TEN TIPS FOR AVOIDING A COMMODITIES SCAM

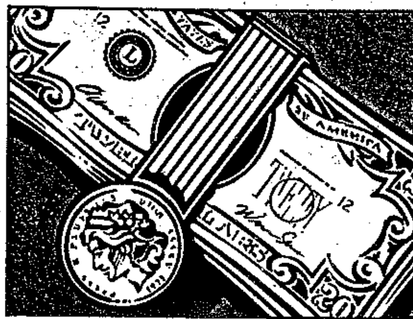
A federal regulator offers his suggestions for safe investing in the volatile world of commodity futures

By FOWLER WEST

One of today's fastest growing investment alternatives is "commodities," a term that has come to include items as diverse as gold and silver, gasoline, heating oil, farm goods, and such less tangible goods as foreign currencies, U.S. Treasury securities, and the newest stock indices. Total trading on the U.S. commodity futures exchanges grew from 13.6 million contracts in 1970 to 112.6 million in 1982, and another record year was established in 1983. Add to this the vigorous cash markets for precious metals and other goods, and the total commodities universe becomes vast.

While the financial risks of commodities speculation are formidable, potential small traders must also be on guard against one of the commodity boom's less savory by-products—a wave of fraud that has swept the country in recent years, causing innocent and trusting investors to lose an estimated $200 million a year.

Public awareness of the commodity-fraud problem was heightened recently by the exposure of two spectacular swindles in which an estimated 50,000 customers were bilked out of nearly $100 million. Both cases involved firms advertising the sale of gold and other precious metals. By the time investigators eventually checked into these firms, however, the customers' money was



gone, and there was no gold in the company vaults.

Obviously, the great majority of commodity dealers are not crooked, but the fact that the bad apples are few does little to compensate their victims. Since October, 1982, I have been a member of the Commodity Futures Trading Commission (CFTC), the federal government's regulator of all U.S. futures trading. The legitimate futures industry, exchanges and brokerage firms alike, has a generally strong record of integrity. However, the regulatory system itself is limited. Precious-metals dealers in the cash market, for instance, are generally not directly regulated by the CFTC or any other federal agency. It is among these nonregulated cash commodity firms where the greatest incidence of fraud has occurred, and where our greatest concerns lie.

The best possible defense against commodity fraud is an educated public. Simple common sense and the backbone to ask questions or say "no" to aggressive salespersons often is enough to prevent a crime, or simply a bad investment. What follows are 10 points to keep in mind if you are considering putting your money in commodities.

1. *Never give your money to a faceless voice over the telephone or in response to an unsolicited advertisement from a firm you've never heard of.*

The most common commodity frauds are the "bucket shops" or "boiler rooms," where bands of salespersons, often operating out of a single office with a bank of telephones, call hundreds of potential victims all over the country, telling them to send money right away for a "can't miss"—and often bogus—investment.

If you get an unsolicited sales call, be suspicious. Ask the caller how the company got your name, and whether there is a local bank or financial firm you can call for a reference. Demand that information about the investment and the firm be sent to you in writing before you send any money. Be leery of any salesman who claims to have special "inside information," who won't give you his company's address or return telephone number, who asks for a sizeable amount of money in advance, or who tries to bully you.

2. *Try to do business with people you know personally and who have good business reputations.*

If you don't know such a person, deal with a brokerage firm or commodities professional with a reputation for honesty and reliability. Above all, get acquainted with the people who will handle your account. If you encounter resistance, go elsewhere.

Choosing the right broker or adviser is very important. Commod-

Illustration by Steve Miller

ities markets are notoriously unpredictable and volatile, and substantial gains or losses can turn on subtle market judgments. A $1-an-ounce drop in the price of silver, for instance, can translate into a $5,000 loss on a single silver futures contract. While your broker's advise and expertise will be invaluable in making decisions, even the most legitimate and cautious brokers are sometimes wrong, and tensions can arise. So it is important that you trust the people managing your account.

If you need information on a particular firm or broker, call or write the CFTC's Office of Public Information, 2033 K Street, NW, Washington, D.C. 20581; (202) 254-8630. They can tell you if a firm is registered and if there are any past or present CFTC legal proceedings against them.

3. *Educate yourself.*

Take time to review the literature on commodities trading that the firm gives you. Also check with your local library or other sources to see what else might be available.

4. *Understand what strategies your broker might want you to employ.*

If your broker is reluctant to take the time to explain them to you, or if you don't feel comfortable with your broker's plan, forget it. Don't trade, or get another broker. I believe most legitimate brokers will want you to understand their strategies and will welcome your input.

5. *Read everything you sign.*

Our agency requires brokers to give you certain risk disclosure information that must be signed. If you are not given any risk disclosure information, don't trade.

