Commodity Futures Trading Commission
CEA CASES

NAME: ARTHUR N. ECONOMOU AND ARTHUR N. ECONOMOU & CO., INC.

CITATION: 32 Agric. Dec. 14

DOCKET NUMBER: 167

DATE: JANUARY 15, 1973

DOCUMENT TYPE: DECISION AND ORDER

(No. 14,938)

In re ARTHUR N. ECONOMOU and ARTHUR N. ECONOMOU & CO., INC. CEA Docket No. 167. Decided January 15, 1973.

Reports listing items as current assets which did not so qualify -- Unsecured loans -- Minimum financial requirements -- Failure to meet -- Denial of trading privileges -- Suspension of expired license -- Sanction is to deter

Where respondents wilfully violated the Act and the regulations as found herein, respondents are denied trading privileges on all contract markets for a period of 90 days, and the expired registration of the respondent corporation is suspended for a period of 90 days.

Richard W. Davis, for complainant.

Respondents *pro se.*

Jack W. Bain, Hearing Examiner.

Decision by Donald A. Campbell, Judicial Officer.

DECISION AND ORDER

PRELIMINARY STATEMENT

The issues in this case raised by the amended complaint relate to whether the respondent corporation, a registered futures commission merchant under the Commodity Exchange Act, had adequate working capital in 1969 and 1970. This involves a determination as to whether four items were "current assets" and whether one item was a "current liability," as defined in the administrative regulations.

In addition, numerous issues are raised by the respondents as to whether their conduct was wilful, and as to whether they were deprived of their rights under the Constitution, the Administrative Procedure Act, and the applicable rules of practice.

Complaint. This is a proceeding under the Commodity Exchange Act (7 U.S.C. Chapter 1, 1970 ed.), hereinafter called the Act. It was instituted by a complaint and notice of hearing filed on

February 19, 1970, by Richard E. Lyng, Assistant Secretary of Agriculture.

It was alleged that Arthur N. Economou & Co., Inc. (hereinafter referred to as the respondent corporation), a registered futures commission merchant controlled by Arthur N. Economou, the individual respondent, had traded for its customers and held "for such customers sums of money, representing deposits of margin by and trading profits accruing to such customers," while it failed to meet the minimum financial requirements of the Act, and had submitted reports as of March 31 and June 30, 1969, listing items as current assets which did not so

qualify, in wilful violation of the Act and the regulations thereunder. It was alleged that when such items were deducted from the respondent corporation's statement of current assets, it lacked approximately $ 6,000 as of March 31, 1969, and $ 700 as of June 30, 1969, in meeting the financial requirements of the Act and regulations.

Answer. At the respondents' request by telegram, the time to answer was extended by the Chief Hearing Examiner to April 15, 1970. By another telegram, the respondents requested a further extension of 30 days to prepare an answer, and an Acting Chief Hearing Examiner extended the time to April 22, 1970.

The respondents filed an answer on April 23, 1970, admitting filing the financial reports but asserting that the items were current assets, and denying any violations. They pled as an affirmative defense an unwillingness or inability of the New York office of complainant to answer the respondents' questions or clearly explain the regulations, and vagueness, deliberately or unintentionally, of the wording of the regulations.

Amended Complaint and Answer. By leave of an Acting Chief Hearing Examiner, the complainant filed an amended complaint on June 22, 1970, alleging additional failures to meet the financial requirements by $ 13,000 as of December 31, 1969, and $ 24,893.38 as of March 31, 1970. On July 16, 1970, the respondents filed denials similar to those in their former answer. Attached was a 16-page affidavit of Arthur N. Economou, asserting malicious actions against him by the complainant, and outlining his experience and accomplishments in the commodities and finnancial fields.

Hearing. A hearing was held in New York City on August 5, 6, 7, and 10, 1970, before Chief Hearing Examiner Jack W. Bain,

United States Department of Agriculture (now retired). Richard W. Davis, Jr., Office of the General Counsel of the Department, appeared for the Commodity Exchange Authority, the complainant. Arthur N. Economou appeared for the respondents.

The complainant called seven witnesses and introduced 14 exhibits in evidence. Mr. Economou and his accountant testified. Mr. Economou called three employees of the complainant, as witnesses, and presented one exhibit, for the respondents. The transcript of the hearing contains 551 pages.

Briefs and Motions. After the hearing, the complainant filed suggested findings, and a brief on October 13, 1970 (23 pages); the respondents filed a brief on December 17, 1970 (50 pages); and the complainant filed a reply thereto on February 10, 1971 (9 pages). At their request, the respondents were given time to file, and did file on March 8, 1971, a reply to the complainant's reply brief (19 pages). Their request for another 30 days to file a further brief was denied.

The respondents' petition to the Secretary, for a list of the names and addresses of the persons to whom the complaint and amended complaint were distributed, was denied on March 31, 1971.

The respondents subsequently filed a statement on July 21, 1971, protesting the "inordinate delay" by the Examiner in failing to file a Recommended Decision, stating that the last brief was filed about four months ago.

Three weeks later, on Friday, August 13, 1971, the respondents filed a Letter of Petition to the Secretary of Agriculture asking him to instruct the Hearing Examiner to file his Recommended Decision.

Hearing Examiner's Recommended Decision, and Exceptions Thereto. On Tuesday, August 17, 1971, the second working day after receipt of the respondents' letter to the Secretary, the Hearing Examiner filed his Recommended Decision and Proposed Order. Except for the preliminary statement, pp. 1-3, and the last page, p. 23, it was a Xeroxed copy of the complainant's brief.

The Examiner found that the respondents wilfully violated the financial requirements of the Act and regulations, as alleged in the amended complaint. He proposed an order requiring the respondents to cease and desist from engaging in such violations in the future; prohibiting their trading privileges on contract

markets for 90 days; and suspending the respondent corporation's registration as a futures commission merchant for 90 days.

The respondents filed exceptions to the Examiner's Recommended Decision and requested oral argument before the Judicial Officer.

Oral Argument Before the Judicial Officer. Oral argument was voluntarily delayed by the Judicial Officer for about eight months at the respondents' request in order to give Mr. Economou an opportunity to obtain an injunction, preventing further administrative action, from the United States District Court for the Southern District of New York. After the Court denied the respondents' request and refused to issue a stay order pending the respondents' appeal, oral argument was held in Washington, D. C., on June 1, 2, and 5, 1972, over the respondents' objection (Oral Arg., pp. 1-6). The respondents' original request that they be allotted 8 hours for oral argument was granted, and this was extended, at their request, to 11 hours. The complainant was allotted four hours.

Prior to the oral argument, the Judicial Officer, in accordance with his usual practice, sent a letter to the parties on February 18, 1972, enclosing a list of 22 questions to be discussed during the oral argument. The list was supplemented by additional questions on March 20, 1972, and May 18, 1972. Mr. Economou refused to discuss, during the oral argument, the questions relating to whether the four items were "current assets," and he refused to discuss most of the questions relating to whether one item was a "current liability" (Oral Arg., pp. 189-191, 195-201). He stated that to discuss these questions would aid the officials of the Department of Agriculture in their defense of an action for $ 32 million in damages instituted by Mr. Economou based on the administrative action involved in this case.

The respondents were given leave to file a brief within two weeks after the oral argument (Oral Arg., pp. 317-319). No brief was filed and no request for an extension of time was made.

Tentative Decision and Order. A Tentative Decision and Order was filed on July 14, 1972, by the Judicial Officer. On January 8, 1973, almost a half year later, respondents filed exceptions thereto. The final Decision and Order is substantially the same as the Tentative Decision and Order.

The Commodity Exchange Act. The Commodity Exchange Act is the amended name of the Grain Futures Act (Act of September 21, 1922, c. 369, 42 Stat. 998, as amended by the Act of June 15, 1936, c. 545, 49 Stat. 1491, as amended, 7 U.S.C. 1970 ed.). With respect to futures trading in designated agricultural commodities the Congress found that transactions and prices on boards of trade "are susceptible to speculation, manipulation, and control, and sudden or unreasonable fluctuations in the prices thereof frequently occur as a result of such speculation, manipulation, or control, which are detrimental to the producer or the consumer and the persons handling commodit[ies] and products and byproducts thereof in interstate commerce, and such fluctuations in prices are an obstruction to and a burden upon interstate commerce in commodit[ies] and the products and byproducts thereof and render regulation imperative for the protection of such commerce and the national public interest therein." 7 U.S.C. 5.

The Act provides for the designation of boards of trade as contract markets, and all trading in futures -- in the commodities referred to in the Act -- must be conducted on the designated markets. 7 U.S.C. 2, 6 and 7. The Secretary of

Agriculture may regulate boards of trade, futures commission merchants, floor brokers, and persons trading on regulated markets. 7 U.S.C. 6 *et seq.*

"The words 'futures commission merchant' shall mean and include individuals, associations, partnerships, corporations, and trusts 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 and that, in or in connection with such solicitation or acceptance of orders, accepts any money, securities, or property (or extends credit in lieu thereof) to margin, guarantee, or secure any trades or contracts that result or may result therefrom." 7 U.S.C. 2.

