Sess. 7-8, 17, 25-26 (1986).

4. The Foregoing Legislative And Regulatory Developments Dispose Of Appellants' Claims That The Paragon Contract Was Leverage And Beyond The Commission's Regulatory Jurisdiction.

It is clear from the above legislative and regulatory history that the definition of the term "leverage contract" as used in original section 217 of the CFTC Act, and later amended twice in section 19 of the Act, had never been precisely fixed until 1984, when the Commission adopted the definition of "leverage contract" as a ten-year (or longer) standardized deferred delivery instrument. Equally clear, Congress never retreated from its position, initially taken in 1974, that the CFTC was to have exclusive regulatory jurisdiction over all leverage transactions that could lawfully be sold off exchanges. This is underscored by Congress' rejection of a bill, discussed above, that would have granted the states regulatory authority over leverage merchants.[32]

This history completely disposes of appellants' assertion that the Paragon contract could be considered a "leverage contract" notwithstanding its failure to meet the Commission's definition (which, as explained above, requires a duration of at least ten years).[33] As for transactions not meeting the prescribed duration, transactions "masquerading as leverage contracts," and other similar off-exchange instruments, the foregoing discussion shows that Congress intended that both the Commission and the states would take enforcement action against them.[34] 7 U.S.C. § 16(e) (1982). Accordingly, this Court should affirm the district court's conclusion that contracts, like the

[32] See 1982 Senate Report at 51-52.

[33] Appellants do not assert that the Paragon contract meets the definition of "leverage contract" in 17 C.F.R. § 31.4(w) (1984).

[34] See 1982 Senate Report at 27-28.

Paragon contract, which do not meet the Commission's definition of "leverage contracts" in 17 C.F.R. § 31.4(w) are not leverage contracts.

## II. THE DISTRICT COURT CORRECTLY DETERMINED THAT APPELLANTS' FRAUDULENT CONDUCT VIOLATED SECTION 4b OF THE COMMODITY EXCHANGE ACT.

The district court found that Paragon and Brandon violated section 4b of the Act by defrauding and willfully deceiving customers. Appellants do not challenge the evidentiary bases for any of these findings of fraud and deception. Rather, their sole argument is that they cannot be held liable under section 4b of the Act because, at the time of their challenged activities, section 4b on its face, appellants assert, only applied to fraud connected with transactions executed on Commission-designated contract markets. Thus, the argument runs, because the Paragon contract was not executed on any contract market, section 4b could not reach appellants' activities.

This attack on the lower court's assertion of jurisdiction is without substance. As discussed _infra_, the legislative history of subsequent amendments to section 4b makes clear that Congress understood that former section 4b had correctly been applied by the courts to reach off-exchange futures transactions. Moreover, former section 4b in any case reached the transactions at issue here because appellants' failure to disclose that Paragon would not adequately cover its commitments through the acquisition of futures contracts after representing that they would do so was fraud "in connection with" orders for futures contracts "to be made" on or subject to the rules of a contract market for or on behalf of Paragon's customers. Finally, even if it is assumed _arguendo_ that former section 4b did not reach appellants' activities, the 1986 amendments to section 4b should be applied retroactively in accordance with the Supreme Court's decision in Bradley v. School Board of Richmond, 416 U.S. 696, 716 (1974).

### A. Former Section 4b Of The Act Governed Fraud In Connection With The Sale Of Off-Exchange Futures Contracts.

At the time the complaint was filed, section 4b of the Act provided, in pertinent part, as follows:

> It shall be unlawful . . . for any person, in or in connection with any order to make, or the making of, any contract of sale of any commodity for future delivery, made, or to be made, on or subject to the rules of any contract market, for or on behalf of any other person . . .
>
> (A) to cheat or defraud or attempt to cheat or defraud such other person; . . .
>
> (C) willfully to deceive or attempt to deceive such other person by any means whatsoever . . . .