If a dispute arises later over your commodity transactions, you may be held legally bound by any documents you sign. It is worth taking the time to read the details of any disclosure statements or contracts that you are asked to enter into, and to ask whatever questions you feel are necessary. The customer must sign the document to attest having read it. We consider the information on this risk-disclosure document very important, and urge you to read it carefully.

6. *Don't be shy to ask questions.*

Because commodity prices can be volatile and investments are often designed to maximize the buyer's "leverage," commodity gains and losses are often large and quick. Also, commodity futures contracts are "marked-to-the-market," which means that losses must be paid up daily to the brokerage firm, and negative balances cannot be carried forward.

Before investing in any commodity deal, be certain that you understand at least the following: What is the investment's total cost to you, and how much of that money will be used to buy the commodity as opposed to paying fees or commissions? What additional liabilities are involved beyond the original cost? Will you have to pay additional margin if prices move against you? Are other charges included, like storage or interest rates? What is the most you can possibly lose? Exactly how much must the market price of the commodity move in your favor before you break even or make a profit? How much money will you lose if the price moves against you or stays the same? Does the firm use the same market prices as those quoted in the daily newspaper? How quickly can you cash in your profit (or cut your loss) and get out of the market?

7. *Beware of high-pressure sales tactics.*

If it sounds too good to be true, it probably is too good to be true. Don't try to argue or reason with high-pressure telephone salesmen. Simply hang up the phone. If they call again, hang up the phone again. Sooner or later, they'll get the message.

8. *Only risk what you can readily afford to lose.*

Commodity markets are not for everyone. One major brokerage firm requires that customers opening commodity futures accounts have a net worth of $100,000 (exclusive of home and insurance), an annual income of $30,000, and make an initial deposit of $10,000. A recent survey of futures speculators showed that 61 percent have household incomes of more than $50,000 per year, and 21 percent more than $100,000 per year. Almost 40 percent of these traders said that only 9 percent or less of their portfolios were devoted to futures.

9. *For every dollar made in futures, at least one dollar is lost.*

Given the experience and expertise of all those playing the market on a minute-by-minute basis, are you likely to be one of the winners?

Commodity futures markets are directly competitive. Each futures contract has a buyer and seller, and one side gains directly against the other side's losses. While the mix varies from commodity to commodity, participants in grain, petroleum, or silver markets will include commercial grain, petroleum, and silver merchants from around the world, as well as experienced speculators, "arbitrageurs," and commodity funds. Traders with exchange memberships can remain on the exchange floor throughout the day following each fluctuation in the market price, and effectively profit from each. This is not to say that a well-informed, well-advised, conscientious layman cannot compete effectively in futures markets, but

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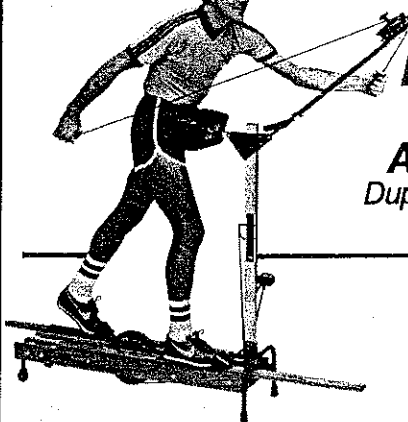

Cross-country skiing is often cited by physiologists as the most perfect form of cardiovascular exercise for both men and women. Its smooth, fluid, total body motion uniformly exercises more muscles so higher heart rates seem easier to attain than when jogging or cycling. NordicTrack closely simulates the pleasant X-C skiing motion and provides the same cardiovascular endurance-building benefits–right in the convenience of your home, year 'round. Eliminates the usual barriers of time, weather, chance of injury, etc. Also highly effective for weight control.

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be realistic in judging your own goals and priorities.

10. *Above all, use common sense and exercise caution.*

Unfortunately, despite the best efforts of law enforcement and government regulators, the chances of recovering money lost to disreputable commodity brokers are slim. If a fraudulent firm goes bankrupt, or its operators abscond with the company funds—much of which belongs to customers—then the money simply may be lost. We can sometimes punish the wrongdoers, but that does not help the victim.

If you feel that you have been cheated or defrauded in a commodities investment involving either futures contracts or physical goods, legal remedies are available. Beyond private lawsuits and criminal actions, the CFTC operates a special "reparations" court system for aggrieved customers to seek damages against futures-industry professionals. You will be asked to submit your case in writing, including as many names and specifics as possible. A significant number of the cases that reach the adjudication stage result in the customer recovering all or part of his losses, though many others fail because the injury is beyond the CFTC's legal jurisdiction, the wrongdoer has managed to evade detection, or the victim fails to present sufficient information to state a legal claim.

The best way to avoid this unhappy ending is to prevent the crime or uninformed investment from occurring in the first place. And the best watchman over your own money is you. ◆

Fowler West is a member of the U.S. Commodity Futures Trading Commission. The views expressed in this article are those of the author and do not necessarily reflect those of the commission.