All futures commission merchants must be registered with the Secretary of Agriculture (7 U.S.C. 6d) and maintain minimum financial requirements (7 U.S.C. 6f).

"Notwithstanding any other provisions of this Act, no person desiring to register as futures commission merchant shall be so registered unless he meets such minimum financial requirements as the Secretary of Agriculture may by regulation prescribe as necessary to insure his meeting his obligations as a registrant,

and each person so registered shall at all times continue to meet such prescribed minimum financial requirements" (7 U.S.C. 6f(2)). The minimum financial requirement provisions were added by an amendment enacted February 19, 1968, effective 120 days thereafter.

"If the Secretary of Agriculture has reason to believe that any person (other than a contract market) * * * is violating or has violated any of the provisions of this chapter or of the rules, regulations, or orders of the Secretary of Agriculture," he may file a complaint against such person. 7 U.S.C. 9. Any person who is named as a respondent in a complaint, by the administrative agency, is entitled to a hearing, and if the evidence reveals a violation of the Act the Secretary may require all contract markets to refuse to such person "all trading privileges" thereon for such period as may be specified in the order, and the Secretary may suspend, for a period of not to exceed six months, or revoke, the registration of a futures commission merchant who violates any of the provisions of the Act. 7 U.S.C. 9. In addition, the Secretary may enter an order directing that such person or futures commission merchant shall cease and desist from the violation involved in the case. 7 U.S.C. 13b.

The Act provides that any such order issued by the administrative agency, pursuant to the Act, may be reviewed by the United States Court of Appeals for the circuit in which the person is doing business and empowers the reviewing court to affirm, set aside, or modify the order of the agency. 7 U.S.C. 9. n1

n1. The regulatory program under the Act is discussed in Campbell, "Trading in Futures Under the Commodity Exchange Act" (1958), 26 *George Washington Law Review,* 215-254.

Final administrative authority to decide cases under the Commodity Exchange Act has been delegated to the Judicial Officer. 36 F.R. 3210; 37 F.R. 28463, 28475. n1a

n1a. The office of Judicial Officer is a career position established pursuant to the Act of April 4, 1940 (7 U.S.C. 450c-450g), and Reorganization Plan No. 2 of 1953 (5 U.S.C. 1970 ed., Appendix, p. 550). The Department's first Judicial Officer held the office from 1942 to 1972. The present Judicial Officer was appointed in January 1971, having been involved with the Department's regulatory programs since 1949 (including 3 years' trial litigation; 10 years' appellate litigation relating to appeals from the decisions of the prior Judicial Officer; and 8 years as administrator of the Packers and Stockyards Act regulatory program).

The Regulations. The minimum financial requirements for futures commission merchants are set forth in 17 CFR 1.17. They were published in the Federal Register on January 16, 1969, effective 60 days thereafter. The principal regulations involved in

this case define "current assets" and "current liabilities" as follows (17 CFR 1.17 (d)(2) and (3)):

(2) The term "current assets" means cash and other assets or resources commonly identified as those which are reasonably expected to be realized in cash or sold during the next 12 months in the normal course of operation of the principal business of the applicant or registrant, and which are available for and intended for payment of current liabilities. The term "current assets" excludes among other things:

* * *

(v) Unsecured advances and loans to any business affiliate that directly or indirectly controls, is controlled by, or is under common control with, the applicant or registrant;

* * *

(x) Unsecured loans and advances to partners, officers and employees of the applicant or registrant;

* * *

(3) The term "current liabilities" means obligations that are or will become due and payable in the next 12 months, or the liquidation of which is reasonably expected to require the use of existing resources classifiable as current assets or the creation of other current liabilities.

FINDINGS OF FACT

1. The respondent Arthur N. Economou & Co., Inc., is now and was at all times material herein, a Delaware corporation with its office and place of business at 286 Fifth Avenue, New York, New York 10001. It was registered as a futures commission merchant under the Commodity Exchange Act at the time of the alleged violations, but it discontinued its registration on December 3, 1970. At all times material herein, the respondent Arthur N. Economou was in complete control of the respondent corporation and initiated and carried out the acts, dealings and transactions of the corporation.

Arthur N. Economou was President and Treasurer of the respondent corporation and his wife was Vice-President and Secretary. He was the controlling stockholder and his wife was the only other stockholder listed on the registration form. In Mr.

Economou's words, "I am the corporation. I am Arthur N. Econo-mou & Company" (Tr. 22; see, also, Tr. 430-431). n1b

n1b. Many citations to the record are included in the Decision, but they are not necessarily exhaustive.

During 1969 and continuing to on or about April 24, 1970, the respondent corporation, acting in the capacity of futures commission merchant under the Commodity Exchange Act, held for its customers sums of money, representing deposits of margin by and trading profits accruing to such customers. (Answer to Amended Complaint, division I, paragraph 1; Affidavit attached to Answer to Amended Complaint, section E, p. 13, paragraph 8; Comp. Exs. 4 and 5; Tr. 126-129, 506, 525, 533-534).

2. At all times material herein, the respondent Arthur N. Economou was in complete control of and initiated and carried out the acts, dealings and transactions of the following entities: The American Association of Commodity Traders (Comp. Ex. 2, p. 3; Tr. 29-30, 519-535); The Economou Precious Metals Futures Trading Syndicate (Comp. Ex. 13, pp. 10-11; Tr. 169-171, 519-535); The Economou Grain Futures Trading Syndicate (Comp. Ex. 12, pp. 9-10; Tr. 169-171, 519-535); The Economou Financial and Development Corp. (Comp. Ex. 11, pp. 11-12; Tr. 169-171, 519-535); The American Board of Trade, The American Board of Trade Service Corp. and The American Board of Trade Clearing Corp. (Affidavit attached to Answer to Amended Complaint, p. 8, section B, paragraphs 1 through 6; Tr. 247-248, 270-273, 519-535).

3. The respondents submitted financial reports on Form 1-FR to the Commodity Exchange Authority for the respondent corporation as of March 31, 1969, June 30, 1969, and December 31, 1969, respectively. The first page of Form 1-FR lists "Current Assets" broken down into 15 subdivisions, some of which require the attachment of a supporting explanation (see, *e.g.,* Comp. Ex. 1). Also, an investigation of the respondent corporation's financial condition was made as of March 31, 1970, by the Commodity Exchange Authority.

4. (a) On the respondent corporation's financial report as of June 30, 1969, the respondents listed as a current asset, under item 9, which includes "All other unsecured receivables due and collectable within 6 months of inception," the following (Comp. Ex. 6):

Due from American Board of Trade $ 846.00.

(b) This involved an unsecured loan or advance to a business affiliate under common control with the respondent corporation (Tr. 132-133, 464-465).

5. (a) On the respondent corporation's financial report as of March 31, 1969, the respondents listed as a current asset, under item 10, which includes "All other secured receivables due within 12 months," the following (Comp. Ex. 1):

Due from Arthur N. Economou . . . $ 2,000.00 (Secured by pledge of GTO Pontiac automobile valued at $ 2,500.00)

The financial report as of June 30, 1969, listed the identical item as a current asset (Comp. Ex. 6). The financial report as of December 31, 1969, listed the identical item as a current asset except that the amount due was $ 1,000 and the automobile was valued at $ 1,500 (Comp. Ex. 7).

An examination of the respondent corporation's books and records as of March 31, 1970, by an auditor of the Commodity Exchange Authority showed that the firm was considering as a current asset $ 1,000 due from Arthur N. Economou allegedly secured by his GTO Pontiac (Comp. Ex. 14; Tr. 172).

(b) The respondent Arthur N. Economou had an arrangement with the respondent corporation under which he had a continuous, large drawing account, making payments into the account and drawing money from the account on a continuous basis, and always having a balance owed to the corporation. With respect to that portion of the loan allegedly secured by his automobile, as of each of the relevant dates, there was no reasonable expectation that payments would be made in a manner involving cash available to the corporation for payment of current liabilities within the next 12 months. In addition, there was no security agreement in existence making the car collateral for the loan, and there was no transfer of possession of the car to the respondent corporation. The loan was an unsecured loan to an officer of the corporation (Tr. 17-25, 46-53, 94-95, 114-118, 135-137, 402, 427-430, 442-447, 456-457, 465-467, 470-473, 513-516, 541-542; Comp. Exs. 3, 9, 10).

6. (a) On the respondent corporation's financial report as of March 31, 1969, the respondents listed as a current asset, under item 10, which includes "All other secured receivables due within 12 months," the following (Comp. Ex. 1):

Due from the American Association of Commodity Traders . . . $ 9,626.81. (Secured by inventory of Association publications, value appraised conservatively at $ 15,000.00).

The financial report as of June 30, 1969, listed the identical item as a current asset except that the amount due was $ 7,070.81 (Comp. Ex. 6), and the report as of December 31, 1969, listed the identical item as a current asset except that the amount due was $ 4,477.31 and the inventory of publications was valued at $ 18,000 (Comp. Ex. 7).