7 U.S.C. § 6b (1982) (emphasis added). On November 10, 1986, after the complaint in this proceeding was filed, Congress amended section 4b to delete the language "on or subject to the rules of any contract market" to clarify that section 4b, among other things, was intended to govern fraud in connection with the sale of off-exchange futures contracts.[35]

[35] Although this Court has construed the same words, "on or subject to the rules of any contract market," restrictively in determining whether a company marketing off-exchange futures contracts was a "commodity broker" and, on that basis, could be forced to liquidate in bankruptcy, see In re CoPetro Marketing Group, 680 F.2d 562 (9th Cir. 1982) ("CoPetro Bankruptcy"), that case should not govern a construction of section 4b in the entirely different context of fraud liability. In CoPetro Bankruptcy, this Court construed the scope of the term "commodity broker" as used in 11 U.S.C. § 101(5), defined as a "futures commission merchant." "Futures commission merchant," in turn, was defined by section 2(a)(1)(A) of the Commodity Exchange Act, 7 U.S.C. § 2, as
(Footnote Continued)

Appellants would have this Court read the words in former section 4b, "on or subject to the rules of any contract market," as limiting its scope to fraud involving exchange-traded futures contracts. Congress has expressly disavowed such a narrow construction. Where, as here, there has been an amendment intended to clarify the language of a statute, it is appropriate to look to the legislative history of the clarifying amendment to determine the meaning of the statute before clarification. E.g., CFTC v. Savage, 611 F.2d 270, 282 (9th Cir. 1979).

In reporting on S. 2045, the Senate version of a bill that was ultimately enacted as the Futures Trading Act of 1986, the Senate Committee On

(Footnote Continued)
a person "engaged in soliciting or in accepting orders for the purchase or sale of any commodity for future delivery on or subject to the rules of any contract market." The CoPetro Bankruptcy Court concluded that CoPetro was not a commodity broker because its off-exchange futures contracts were "not on or subject to the rules of any contract market." 680 F.2d at 569. The Court found that this reading of the words "on or subject to the rules of any contract market" was warranted because the customer protection goals of the Commodity Exchange Act were adequately served by the statutory prohibition against off-exchange futures (formerly, sections 4 and 4h of the Act, now section 4(a)) and because no provision of the Bankruptcy Code would be subverted by holding that CoPetro was not a commodity broker. Id. at 569-70.

The CoPetro Bankruptcy case is clearly distinguishable from this one. Although applying the terms "on or subject to the rules of any contract market" from section 2(a)(1) of the Act literally in that case, the CoPetro Bankruptcy Court carefully explained that "[t]his is not a case where, by virtue of a restrictive reading of the statute, a wrongdoer escapes liability . . . . ." Id. at 570 n.7. A restrictive reading of the language of section 4b here, unlike CoPetro Bankruptcy, would enable Brandon to escape fraud liability, including the lower court's injunction prohibiting him from engaging in fraudulent and deceptive activities. (Paragon did not appeal the district court's January 5, 1987 order enjoining it from further fraudulent and deceptive activities.) As explained infra, such a result would be at odds not only with congressional intent (as evidenced by the legislative history of the 1986 amendments to section 4b), but also with well-settled judicial precedents establishing that section 4b should not be construed restrictively. See also note 38, infra.

Agriculture, Nutrition, and Forestry unequivocally rejected any notion that section 4b had previously been limited in scope to contracts executed on a contract market:

> The Committee bill deletes the phrase "on or subject to the rules of a contract market" from section 4b of the Commodity Exchange Act to make clear that the proscription against fraud and other abusive practices in section 4b applies to the offer or sale of all commodity futures contracts, whether or not the contracts are traded on exchanges designated as contract markets by the Commission. Therefore, the bill ensures that persons may be held liable for fraud under section 4b in connection with the marketing of illegal, off-exchange futures contracts in the United States.
>
> Since Congress has historically confirmed that all futures trading must take place on designated exchanges, it would be anomalous if section 4b were read narrowly, so as not to apply to the sale of unlawful futures contracts. The amendment, however, removes all doubt as to the applicability of section 4b.

S. Rep. No. 291, 99th Cong. 2d Sess. 5 (1986). Similarly, reporting on H.R. 4613, the companion bill to S. 2045, the House Committee on Agriculture explained:

> The Committee bill would make a technical amendment to section 4b of the Commodity Exchange Act . . . . Several courts have entered injunctions against violations of section 4b in cases brought by the Commission involving the off-exchange sale of futures contracts. Nonetheless, the current language of section 4b could be interpreted narrowly to limit its authority to exchange-traded futures, resulting in a court's refusal to apply section 4b to the sale of off-exchange futures contracts. The proposed amendment would simply codify the Commission's interpretation of section 4b and make it consistent with other antifraud provisions of the Act and Commission rules, which are not limited to transactions conducted on a contract market.

H.R. Rep. No. 624, 99th Cong. 2d Sess. 8-9 (1986) (emphasis added). In the face of these pronouncements, it is abundantly clear that Congress understood that former section 4b governed fraud in the sale of off-exchange contracts, that the words "on or subject to the rules of any contract market" were not intended to limit former section 4b's scope to transactions executed on contract markets, and that former section 4b was not to be given a narrow construction.

Apart from these expressions of legislative intent, section 4b must not be given a narrow construction where to do so would frustrate the customer protection purposes of the Act,[36] and allow wrongdoers to escape liability. Compare CFTC v. Savage, 611 F.2d 270 at 281-82 (9th Cir. 1979) with In re CoPetro Marketing Group, 680 F.2d 566, 570 n.7 (9th Cir. 1980). As the Supreme Court has recognized, the Commodity Exchange Act is remedial legislation. Merrill Lynch Pierce Fenner & Smith v. Curran, 456 U.S. 353, 387 n.85 (1982). As such, its antifraud provisions are entitled to a liberal construction. See Lorenz v. Sauer, 807 F.2d 1509, 1511 (9th Cir. 1987). "[T]he language of § 4b must be read 'flexibly, not technically and restrictively,'" Leist v. Simplot, 638 F.2d 283 (2d Cir. 1980), aff'd sub. nom., Merrill Lynch Pierce Fenner & Smith, 456 U.S. 353, 396 (1982); see also Herman & MacLean v. Huddleston, 459 U.S. 375, 386-87 (1986). Accordingly, the district court's determination that section 4b reached all of Paragon's and Brandon's fraudulent activities should be affirmed.

[36] Both the Second Circuit and this Court have recognized that a primary goal of the Commodity Exchange Act is the protection of customers. CFTC v. British American Commodity Options Corp., 788 F.2d 92, 94 (2d Cir. 1986); In re CoPetro Marketing Group, 680 F.2d 566, 570 (9th Cir. 1982).

### B. By Misrepresenting That They Intended To Cover Obligations To Customers Through The Futures Markets, And By Failing To Disclose That They Would Not Sufficiently Cover Those Obligations Through Futures Contracts, Paragon And Brandon Committed Fraud "In Connection With" Transactions Made, Or To Be Made, On Or Subject To The Rules Of Any Contract Market For Or On Behalf Of Any Other Person

Even in the absence of legislative history of the 1986 amendments, appellants' activities would still fall within the reach of former section 4b. Contrary to appellants' assertion, former section 4b's scope was not so narrow as to reach only fraudulent transactions executed on contract markets. Rather, section 4b, by its terms, broadly proscribed all fraud committed in connection with orders and contracts that are made, or to be made, on or subject to the rules of any contract market" for or on behalf of any other person. 7 U.S.C. § 6b (1982). Thus, former section 4b reached any activity that defrauds a commodity investor who is induced to invest on the basis of any material misrepresentation, or nondisclosure of material fact, made in connection with orders for futures contracts that are made, or to be made, on a contract market on his behalf.

In the instant case, the district court determined that the appellants' failure to disclose that they did not sufficiently cover their obligations to customers through trades executed on Commission-designated contract markets was an independent violation of section 4b. (C.R. 189 at p. 4-5.) There is ample support in the record for this determination. Paragon told customers that once they had purchased a Paragon silver contract, Paragon would buy silver on their behalf on the COMEX futures exchange, a Commission-designated contract market. (C.R. 209, N.T.R. at 165.) These representations were consistent with language in Paragon's Risk Disclosure Statement distributed to customers, which stated:

> Precious metals purchased by you for later delivery may not, and in all likelihood will not, be held in the Paragon Investments inventory on the date of purchase or at any time until the agreed date of delivery. Rather, Paragon Investments may acquire precious metals for delivery to you through the purchase of futures contracts and/or options on such futures contracts. (C.R. 79 at Exhibits 1-8.)

The clear import of this language is that Paragon would secure their customer obligations through positions to be acquired in lawful futures contracts traded on Commission-designated contract markets. In other words, prospective customers who read this risk disclosure in deciding whether to invest, and who might otherwise have been alarmed by the likelihood that Paragon would not store the metals they had purchased in inventory, could readily have relied on these assurances that Paragon would alternatively cover its commitments through the futures markets. Under these circumstances, Paragon's failure to disclose that its commitments to customers would not be sufficiently covered, or hedged, through transactions on a contract market was fraud "in connection with" an order made "or to be made" on a contract market "on behalf of" the customers, and, therefore, governed by former section 4b of the Act.[37/]

The case law also supports this reading. In CFTC v. Morse, 762 F.2d 60 (8th Cir. 1985) ("Morse"), section 4b liability was affirmed even though the investment sold to the public was not made, or to be made, on a contract