An examination of the respondent corporation's books and records as of March 31, 1970, by an auditor of the Commodity Exchange Authority showed that the firm was considering as a current asset $ 3,327.31 due from The American Association of Commodity Traders allegedly secured by the inventory of publications (Comp. Ex. 14; Tr. 172).

(b) This item represented an unsecured loan or advance to a business affiliate under common control with the respondent corporation (Tr. 25-30, 34, 402-403, 427-430, 446-447, 450-460, 465-473, 513-518, 541-542).

7. (a) On the respondent corporation's financial report as of March 31, 1969, the respondents listed as a current asset, under item 15, which includes "Other current assets (Itemize on separate page)," the following (Comp. Ex. 1):

We have listed as a current asset our equity, or "acquisition cost", in The Economou Precious Metals Futures Trading Syndicate in the amount of $ 6,016.80

This current asset represents our actual outlay or expenditure in helping to bring to fruition The Economou Precious Metals Futures Trading Syndicate, a mutual fund in the form of a Limited Partnership, filed with the Securities and Exchange Commission under the Securities Act if [*sic*] 1933 and approved by the SEC as of March 20, 1969. A copy of the actual effective Prospectus is attached for your files.

Under the terms of the Partnership Agreement, our Company, Arthur N. Economou & Co., Inc. will act as exclusive brokers for the Partnership and in view of the large amount of capital involved this arrangement will result in substantial added revenue for our Company in the months directly ahead. It is anticipated that the Partnership will start trading on May 20, 1969.

The $ 6,016.80 is a modest sum compared to the actual value of this contract that we have with the Partnership and does not at all reflect the large amount of personal work put into

the new concept by Arthur N. Economou over the past two years in developing this Partnership to the point where it was approved for distribution by the SEC.

In view of the above, we trust you will agree that we are justified in carrying the amount of $ 6,016.80 as a current asset in our financial statement as of March 31, 1969.

The respondent corporation's financial report as of June 30, 1969, omitted the explanation set forth immediately above, but listed the following current assets (Comp. Ex. 6):

Other Current Assets

Contract acquisitions:

Economou Precious Metals Futures Trading Syndicate	$ 9,304.97
Economou Grain Futures Trading Syndicate	$ 23.00

The respondent corporation's financial report as of December 31, 1969, listed the following current assets (Comp. Ex. 7):

Other Current Assets

Contract acquisitions:

Economou Precious Metals Futures Trading Syndicate	$ 8,089.53
Economou Grain Futures Trading Syndicate	$ 1,881.28

An examination of the respondent corporation's books and records as of March 31, 1970, by an auditor of the Commodity Exchange Authority showed that the firm was considering as a current asset totalling $ 9,049.06 an account entitled "Contract Acquisitions" (Comp. Ex. 14; Tr. 172).

(b) The Economou Precious Metals Futures Trading Syndicate and the Economou Grain Futures Trading Syndicate are identical in nature except that one trades in metal futures and the other, not yet activated at the time of the hearing, was organized to trade in grain futures (Tr. 134, 166, 471-474, 519-520; Comp. Ex. 12). The organizational costs of the Trading Syndicates, resulting in exclusive brokerage contracts, are properly classified as "intangible assets" or "deferred charges," neither of which is a "current asset" (Tr. 35-45, 97-98).

8. (a) An examination of the respondent corporation's books and records as of March 31, 1970, by an auditor of the Commodity Exchange Authority showed that the firm was considering as a "reserve," rather than as a current liability, an item of $ 11,162.97 (Answer to Amended Complaint, p. 4).

(b) The $ 11,162.97 "reserve" resulted from an arrangement between The Economou Financial and Development Corp. (hereinafter referred to as the Financial Corporation) and the respondent corporation, under which the respondent corporation paid the bills of the Finacial Corporation because the Financial Corporation had no staff or facilities to pay its own bills (Tr. 291-292, 521-523).

Initially, the bills paid by the respondent corporation were greater in amount than the reimbursements received from the Financial Corporation. At that time, the Financial Corporation owed money to the respondent corporation, which was reflected on the respondent corporation's books as a "debit balance" (*i.e.,* a receivable which was a "current asset").

Later, as the respondent corporation needed more funds, the Financial Corporation paid $ 11,162.97 more to the respondent corporation than was owed, so the account became a "credit balance" on the respondent corporation's books (Tr. 167, 181, 186, 249, 253, 256, 265, 267, 280, 287). This was reflected on the respondent corporation's ledger in an account labeled "Expenses charged to Economou Financial & Development Corporation and Deposits to Cover Same; Credit Balance to Cover Accruing Expenses" (Tr. 267).

Each month the respondent corporation would reduce the amount of the account (*i.e.* reduce the "credit balance") by the amount of money paid by the respondent corporation on behalf of the Financial Corporation (Tr. 195, 198-199, 204-205, 253). On its balance sheet as of March 31, 1970, the respondent corporation shows the $ 11,162.97 in a separate classification, appearing between the liabilities and the capital (or stockholders' equity), labeled "Reserves to cover accruing expenses." The relevant entries on the respondent corporation's balance sheet as of March 31, 1970, are as follows (Answer to Amended Complaint, p. 4):

Balance Sheet, March 31, 1970

Total Assets	$ 52,268.23	Total Liabilities	$ 14,091.70
		Reserve, Surplus & Capital	
		Reserves to cover accruing expenses	11,162.97
		Capital and Capital Surplus	27,373.56
		Total Liabilities & Capital	$ 52,628.23

The Financial Corporation treated this overpayment of $ 11,162.97 on its books and in the Prospectus filed with the Securities and Exchange Commission as a "current asset," designated as a "prepaid expense" (Tr. 185, 252, 257; Comp. Ex. 11, p. 14).

The "reserve" account reflected a "one-way flow of money" from the Financial Corporation to the respondent corporation, "and then the [respondent] corporation turns it out and pays the necessary expenses that are involved" for the Financial Corporation (Tr. 250; see, also, Tr. 107, 181, 186). The "prepaid expenses" were "in anticipation of future expenses" of the Financial Corporation (Tr. 252).

Mr. Economou, who controlled both corporations, did not require the respondent corporation to hold the Financial Corporation's money in trust, but permitted the respondent corporation to use the money as its own until it was needed to pay the Financial Corporation's expenses (Tr. 167-168). As of March 31, 1970, the respondent corporation had only $ 510.41 cash on hand from all sources (Answer to Amended Complaint, p. 4). The remainder of the $ 11,162.97 had been loaned to Mr. Economou or to his affiliated corporations or had been used to pay some of the respondent corporation's current liabilities (Tr. 275-283).

Theoretically, the "reserve" account could have been liquidated by the performance of services by the respondent corporation for the Financial Corporation, *i.e.,* the respondent corporation could have charged a management fee to the Financial Corporation, liquidating all or part of the reserve (Tr. 210-211, 253-256, 294, 297). Actually, the account was liquidated almost exclusively by making payments to other persons for the expenses of the Financial Corporation (Tr. 255-258).

Instead of using the $ 11,162.97 to pay the expenses of the Financial Corporation, the respondent corporation used the money as its own, increasing its current assets (or decreasing its current liabilities) by that amount. This item of $ 11,162.97 was a "current liability" of the respondent corporation.

9. The items listed by the respondent corporation as current assets as of March 31, 1969, referred to in Findings of Fact 5, 6, and 7 (totalling $ 17,643.61), were not "current assets" and, therefore, the respondent corporation failed to meet the minimum financial requirements on March 31, 1969, by $ 5,943.42 (Comp. Ex. 3; Tr. 46-52).

The items listed by the respondent corporation as current assets as of June 30, 1969, referred to in Findings of Fact 4, 5, 6, and 7 (totalling $ 19,244.78), were not "current assets" and, therefore, the respondent corporation failed to meet the minimum financial requirements on June 30, 1969, by $ 800.38 (Comp. Ex. 9; Tr. 135-137).

The items listed by the respondent corporation as current assets as of December 31, 1969, referred to in Findings of Fact 5, 6, and 7 (totalling $ 15,448.12) were not "current assets" and, therefore, the respondent corporation failed to meet the minimum financial requirements on December 31, 1969, by $ 12,807.88 (Comp. Ex. 10; Tr. 135-137).

The items considered by the respondent corporation as current assets as of March 31, 1970, referred to in Findings of Fact 5, 6, and 7 (totalling $ 13,376.37) were not "current assets," and an item of $ 11,162.97 n2 considered by the respondent corporation as a "reserve," rather than a current liability, was a "current liability" due to the Economou Financial and Development Corp. Accordingly, the respondent corporation failed to meet the minimum financial requirements as of March 31, 1970, by $ 22,434.84 n3 (Comp. Ex. 14; Tr. 172).

n2. The amount was shown as $ 13,621.51 by the complainant's auditor (Comp. Ex. 14) and as $ 11,162.97 by the respondent (Answer to Amended Complaint, p. 4). The difference between the two amounts ($ 2,458.54) is

immaterial. The respondent's figure is accepted as correct since the compainant concedes that minor adjustments might have been properly made after the complainant's audit.

n3. The amount is shown as $ 24,893.38 by the complainant's exhibit (Comp. Ex. 14). The difference of $ 2,458.54 is explained in the preceding footnote.

10. The respondents wilfully failed to meet the minimum financial requirements of the Act and regulations as of March 31, June 30, and December 31, 1969, and March 31, 1970.

CONCLUSIONS

A detailed knowledge of accounting terminology and procedures is necessary to understand some of the issues in this case. n3a Those issues will be discussed later. For the purpose of considering the first three issues, it is sufficient to understand that "current assets" include not only cash, but also other assets which are reasonably

expected to be realized in cash during the next 12 months, and which are available for and intended for payment of current liabilities (17 CFR 1.17(d)(2)).

n3a. The respondents question the qualifications of the Judicial Officer to discuss or evaluate technical accounting terms (Exceptions to Tentative Decision, p. 12). As administrator of the Packers and Stockyards Act regulatory program for 8 years, I supervised about 35 accountants, supervised the preparation of regulations as to current assets and current liabilities similar to those at issue here (9 CFR 203.10), and issued about 250 complaints charging firms with having current liabilities in excess of their assets.

For example, as a general rule, a creditor can claim as a current asset, as of a particular date, the amount of a debt which is reasonably expected to be paid within the next 12 months provided such payment will provide money available for and intended for the payment of current liabilities.

The regulations contain certain exceptions, however, which are important in this case. For example, the regulations specifically exclude from "current assets" all *unsecured* advances and loans to officers of the registrant or to business affiliates under common control with the registrant (17 CFR 1.17 (d)(2) (v) and (x)).

I. *Respondent Corporation's Loan or Advance to The American Board of Trade*

As of June 30, 1969, the respondent corporation included as a "current asset" $ 846.00 due and collectable from The American Board of Trade. The Hearing Examiner found that the item was "specifically excluded as a current asset by section 1.17(d)(2)(v) in that it is an unsecured loan to a business affiliate under common control with the registrant" (Recommended Decision, p. 16; see, also, pp. 10-11).

The regulations exclude from "current assets" (17 CFR 1.17 (d)(2)(v)):

(v) Unsecured advances and loans to any business affiliate that directly or indirectly controls, is controlled by, or is under common control with, the applicant or registrant;

Richard E. Kirchhoff, Deputy Director, Registration and Audit Division, Commodity Exchange Authority (Tr. 126), testified that the item was specifically excluded by the regulations from "current assets" (17 CFR 1.17(d)(2)(v)) because it was an unsecured loan or advance to a business affiliate that was under common control with the respondent corporation (Tr. 132-133).

The respondents concede that The American Board of Trade is a business affiliate under common control with the respondent corporation (Affidavit attached to Answer to Amended Complaint, pp. 7-8). n3b Mr. Economou conceded at the hearing that this item

was an unsecured advance to The American Board of Trade, and that it was not a "current asset" (Tr. 464-465).

n3b. The first page of the Affidavit is numbered p. 7.

However, in the respondents' Suggested Findings and Brief, pp. 18, 42, they contend that the item was a "current asset" because it was an unsecured receivable due within six months. They rely on 17 CFR 1.17 (d) (2) (iii), which excludes from "current assets":

(iii) All other unsecured receivables that are not due and collectable within 6 months from the respective dates of their inception;

The respondents argue that there is an implication from this subsection (iii) that *all* unsecured receivables that *are* due and collectable within six months from their inception are "current assets." They argue that since the loan or advance to The American Board of Trade was an unsecured receivable due and collectable within six months from its inception, it was a "current asset." This argument cannot prevail, however, in view of the specific exclusion cited *supra,* p. 24.

As shown, *infra,* pp. 78-79, 94-97, the broad category of "receivables" includes, *inter alia,* all loans and advances. The regulations specifically exclude from "current assets" those receivables that are unsecured advances and loans to a business affiliate under common control with the registrant (17 CFR 1.17(d)(2)(v)). This specific exclusion prevails over any contrary implication from the more general provisions of 17 CFR 1.17(d)(2)(iii).

Hence the item was not a "current asset" because it was an unsecured advance or loan to a business affiliate under common control with the registrant, which is expressly excluded from "current assets" by 17 CFR 1.17(d)(2)(v).

II. *Respondent Corporation's Loan or Advance to Arthur N. Economou*

As of each of the relevant dates involved in this case (see Finding of Fact 5(a)), the respondent corporation considered as a "current asset" an amount due from a loan or advance by the respondent corporation to Arthur N. Economou in the amount of $ 2,000 (later $ 1,000) which the respondents contend was secured by a pledge of Mr. Economou's GTO Pontiac automobile valued at $ 2,500 (later $ 1,500).

The Hearing Examiner found that the item was not a "current asset" because (i) the loan was not evidenced by a note or other

evidence of indebtedness and, therefore, it was not possible to determine whether the asset could be "reasonably expected to be realized in cash * * * during the next twelve months" as required by the regulations (17 CFR 1.17(d) (2)), and (ii) inasmuch as there was no evidence of a security agreement showing that the automobile was collateral for the obligation, the loan was an unsecured loan to an officer of the registrant excluded as a "current asset" by 17 CFR 1.17(d) (2) (x) (Recommended Decision, pp. 8, 15).

The regulations define current assets as follows (17 CFR 1.17(d)(2)):

The term "current assets" means cash and other assets or resources commonly identified as those which are reasonably expected to be realized in cash or sold during the next 12 months in the normal course of operation of the principal

business of the applicant or registrant, and which are available for and intended for payment of current liabilities. * * *

The regulations expressly exclude from "current assets" (17 CFR 1.17(d) (2) (x)):

(x) Unsecured loans and advances to partners, officers and employees of the applicant or registrant;

I conclude that the item was not part of respondent corporation's current assets because it was not part of the assets "reasonably expected to be realized in cash * * * during the next 12 months * * * and which are available for and intended for payment of current liabilities" (17 CFR 1.17(d)(2)). But even if it met that test, it would be expressly excluded from current assets (17 CFR 1.17(d)(2)(x)) because it was an "unsecured" loan to an officer of the registrant. These matters will be discussed *seriatim.*

The $ 2,000 loan was not a separate item but, rather, it was part of Mr. Economou's much larger personal drawing account. It was recorded on the general ledger of the respondent corporation as "ANE Drawings" or "Personal Drawings" (Tr. 23).

Mr. Economou testified (Tr. 402, 456-457, 465-467, 470-473, 513-516, 541-542) that he had a continuous arrangement with the respondent corporation under which advances were made to him and he continuously made payments on the account, leaving a $ 2,000 portion at all times secured (Tr. 465-467). He explained (Tr. 465-466, 513-515):

A * * * It can be said that any money I paid back to Arthur N. Economou [& Co., Inc.] over a period of the year, any month, could have been used to pay off that specific loan.

We didn't do it that way. We simply reduced the general debt or applied any money I paid back to the amount in general, but simply kept a portion of it secured by the GTO collateral. We felt that that would eliminate the need of cancelling a note out from time to time and replacing it with a new one and it would save considerable bookkeeping work attached to maintaining it in accordance with the rules under 1.17.

* * *

Q You stated on your direct testimony that that particular note was paid in April of 1969?

A Yes, sir.

Q But it continues to show, or an obligation continues to show in financial reports which you submitted to the CEA subsequent to that date ?

A Yes.

Q I am not quite sure I understand how this can be. Was there another note?

A No. First of all, the note was a demand note, so it is open-ended, so to speak.

Q You said you paid the note. Then there appears another obligation in the subsequent report, so there must have been another note, is that right?

A No, you do not understand the specific arrangement.

Q I do not.

A Let me put it this way: I paid three thousand dollars in April, sir, on my account. That note conceivably could have been indicated as paid and a new debt structured into that particular picture. In other words, two thousand dollars was at all times secured on a continuous basis.

Q Then the note wasn't paid? You paid another three thousand dollars, but not that two thousand dollars, is that right?

A No, no, I paid three thousand dollars into my account. It could have been considered that note. That note could have been automatically renewed at that particular point, since it was an open-ended note, so to speak. It was a demand note, Mr. Davis. Instead of simply --

Q But you didn't pay it?

A I paid three thousand dollars into my account. Did that pay the note? I would say it did.

Q I am asking you.

A Yes, that note could be considered as having been paid.

Q Was it?

A It all depends on how you want to look at it.

Q No, sir, it does not. It depends on whether or not it was paid.

A A portion of my debt was paid. That could be considered as automatically a new two thousand dollars. We could consider on our books a new section of the debt that I owed to the corporation was secured at that point.

Mr. Edward F. Fitzpatrick, an auditor for the Commodity Exchange Authority (Tr. 4-5), and Mr. Kirchhoff, Deputy Director, Registration and Audit Division, Commodity Exchange Authority (Tr. 126), expressed the opinion that the loan was not a "current asset" because, *inter alia,* there was no indication that the advances to Mr. Economou were to be repaid during the next 12 months (Tr. 17-25, 46-53, 94-95, 135-137; Comp. Ex. 3, p. 2; Comp. Ex. 9, p. 2; Comp. Ex. 10, p. 2).