[37/] Because Paragon represented that it would probably acquire futures contracts, in lieu of holding and storing the actual metals, as a means of "covering" its obligations, and because Paragon did in fact "cover" as much as 27.08% of its customer obligations in the futures markets, these orders for futures contracts were represented to be made "for or on behalf of any other person," namely, on behalf of Paragon's customers. These contracts, although in Paragon's name, were made on behalf of its customers because they provided Paragon's customers greater assurances of Paragon's solvency and of Paragon's ability to perform its repurchase and/or delivery obligations under the Paragon contract.

market. In Morse, the defendant offered a "spot" investment instrument to the public which enabled investors to purchase a controlling interest in gold or silver at a price pegged to the prevailing commercial rate. Investors were required initially to pay only 30% of the purchase price to Morse, with the remainder of the purchase price carried as a loan with daily interest at the prevailing rate. Morse represented to these investors that he would hedge their investments by the purchase of futures contracts in gold and silver. Instead, he converted to his own use funds which should have been used to hedge his customer obligations in the futures markets. Morse also used part of the funds to speculate in other commodities, and sometimes he even traded opposite his customers in the gold and silver markets.

In upholding a lower court finding of fraud, the Eighth Circuit effectively ruled that former section 4b of the Act reached fraudulent activity in connection with off-exchange commodity investments where misrepresentations were made that the investments would be hedged in the futures markets. There, section 4b liability turned on Morse's misrepresentation to customers that he would hedge their investments in the lawful futures markets. 762 F.2d at 62.

The factual pattern in Morse is almost identical to this case. As in Morse, Paragon told at least one customer that his investment would be secured by positions taken on the COMEX (C.R. 209, at p. 165). As in Morse, the district court here found that Brandon (who personally conducted Paragon's cover program) did not adequately cover or "hedge" customer obligations:

> In some metals and currencies Brandon purchased no cover. Brandon covered silver, the principle [sic] metal sold to Paragon customers, at the most 27% during 1986. In the case of the British pound, Brandon actually took positions opposite those of his customers. (C.R. 189 at p. 3.)

This Court should reach the same result.[38/]

C. Current Section 4b Of The Act Should Be Applied To Appellants' Fraudulent Activities

The district court's January 5, 1987 opinion does not specifically state whether the court's findings of section 4b violations were predicated on former section 4b or the current version of section 4b. Nonetheless, appellants argue that the lower court in effect erroneously applied the 1986 amendments to section 4b retroactively to their misconduct.

It is well-established that a court is required to apply the law in effect at the time it renders its decision, unless doing so would result in a manifest justice or there is statutory direction or legislative history to the contrary. Bradley v. School Board of Richmond, 416 U.S. 696, 716 (1974) ("Bradley"); NLRB v. Best Products, Inc., 765 F.2d 903, 913 (9th Cir. 1985). City of Great Falls v. U.S. Dept. of Labor, 673 F.2d 1065, 1068-69 (9th Cir. 1982) (discussing balancing approach for determining "manifest justice").

[38/] In asserting that section 4b has no application to their activities, appellants stress that none of their transactions with their customers "were executed on a contract market" (App. Br. at 20). Such a reading of section 4b would strip the provision of its reach to fraud "in connection with" any order or contract "made or to be made" on behalf of another person. Courts have rejected such a restrictive view. Thus, section 4b has been applied to soliciting activities occurring well before an order was ever placed for a futures contract. See Saxe v. E.F. Hutton & Co., 789 F.2d 105, 110-11 (2d Cir. 1986); Hirk v. Agri-Research Council, Inc., 561 F.2d 96, 103-04 (7th Cir. 1977). As we have shown, in purveying the Paragon contract, appellants misrepresented to their customers that their rights would be secured by COMEX futures contracts acquired with their funds. Thus, these misrepresentations, too, were made "in connection with" orders to be made on the COMEX on behalf of Paragon's customers. For this reason, the present case is distinguishable from CoPetro Bankruptcy, where the "commodities represented by those [gasoline] futures contracts," 680 F.2d at 569, were not traded "on or subject to the rules of a contract market." Id.

In the present case, the district court reached its decision with respect to appellants' section 4b violations after the 1986 amendments became effective. Neither section 4b in its current form, nor the legislative history, contains any directive that the 1982 amendments were to be applied prospectively only. Thus, under *Bradley*, the court below would have been required to apply the 1986 amendments to section 4b retroactively unless such a retroactive application would cause "manifest injustice" to appellants.