In these circumstances, it is clear that Mr. Economou's "loan" was not part of the respondent corporation's assets "which are reasonably expected to be realized in cash * * * during the next 12 months * * * and which are available for and intended for payment of current liabilities" (17 CFR 1.17(d)(2)). Mr. Economou's testimony (Tr. 402, 456-457, 465-467, 470-473, 513-516, 541-542) shows that the $ 2,000 claimed as a secured loan was part of Mr. Economou's much larger obligation resulting from his personal drawing account, and although he continuously made payments into his account, he continuously drew money from the account, so his payments on the loan did not give the respondent corporation money that was "available for and intended for payment of current liabilities." n4

n4. The fact that the loan allegedly secured by Mr. Economou's car was reduced from $ 2,000 to $ 1,000 is not inconsistent with this conclusion. The reduction did not occur because of payments made against the loan or drawing account; it occurred because the value of the car was decreasing. The respondents had a $ 500 "cushion" between the claimed value of the car and the amount of the loan allegedly secured by the car. When the respondents valued the car at $ 2,500, they claimed $ 2,000 as a secured loan; when the respondents valued the car at $ 1,500, they claimed $ 1,000 as a secured loan.

The Hearing Examiner may have concluded that there was no evidence that the loan to Mr. Economou would be "reasonably expected to be realized in cash * * * during the next twelve months" solely because he found that there was no written note (Recommended Decision, pp. 8, 15). If so, I do not agree that the lack of a note is conclusive. The regulations do not expressly require that loans to an officer of a registrant be in writing to qualify as "current assets" (17 CFR 1.17(d)(2)(x)). In another subsection of the same section of the regulations,

it is specifically provided that crop loans to farmers must be "evidenced by legally-enforceable written instruments in the possession of the registrant" to qualify as "current assets" (17 CFR 1.17(d)(2)(ii); see, also, 17 CFR 1.17(d)(4)). Hence it is inappropriate to read the requirement of a written instrument into other subsections of this section of the regulations where it does not appear. But, in any event, I agree with the Hearing Examiner's conclusion that the loan does not come within the definition of current assets in 17 CFR 1.17(d)(2).

Since the loan failed to meet the definition of "current assets" in 17 CFR 1.17(d)(2), it is not necessary to consider whether the loan was excluded from "current assets" by one of the specific exclusions. But even if the loan had met the foregoing definition of "current assets," it was an "unsecured" loan to an officer of the registrant, which is expressly excluded from "current assets" by 17 CFR 1.17(d)(2)(x).

Edward F. Fitzpatrick, an auditor for the Commodity Exchange Authority (Tr. 4-5), testified that he was instructed to investigate several current assets claimed by the respondents on the March 31, 1969, financial report, including the loan allegedly secured by Mr. Economou's car (Tr. 10-12). He testified that he visited Mr. Economou at the respondent corporation's office "seeking a note or some tangible evidence, something in writing which would indicate to me the date on which the note would be payable" (Tr. 17). He also testified that "I was seeking some written document whereby the automobile had been pledged to the corporation to secure the loan. I thought that this information may be included in

the document I have just referred to, or perhaps there might be a chattel mortgage or some such document which would legally pledge that automobile to the corporation" (Tr. 18). n4a

n4a. As previously stated, the lack of a written note would not be decisive, but the evidence as to the absence of a note is tied in with the evidence as to the lack of a written security agreement.

Mr. Fitzpatrick testified that he was not shown any written evidence of the loan or of any security agreement (Tr. 17-25, 94-95, 114-118; see, also, Comp. Ex. 3, p. 2, and Tr. 46-53), but that Mr. Economou showed him an automobile registration "evidencing the fact that such an automobile did exist and it was registered in New York State under his name" (Tr. 18). When Mr. Fitzpatrick told Mr. Economou that it would be very difficult for him to accept the $ 2,000 as a secured loan, without written documentation, Mr. Economou "became heated" and said, "If I tell you that the automobile is pledged to the corporation, then that is so. * * * Don't you understand? I am the corporation. I am Arthur N. Economou & Company. If I say the automobile is pledged to the corporation, it's so" (Tr. 22).

Mr. Fitzpatrick testified that the respondents' Certified Public Accountant, Mr. Radcliffe, explained that the loan was part of a larger personal drawing account of Mr. Economou's, and in Mr. Fitzpatrick's presence, Mr. Radcliffe wrote on the account the words, "Secured to the extent of $ 2,000 by automobile," or "ANE's automobile" (Tr. 23-24). n4b

n4b. This was insufficient to create a valid security interest since it was not *signed* by Mr. Economou, see *infra,* pp. 39-40.

Mr. Fitzpatrick and Mr. Kirchhoff, Deputy Director, Registration and Audit Division, Commodity Exchange Authority (Tr. 126), expressed the opinion that the loan was not a "current asset" because, *inter alia,* the amount was unsecured (Tr. 17-25, 46-53, 94-95, 135-137; Comp. Ex. 3, p. 2; Comp. Ex. 9, p. 2; Comp. Ex. 10, p. 2).

Mr. Economou testified that the arrangement was reflected in a written demand note and in a written security agreement pledging his automobile as payment for $ 2,000 of the loan. He admitted that he did not show Mr. Fitzpatrick a copy of the demand note or the security agreement, stating that Mr. Fitzpatrick did not ask to see them (Tr. 513-516).

Mr. Economou explained that he had a great deal of difficulty working with Mr. Fitzpatrick because they did not understand

each other (Tr. 418, 427-431, 446-447, 542), and he admitted that part of the misunderstanding was because Mr. Fitzpatrick was concentrating on whether the items were properly documented (Tr. 427-430, 446-447), whereas Mr. Economou was concentrating on "various ideas or concepts" or "preliminary sketches" (Tr. 429). This supports Mr. Fitzpatrick's testimony that he asked to see the written documents and was not shown them.

Other circumstances also support the Hearing Examiner's finding that the loan to Mr. Economou was not supported by a written note or security agreement.

Mr. Economou admitted on cross-examination that he did not have the documents finalized at the time of Mr. Fitzpatrick's visit, but he said that the documents were later finalized (Tr. 402, 456-457, 465-467, 470-473, 513-516, 541-542). However, he failed to produce them at the hearing despite notice that they were regarded as important.

Mr. Economou was advised by Mr. Fitzpatrick in the spring of 1969 that documentation of the various loans and agreements was required for the assets to be regarded as "current assets" (Tr. 17-30, 94-95, 114-118, 402-403, 427-430, 446-447, 450-459, 465-468, 470-473, 513-517, 541-543). Mr. Fitzpatrick's testimony that he looked for and was not shown a copy of a note or security agreement with respect to the loan to Mr. Economou was given on the first day of the hearing, Wednesday, August 5, 1970. On Friday, August 7, 1970, Mr. Economou attempted to read into the record drafts of various written documents prepared by his attorney but they were excluded on the ground that they were not finalized (Tr. 442-444). The Hearing Examiner told Mr. Economou to put the finalized documents into evidence, stating (Tr. 445):

THE WITNESS: In order for us to have legal instruments, we have to start somewhere.

THE REFEREE: No, you don't have to start; you have to have them.

THE WITNESS: I have them. I am leading up to it.

THE REFEREE: If you have them, bring them out and put them into evidence, if there is no objection. Don't tell us how you prepared them.

THE WITNESS: Supposing they are scattered in corporate records?

THE REFEREE: That's too bad. You have had time to produce them for a long time.

THE WITNESS: We were not asked to produce them.

THE REFEREE: You are saying you want to produce them.

THE WITNESS: We do.

However, on Monday, August 10, 1970, the last day of the hearing, Mr. Economou produced only one finalized document, relating to one of the other issues in the case (Resp. Ex. 1; Tr. 489-491). This gives rise to the strong inference that there was no finalized written documents in existence supporting the respondents' contentions as to the note or security agreement involved in the loan to Mr. Economou. See Wigmore, *Evidence,* (3rd ed. 1940), §§ 285-291; *United States* v. *Di RE,* 332 U.S. 581, 593; *Interstate Circuit* v. *United States,*

306 U.S. 208, 225-227; *Vajtauer* v. *Comm'r of Immigration,* 273 U.S. 103, 111; *Bilokumsky* v. *Tod,* 263 U.S. 149, 153-155; *Kirby* v. *Tallmadge,* 160 U.S. 379, 383; *International Union* v. *N.L.R.B.,* 455 F.2d 1357, 1362-1370 (C.A.D.C.); *Hoffman* v. *C. I. R.,* 298 F.2d 784, 788 (C.A. 3); *Neidhoefer* v. *Automobile Ins. Co. of Hartford, Conn.,* 182 F.2d 269, 270-271 (C.A. 7); *Mid-Continent Petroleum Corporation* v. *Keen,* 157 F.2d 310, 315 (C.A. 8); *Bowles* v. *Lentin,* 151 F.2d 615, 619 (C.A. 7), certiorari denied, 327 U.S. 805; *Longini Shoe Mfg. Co.* v. *Ratcliff,* 108 F.2d 253, 256-257 (C.C.P.A.); *National Labor Relations Board* v. *Remington Rand, Inc.,* 94 F.2d 862, 867-868 (C.A. 2), certiorari denied, 304 U.S. 576. See, also, *In re Sy B. Gaiber & Co.,* 31 Agriculture Decisions 474, 499.

"It is certainly a maxim that all evidence is to be weighed according to the proof which it was in the power of one side to have produced and in the power of the other to have contradicted." Lord Mansfield, in *Blatch* v. *Archer,* Cowp. 66, quoted with approval in Wigmore, *Evidence* (3rd ed. 1940), § 285.

The Hearing Examiner, who saw and heard the witnesses testify, did not believe Mr. Economou's testimony that the loan was reflected by a written note or security agreement. The weight to be given to a Hearing Examiner's findings reaches its maximum when it turns on credibility (see *Fairbank* v. *Hardin,* 429 F.2d 264, 268 (C.A. 9); *NLRB* v. *Majestic Weaving Co.,* 355 F.2d 854, 859 (C.A. 2); *Cella* v. *United States,* 208 F.2d 783, 788 (C.A. 7), certiorari denied, 347 U.S. 1016; *National Labor Relations Board* v. *Swinerton,* 202 F.2d 511, 514 (C.A. 9), certiorari denied, 346 U.S. 814; *National Labor Relations Board* v. *Dinion Coil Co.,* 201 F.2d 484, 490 (C.A. 2)). A review of the entire record compels me to reach the same conclusion as that of the Hearing Examiner.

The respondents argue that there was no investigation made to determine that a note or security agreement was not in existence after Mr. Fitzpatrick's investigation in the spring of 1969. The complainant relies on the doctrine that a "fact, once shown to exist, is presumed to continue until the contrary is proven." *Humble Oil and Refining Co.* v. *Sun Oil Co.,* 191 F.2d 705, 715 (C.A. 5). See, also, *Allstate Finance Corp.* v. *Zimmerman,* 330 F.2d 740, 744 (C.A. 5); *Falconi* v. *Federal Deposit Insurance Corp.,* 257 F.2d 287, 291 (C.A. 3); *Baltimore and Ohio R. Co.* v. *Felgenhauer,* 168 F.2d 12, 17 (C.A. 8); *Mount Vernon Hotel Co.* v. *Block,* 157 F.2d 637, 639 (C.A. 9).

The foregoing presumption relied on by the complainant is sufficient, in this respect. But of even greater weight is the inference drawn from the failure of the respondents to produce the alleged documents at the hearing. The combined weight of this presumption and inference would compel a finding, even without giving any weight to the Hearing Examiner's determination as to the credibility of the witnesses, that as of each of the relevant dates, there were no written documents in existence supporting the respondents' contentions.

As we shall show, since there was no written security agreement, and since there was no transfer of possession of the car to the respondent corporation, the loan to Mr. Economou was an unsecured loan.

The term "unsecured" is is not defined in the regulations. In the absence of a definition, it is presumed that the word is used in its ordinary signification. *Miller* v. *Robertson,* 266 U.S. 243, 250; *Old Colony R. Co.* v. *Commissioner,* 284 U.S. 552, 560; *United States* v. *Stewart,* 311 U.S. 60, 63; *Jones* v. *Liberty Glass Co.,* 332 U.S. 524, 531; *Bruhn's Freezer Meats* v. *U. S. Department of Agriculture,* 438 F.2d 1332, 1338 (C.A. 8); *Volkart Brothers, Inc.* v. *Freeman,* 311 F.2d 52, 58 (C.A. 5).

The meaning of "unsecured" is determined by federal law since federal law governs where a federal statute or interest is involved. n5

In determining "the applicable federal rule we have occasionally selected state law." *Clearfield Trust Co.* v. *United States,* 318 U.S. 363, 367. It would seem that in determining whether a loan or receivable is secured, state law should be selected as the appropriate source of federal law. Unless the relevant state law recognizes that certain property is subject to a security interest, it would serve no purpose to regard a loan or receivable as "secured" by such property under federal law.

n5. *South Buffalo R. Co.* v. *Ahern,* 344 U.S. 367, 372; *Dice* v. *Akron. C. & Y. R. Co.,* 342 U.S. 359, 361-362; *United States* v. *Standard Oil Co. of Calif.,* 332 U.S. 301, 305; *Labor Board* v. *Hearst Publications, Inc.,* 322 U.S. 111, 123; *Brady* v. *Southern Ry. Co.,* 320 U.S. 476, 479; *Illinois Steel Company* v. *B. & O. R. Co.,* 320 U.S. 508, 510-511; *Clearfield Trust Co.* v. *United States,* 318 U.S. 363, 366-367; *Sola Electric Co.* v. *Jefferson Electric Co.,* 317 U.S. 173, 17; *Prudence Corp.* v. *Geist,* 316 U.S. 89, 95; *D'oench, Duhme & Co., Inc.* v. *F.D.I.C.,* 315 U.S. 447, 453-462. See, also, *United States* v. *Hext,* 444 F.2d 804, 807-809 (C.A. 5).

Moreover, if we were to fashion the applicable federal law without resorting to state law, we would be guided by the Uniform Commercial Code. *United States* v. *Hext,* 444 F.2d 804, 809-810 (C.A. 5); *United States* v. *Wegematic Corporation,* 360 F.2d 674, 676 (C.A. 2). The transactions at issue in this case occurred in New York, which has adopted the Uniform Commercial Code -- Secured Transactions. Hence the Uniform Commercial Code -- Secured Transactions, is unquestionably the appropriate source to determine whether the $ 2,000 loan was "secured" by Mr. Economou's car.

As we shall show, a loan or advance is secured, within the meaning of the regulations, if the creditor is a "secured party" under the Uniform Commercial Code -- Secured Transactions. Under the Uniform Code, a party is a "secured party" (i) if he has the collateral in his possession, or (ii) if he has a signed security agreement. There is no requirement under the regulations that the secured party have a "perfected" security interest, which is created under the Uniform Code (i) by having possession of the collateral, or (ii) by filing in the appropriate office a financing statement.

Under the Uniform Commercial Code -- Secured Transactions, a "Secured party" is a "lender, seller or other person in whose favor there is a security interest" in collateral. n6 "'Collateral' means the property subject to a security interest * * *." n7

n6. *McKinney's Consolidated Laws of New York, Annotated,* Book 62-1/2, Part 3, Uniform Commercial Code, § 9-105(i).

n7. *Id.,* § 9-105(c).

A "security interest" is not enforceable against the debtor or third parties unless: n8

(a) the collateral is in the possession of the secured party; or

(b) the debtor has signed a security agreement which contains a description of the collateral and in addition, when the security interest covers crops or oil, gas or minerals to be extracted or timber to be cut, a description of the land concerned. In describing collateral, the word "proceeds" is sufficient without further description to cover proceeds of any character.

n8. *Id.,* § 9-203(1).

Hence a valid "security interest" may be created either by a signed security agreement or by the secured party's possession of the collateral. n9 This is explained in the Official Comment to the Uniform Commercial Code -- Secured Transactions, as follows: n10

3. One purpose of the formal requisites stated in subsection (1)(b) is evidentiary. The requirement of written record minimizes the possibility of future dispute as to the terms of a security agreement and as to what property stands as collateral for the obligation secured. Where the collateral is in the possession of the secured party, the evidentiary need for a written record is much less than where the collateral is in the debtor's possession; customarily, of course, as a matter of business practice the written record will be kept, but, in this Article as at common law, the writing is not a formal requisite. Subsection (1)(a), therefore, dispenses with the written agreement -- and thus with signature and description -- if the collateral is in the secured party's possession.

n9. The creation of a security interest by delivering pledged property to the lender dates back to the days of Moses. See Deuteronomy 24:10-11.

n10 *McKinney's Consolidated Laws of New York, Annotated,* Book 62-1/2, Part 3, Uniform Commercial Code, Official Comment to § 9-203, paragraph 3, p. 396.

The complainant contends that in order to have a secured loan or receivable under the regulations there must not only be an enforceable "security interest," but the security interest must be "perfected." With certain exceptions, a "financing statement" must be filed in the appropriate office to "perfect" a security interest. n11

A "financing statement" is a document which must be signed by the debtor and the secured party, give the address of the debtor and secured party, and contain a statement indicating the types, or describing the items, of collateral. n12

n11. *McKinney's Consolidated Laws of New York, Annotated,* Book 62-1/2, Part 3, Uniform Commercial Code, §§ 9-302(1); 9-303; 9-401.

n12. *Id.,* § 9-402(1).

One of the exceptions to the requirement of filing a financing statement in order to perfect a security interest arises if the collateral is "in possession of the secured party * * *." n13 That is, possession of the collateral by the secured party "perfects" a security interest just the same as filing. This is explained in the Official Comment to the Uniform Commercial Code -- Secured Transactions, as follows: n14

As under the common law of pledge, no filing is required by this Article to perfect a security interest where the secured party has possession of the collateral.

* * *

Possession may be by the secured party himself or by an agent on his behalf: it is of course clear, however, that the debtor or a person controlled by him cannot qualify as such an agent for the secured party.

n13. *Id.,* §§ 9-302(1)(a); 9-305.

n14. *Id.,* Official Comment to § 9-305, paragraphs 1 and 2, p. 476.