Appellants make no showing that retroactive application of section 4b would work a manifest injustice upon them. This is not surprising, as no court has ever held that former section 4b was inapplicable to fraud committed in connection with off-exchange domestic futures contracts.[39]

To the contrary, the Commission, pursuant to its authority to seek injunctions to enforce compliance with the Act, routinely invoked former section 4b whenever there was evidence of fraud in conjunction with the sale of off-exchange futures contracts. Federal district courts repeatedly have enjoined fraud in connection with off-exchange futures under former section

[39] To the extent that appellants rely on *Palmer Trading Co. v. Shearson Hayden Stone*, [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,900 (N.D. Ill. 1979) ("*Palmer*"), and on *deAtucha v. Commodity Exchange, Inc.*, 608 F. Supp. 510, 520 (S.D.N.Y. 1985) ("*deAtucha*") in support of their assertion that former section 4b did not reach off-exchange fraud, their reliance is misplaced. Neither case involved the application of section 4b to off-exchange futures in the United States. Rather, those cases involved the applicability of section 4b to the *foreign* futures and options. *Palmer* and *deAtucha* correctly decided that section 4b does not apply to foreign instruments, as Congress made clear in 1982 when it enacted section 4(b) of the Act, 7 U.S.C. § 6(b) (1982), which created a separate regulatory scheme for foreign instruments.

4b.[40] And, at least one Court expressly has found violations of Section 4b of the Act in conjunction with off-exchange futures. See CFTC v. National Coal Exchange, Inc., [1980-1982 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶21,424 (W.D. Tenn. 1982).

For these reasons, appellants cannot claim surprise by retroactive application of section 4b, or that such application would upset legitimate expectations based on settled law to the contrary in this area. And, as an equitable exception to the Bradley rule, "manifest injustice" cannot be invoked by those who have perpetrated fraud on the public. Accordingly, even if it is assumed that the lower court applied the current language of section 4b, such application was clearly appropriate.

## III. THE DISTRICT COURT ACTED WITHIN ITS DISCRETION IN ORDERING BRANDON TO DISGORGE HIS ILL-GOTTEN GAINS.

As explained above, the district court ordered appellant Brandon to disgorge $496,495.39 to Paragon's trustee in Chapter 11 bankruptcy. (C.R. 188 at p.4.) The court computed the figure by totalling Brandon's withdrawals from Paragon from 1985 through June 23, 1986, and then subtracting a $5,000 loan by Brandon and a reasonable salary for Brandon's management of the firm ($96,720), which Brandon was allowed to keep. The lower court's order also

[40] See, e.g., CFTC v. First American Currency, CA No. 85-7871 WBM (Gx) (C.D. Cal.) (preliminary injunction December 5, 1985); CFTC v. First International Trading Company, C.A. No. 85-1555 (N.D. Cal.) (preliminary injunction June 6, 1985); CFTC v. First National Monetary Corp., No. 85-72570 (E.D. Mich.) (preliminary injunction July 22, 1985); CFTC v. International Silver Bullion, No. 84 C 10501 (N.D. Ill.) (temporary restraining order Jan. 11, 1985).

provided that the bankruptcy trustee would be "entitled to enforce this Order as a third party beneficiary . . . and shall have the rights of a judgment creditor" on behalf of the bankrupt's estate. Finally, the order provided that the court would retain jurisdiction to ensure compliance with its disgorgement order.

Appellants acknowledge that the remedy of disgorgement lies within the inherent equitable powers of district courts in actions brought pursuant to section 6c of the Act. (App. Br. at 22.) Nevertheless, they argue that the district court abused its discretion by empowering the trustee in bankruptcy to enforce the disgorgement order with the same authority as that of a judgment creditor. Moreover, they assert that the Commission does not have standing to seek what amounts to a money judgment against them. As a separate matter, appellants urge that the disgorgement order is punitive because it has the same effect as a money judgment that may be satisfied from any of Brandon's assets, and may even be assessable against his future earnings. None of these contentions has any merit.

"[C]ourts have uniformly recognized that the authority granted by Section 6c of the Act, 7 U.S.C. § 13a-1, permits courts to order . . . disgorgement, and restitution." CFTC v. Skorupskas, 605 F. Supp. 923, 943 (E.D. Mich. 1985); see also CFTC v. British American Commodity Options Corp., 788 F.2d 92 (2d Cir. 1986); CFTC v. CoPetro Marketing Group, 680 F.2d 573, 583 (9th Cir. 1982); CFTC v. Hunt, 591 F.2d 1211, 1223 (7th Cir. 1979), cert. denied, 442 U.S. 921 (1979). Moreover, as this Court observed in CoPetro, unlike other statutes,

> Section 6c is very broad. It does not list specific types of misconduct and specific remedies for each; instead, it provides the court with authority to issue a broad variety of orders.