In this case, since there was no signed security agreement in existence with respect to Mr. Economou's automobile, no valid security interest was created unless the collateral was in the possession of the secured party. But if the collateral was in the possession of the secured party, the security interest was not only valid, but it was also "perfected." Hence under the facts of this case, it would not be possible for the respondent corporation to have an unperfected security interest in Mr. Economou's car.

But in other cases, there may be a valid security interest created by a signed security agreement, with no steps taken to perfect the security interest by filing. Although the issue is not presented here, it would seem that such an unperfected security interest would be sufficient under the regulations.

The regulations use the word "unsecured" without defining the term. An unperfected security interest is a valid security interest,

even though it is inferior to perfected security interests. The Practice Commentary on the Uniform Code -- Secured Transactions, states: n15

(3) This article nowhere says plainly that an unperfected security interest is invalid against or inferior to any perfected security interest. Subsec. (1)(a) of this section does say that the unperfected security interest is subordinate to persons entitled to priority under U.C.C. § 9-312, which sets forth or absorbs by cross-reference a number of rules of priority. Fortunately, it can be deduced from U.C.C. § 9-312 (5) that a perfected security interest outranks one which is not yet perfected.

n15. *McKinney's Consolidated Laws of New York, Annotated,* Book 62-1/2, Part 3, Practice Commentary to § 9-301, p. 428.

Even though an unperfected security interest is inferior to a perfected security interest, a person having an unperfected security interest is still a "secured party" under the Uniform Commercial Code -- Secured Transactions (§ 9-105(i)), and I would not hold that a person has an "unsecured loan" within the meaning of the regulations, when he is a "secured party," under the Uniform Commercial Code -- Secured Transactions, as to the same loan, in the absence of an express requirement in the regulations that there must be a perfected security interest. *Cf., In re American Fruit Purveyor's Inc.,* 30 Agriculture Decisions 1542, 1561.

At this point, it is appropriate to restate the rule that general expressions in any opinion are to be limited to the facts involved in the particular case (*Osaka Shosen Line* v. *United States,* 300 U.S. 98, 102-104; *Humphrey's Executor* v. *United States,* 295 U.S. 602, 626-627; *Cohens* v. *Virginia,* 6 Wheat, 264, 399). The legal principles as to secured transactions very depending on the particular circumstances involved.

For example, with respect to a security interest in motor vehicles which are not "inventory held for sale," the Uniform Commercial Code -- Secured Transactions, provides that the filing provisions do not apply if the State statute requires a certificate of title and "a notation of such a security interest can be indicated by a public official on a certificate or a duplicate thereof." n16 However, New York does not have such a title notation system, n17 and,

therefore, this provision is irrelevant in this case. Hence, in the case of a motor vehicle in New York, a security interest is perfected either by filing or by transferring possession to the creditor.

n16. *McKinney's Consolidated Laws of New York, Annotated,* Book 62- 1/2, Part 3, § 9-302-(3)(b).

n17. *Id.,* Practice Commentary to § 9-302, paragraph 11, p. 456; *Seely v. First National Bank & Trust, Boynton Beach, Florida,* 64 N.Y. Mis. Rep.2d 845; 315 N.Y. S.2d 374, 376, 378.

Turning now to the question as to whether third persons had notice that the car was pledged or whether the respondent corporation had possession of the collateral (the car) which would give it a valid security interest, it has been

recognized that "'possession' is 'not a self-expounding term." *Sweetnam* v. *Edmund Wright Ginsberg Corporation,* 128 F.2d 1, 2 (C.A. 2), certiorari denied, 317 U.S. 647. Whether enough has been done to transfer possession is frequently "a question of more or less." Mr. Justice Holmes, in *Sexton* v. *Kessler,* 225 U.S. 90, 98.

The "real purpose of requiring possession" is to give "notice to third parties that property apparently owned by the debtor is subject to a security interest." *Sweetnam* v. *Edmund Wright Ginsberg Corporation,* 128 F.2d 1, 2 (C.A. 2), certiorari denied, 317 U.S. 647; see, also, *Gins* v. *Mauser Plumbing Supply Co.,* 148 F.2d 974, 977 (C.A. 2). "The crucial question is how well * * * [the respondents] signified to the world what property was and what property was not pledged." *Sweetnam* v. *Edmund Wright Ginsberg Corporation,* 128 F.2d 1, 2 (C.A. 2), certiorari denied, 317 U.S. 647. The transfer to the creditor "should be all that the situation permits of at the time to remove the property from the ostensible ownership of the pledgor" (*Gins* v. *Mauser Plumbing Supply Co.,* 148 F.2d 974, 977 (C.A. 2)). See, also, *T. A. Gaskin Lumber Company* v. *Airline Lumber Company, Inc.,* 127 F.Supp. 461, 462-463 (E.D. La.).

Situations analogous to the present case occur where a creditor loans money to a firm and the creditor wants to leave the borrower in control of the pledged merchandise for processing or other business reasons, but the creditor wants to retain legal possession under the common law of pledge. In such situations, the courts will look at all of the circumstances, such as the size and location of signs denoting the creditor's interest in the collateral, in order to determine whether reasonable measures have been taken to place third persons on notice of the creditor's interest in the collateral. *Sweetnam* v. *Edmund Wright Ginsberg Corporation,* 128 F.2d 1, 2-3 (C.A. 2), certiorari denied, 317 U.S. 647; *In re Merz,* 37 F.2d 1, 1-3 (C.A. 2), certiorari denied, 281 U.S. 738; *In re North American Builders, Inc.,* 320 F.Supp. 1229, 1232 (D. Neb.); *Kirst* v. *Buffalo Cold Storage Co.,* 36 F.Supp. 401, 402-403 (W.D.

N.Y.). See, also, "Security Interests Under Pledge Agreements," 51 *Yale L.J.* (1942) 431, 431-438.

The Uniform Commercial Code -- Secured Transactions, provides that a security interest is not invalid merely because the debtor has the right to use the collateral, but this "does not relax the requirements of possession where perfection of a security interest depends upon possession of the collateral by the secured party or by a bailee." *McKinney's Consolidated Laws of New York, Annotated,* Book 62-1/2, Part 3, § 9-205. Specifically, the Code provides (*ibid.*):

A security interest is not invalid or fraudulent against creditors by reason of liberty in the debtor to use, commingle or dispose of all or part of the collateral (including returned or repossessed goods) or to collect or compromise accounts, contract rights or chattel paper, or to accept the return of goods or make repossessions, or to use, commingle or dispose of proceeds, or by reason of the failure of the secured party to require the debtor to account for proceeds or replace collateral. This section does not relax the requirements of possession where perfection of a security interest depends upon possession of the collateral by the secured party or by a bailee.

The Official Comment as to this section states (*McKinney's Consolidated Laws of New York, Annotated,* Book 62- 1/2, Part 3, Official Comment to § 9-205, p. 413):

6. The last sentence is added to make clear that the Section does not mean that the holder of an unfiled security interest, whose perfection depends on possession of the collateral by the secured party or by a bailee (such as a field warehouseman), can allow the debtor access to and control over the goods without thereby losing his perfected interest. The common law rules on the degree and extent of possession which are necessary to perfect a pledge interest

or to constitute a valid field warehouse are not relaxed by this or any other section of this Article.

Similarly, although this section of the regulations does not specifically refer to those instances where possession is necessary to create a valid security interest (*i.e.,* it refers to possession necessary for "perfection" of a security interest), it is obvious that this section of the regulations does not relax the requirements of possession needed to create a valid security interest where there is no signed security agreement (§ 9-203).

In the present case, the record is devoid of evidence that anything was done to transfer possession of the car or to indicate to third persons that the car was pledged to the corporation. Although the complainant has the burden of proving that the loan was unsecured, it established a prima facie case by Mr. Fitzpatrick's testimony that he asked for and was not shown any evidence of a security agreement, and that he advised Mr. Economou that it would be very difficult for him to accept the loan as a secured loan (Tr. 18, 22).

The inference is inescapable that Mr. Economou continued to use his car. If he had transferred possession of the car to the corporation, or done anything to indicate to third persons that the car was pledged, he would have said so when Mr. Fitzpatrick challenged the item. Moreover, he made no claim in this respect at the hearing. He relied, instead, on a written security agreement, which the Hearing Examiner and I have concluded was nonexistent. Hence the inference is inescapable that nothing was done to transfer possession of the car or to indicate to third persons that the car was pledged to the corporation. The loan was, therefore, specifically excluded from "current assets" because it was an unsecured loan to an officer of the registrant (17 CFR 1.17(d)(2)(x)).

III. *Respondent Corporation's Loan or Advance to The American Association of Commodity Traders*

As of each of the relevant dates involved in this case (see Finding of Fact 6(a)), the respondent corporation considered as a "current asset" under the heading "secured receivables due within 12 months" an amount ranging from $ 9,626.81 to $ 3,327.31 due from The American Association of Commodity Traders which the respondents contend was secured by an inventory of Association publications.