680 F.2d at 583.

In CoPetro, this Court affirmed a district court's order of disgorgement of funds derived from illegal sale of off-exchange futures, the same violation found in this case. It recognized that disgorgement is necessary to deter future violations, because otherwise "it would frustrate the regulatory purpose of the [Commodity Exchange] Act to allow a violator to retain his ill-gotten gains." 680 F.2d at 583. It is thus clear that the Commission has standing, pursuant to section 6c of the Act, to seek not only the express remedies set forth in that statute but also the ancillary equitable remedies available to the district court, including disgorgement and restitution.

By ordering Brandon to disgorge his ill-gotten proceeds to Paragon's bankruptcy trustee, the district court duly exercised its equitable authority to order restitution, and to implement that order through the most practical means available. By authorizing the bankruptcy trustee to enforce the disgorgement order with all the rights of a judgment creditor, the court afforded the trustee the opportunity under Fed. R. Civ. P. 69, not otherwise available, to depose Brandon to identify and locate assets that could be the source of disgorgeable funds. Thus, this authorization arose out of practical necessity, and was consistent with a court of equity's inherent power to provide a complete and effective remedy. As the Supreme Court has recognized:

> When Congress entrusts to an equity court the enforcement of prohibitions contained in a regulatory enactment, it must be taken to have acted cognizant of the historic power of equity to provide complete relief in light of the statutory purposes. As this Court long ago recognized, 'there is inherent in the Courts of Equity a jurisdiction to give effect to the policy of the legislature.'

Mitchell v. DeMario Jewelry, 361 U.S. 288, 291-92 (1960). Where, as here, the primary goal of the Commodity Exchange Act is the protection of commodity investors, see, e.g., CFTC v. British American Commodity Options Corp., 788 F.2d at 94, the district court clearly acted well within its discretion in authorizing the bankruptcy trustee to enforce the disgorgement order with the same rights as a judgment creditor.

Finally, Paragon's and Brandon's claims that the "money judgment" nature of the disgorgement order is "draconian" and impermissibly punitive (see App. Br. 24) are without substance. Appellants do not argue that the district court erroneously calculated the amount of illegal income Brandon received from Paragon during 1985 through June 23, 1986. Rather, their argument appears to be that the district court's disgorgement order is defective because it does not require the trustee to trace, locate, and identify "dollar for dollar" the actual funds that Brandon illegally received from Paragon. In other words, they argue that the district court is without power to order disgorgement if, for instance, Brandon had spent the illegal income, or the trustee could not trace any funds in his possession or control directly to the actual, unlawful income he received from Paragon. The argument falls by its mere restatement. Taken to its conclusion, wrongdoers who spent or otherwise dissipated illegally obtained assets would be immune from the disgorgement remedy, and the deterrence value of the disgorgement remedy would be seriously undermined. Such a rule would have the incongruous effect of encouraging violators to spend or conceal their illegally obtained income before a disgorgement order could be entered. To our knowledge, no court has ever recognized such a rule, and appellants offer no case law in support of the proposition.[41]

Because the district court allowed Brandon to retain $96,720 as a reasonable salary for the eighteen-month period beginning January 1, 1985, the disgorgement order was more than equitable to Brandon, and cannot be characterized as punitive. Accordingly, the conclusion is inescapable that the district court acted well within its discretion in ordering Brandon to disgorge $496,495.39 to Paragon's trustee in bankruptcy.

## CONCLUSION

The district court's orders should be affirmed in all respects.

[41] This is not a case where "tracing" is at all relevant, because Brandon is not being required to disgorge lawful income earned from illegal proceeds. See SEC v. Manor Nursing Centers, 458 F.2d 1082, 1104 (2d Cir. 1972) (disallowing disgorgement of proceeds lawfully earned from ill-gotten gains). The disgorgement order is limited to the precise amount that Brandon illegally received from Paragon, $496,495.39. For example, under the terms of the disgorgement order, Brandon is not required to disgorge any interest he may have earned on the $496,495.39.

Respectfully submitted,

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STATEMENT OF RELATED CASES

The Commission knows of no related cases, as defined by Circuit Rule 28-2.6, presently pending in this Court.

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