The Hearing Examiner found (Recommended Decision, pp. 8-9, 15) that the item was not a "current asset" because it was an unsecured loan to a business affiliate under common control with the registrant, which is specifically excluded as a current asset by the regulations (17 CFR 1.17(d)(2)(v)).

The respondent Arthur N. Economou is the President and founder of The American Association of Commodity Traders, a non-profit educational organization of about 1,200 members, and he is Editor of its publication, "The Journal of Commodity Trading"

(Affidavit attached to Answer to Amended Complaint, p. 8). His wife is the Secretary-Treasurer of the Association and Associate Editor of its publication (Comp. Ex. 2, p. 3).

Before the minimum financial requirements were imposed by the Commodity Exchange Authority, the expenses of the Association were taken by the respondent corporation as its own expenses, but in the financial report as of March 31, 1969, the respondent corporation showed an amount due from the Association of $ 9,626.81 (Tr. 25-26, 517-518). Mr. Fitzpatrick testified that Mr. Economou told him that this represented editorial expenses of $ 5,000 rent $ 900, supplies $ 300, maintenance $ 100, ticker expenses $ 300, telephone expense $ 100, travel expense $ 100, salaries to outside persons $ 1,600, and $ 1,226.81 in additional, unspecified expenses (Tr. 26). Mr. Economou testified that the

"major portion of the charge was in the form of a management fee which we made to the Association" (Tr. 458-459). Presumably, Mr. Economou was referring to the $ 5,000 "editorial expense," although the record is not clear in this respect.

The expenses were not current operating expenses. They had been incurred during previous fiscal periods (Tr. 26).

If any portion of such expenses had not been *paid* by the respondent corporation on behalf of the Association, but, on the other hand, represented an obligation owed to the respondent corporation, *e.g.,* for services rendered and no payment made therefor, the item would not have been a loan or advance, and we would have to consider whether the item was excluded from "current assets" as an unsecured receivable not due and collectable within six months from its inception (17 CFR 1.17(d)(2) (iii)). In such circumstances, it is likely that that exception would have excluded the item from "current assets." But the evidence adequately supports the Hearing Examiner's finding and conclusion that the term was a "loan," *i.e.,* that money was actually paid to or on behalf of the Association, and that it was an unsecured loan to a business affiliate under common control with the registrant.

Mr. Fitzpatrick testified that he "determined that the account represented expenses of the American Association of Commodity Traders which were *paid* by the Economou Corporation" (emphasis supplied; Tr. 25; see, also, Comp. Ex. 3, p. 2; Tr. 46-53; Comp. Ex. 9, pp. 2-3; Comp. Ex. 10, p. 12; Tr. 135-137). Mr. Economou

testified that about $ 7,000 was paid on the account during the last year and that "[w]e were delighted to have the money *back"* (emphasis supplied; Tr. 460; see, also, Tr. 519). Mr. Economou also testified that "this amount [*i.e.,* $ 9,626.81] was secured and is specifically included as a current asset by section 1.17(d)(2)(v) of the CEA regulations" (Tr. 459; see, also, Tr. 468). The section cited by Mr. Economou, 1.17(d)(2)(v), is relevant only if the item represented a loan or advance. Mr. Economou referred to the item as a "loan" on seven occasions (Tr. 457, 468 (five times), 469), but at times he corrected himself to say that it was an account receivable (Tr. 457, 459, 468). However, his "correction" of terminology is not the equivalent of a denial that the item was a loan. Under the respondents' theory, even though an item is a loan or advance, if it is carried on the respondent corporation's books as a "receivable," the complainant is not justified in treating the item as a loan or advance without notifying the respondents in advance of the hearing.

Perhaps of greatest weight is the fact that the respondent corporation lists the amount due from the Association on its balance sheet under the heading "Loans and Advances, Secured" (Answer to Amended Complaint, p. 4).

Prior to the oral argument, question la was sent to the parties on May 18, 1972, for discussion during the oral argument. It was designed to explore the possibility of whether some of the expenses were not actually paid by the respondent corporation and, therefore, were not loans or advances. But Mr. Economou refused to discuss that question during the oral argument (Oral Arg. pp. 189-191, 195-201).

It is concluded that the record abundantly supports the Hearing Examiner's finding and conclusion that this item was a "loan" or advance to a business affiliate under common control with the respondent corporation.

The evidence with respect to whether the loan or advance was secured by the Association's publications (Tr. 28-30, 34, 402-403, 427-430, 446-447, 450-459, 465-468, 470-473, 513-517, 541-542) is similar to the evidence relating to Mr. Economou's car. For the same reasons set forth above as to that issue, I agree with the Hearing Examiner's finding and conclusion that the loan was unsecured.

Accordingly, the item was not a "current asset" because it was an unsecured loan or advance to a business affiliate under common control with the registrant. 17 CFR 1.17(d)(2)(v).

Since the Hearing Examiner based his decision solely on this ground, which is supported by the record, I will not resolve the issue as to whether this item also fails to meet the general definition of a "current asset," *i.e.,* whether it was reasonably expected to be realized in cash during the next 12 months.

IV. *Respondent Corporation's Costs of Organizing The Economou Precious Metals Futures Trading Syndicate and The Economou Grain Futures Trading Syndicate (Cost of Contract Acquisitions); Analysis of "Current Assets" Regulations*

The respondents contend that the financial requirement regulation are "so abstrusely and amorphously written as to readily lend themselves to myriad varying and conflicting interpretations and thus constitute deprivation of due process" (Respondents' Suggested Findings and Brief, p. 22). The respondents contend that "[a]ll subsections and subparagraphs of the definitions of 'current assets,' "current liabilities' and 'satisfactory subordinate agreement' are involved in this proceeding, either directly, indirectly or for analysis and comparison purposes" (Respondents' Suggested Findings and Brief, p. 22). In view of this argument by the respondents, all of the regulations relating to minimum financial requirements (17 CFR 1.17) will be analyzed.

An understanding of the entire regulatory program as to minimum financial requirements will also facilitate an understanding of the remaining two accounting issues presented in this case. One of the accounting issues involves "current assets" and one involves "current liabilities." The remaining accounting issue involving "current assets" will be discussed in this section of the Decision (IV) together with the analysis of the regulations involving "current assets," and the accounting issue involving "current liabilities" will be discussed in the next section of this Decision (V) together with the analysis of the regulations involving "current liabilities."

A. Organizational Costs of the Trading Syndicates (Cost of Contract Acquisitions)

As of each of the relevant dates involved in this case (see Finding of Fact 7), the respondent corporation considered as a "current asset," in amounts ranging from $ 6,016.80 to $ 9,304.97, the

cost of organizing The Economou Precious Metals Futures Trading Syndicate. The respondents considered this as a current asset because under the terms of the Partnership Agreement of the Trading Syndicate, the respondent corporation was to act as the exclusive broker for the Trading Syndicate, with the expectation of earning substantial brokerage commissions. The respondents' explanation as to this asset is set forth in the respondent corporation's financial report as of March 31, 1969, as follows (Comp. Ex. 1, last page):

We have listed as a current asset our equity, or "acquisition cost", in The Economou Precious Metals Futures Trading Syndicate in the amount of $ 6,016.80

This current asset represents our actual outlay or expenditure in helping to bring to fruition The Economou Precious Metals Futures Trading Syndicate, a mutual fund in the form of a Limited Partnership, filed with the Securities and Exchange Commission under the Securities Act if [*sic*] 1933 and approved by the SEC as of March 20, 1969. A copy of the actual effective Prospectus is attached for your files.

Under the terms of the Partnership Agreement, our Company, Arthur N. Economou & Co., Inc. will act as exclusive brokers for the Partnership and in view of the large amount of capital involved this arragement will result in substantial added revenue for our Company in the months directly ahead. It is anticipated that the Partnership will start trading on May 20, 1969.

The $ 6,016.80 is a modest sum compared to the actual value of this contract that we have with the Partnership and does not at all reflect the large amount of personal work put into the new concept by Arthur N. Economou over the past two years in developing this Partnership to the point where it was approved for distribution by the SEC.

In view of the above, we trust you will agree that we are justified in carrying the amount of $ 6,016.80 as a current asset in our financial statement as of March 31, 1969.

The Hearing Examiner found and concluded that this item was not a "current asset" because (1) there was no material, credible evidence that a contract existed between the respondent corporation and the Trading Syndicate providing for the respondent corporation to act as exclusive broker for the Trading Syndicate; (ii) the item was an unsecured loan to a business affiliate under

common control with the registrant which is excluded from "current assets" by § 1.17(d)(2)(v) of the regulations; (iii) even if there were a contract, the item would be an "intangible asset," which is not a "current asset;" (iv) if the item is a "deferred charge," as carried on the books of the respondent corporation, it is excluded as a current asset by § 1.17(d)(2)(ix) of the regulations; and (v) the evidence clearly shows that it could not be reasonably expected to be realized in cash during the next 12 months.

I disagree with the Examiner's first two conclusions, but agree with (iii), (iv), and (v).

The Economou Precious Metals Futures Trading Syndicate is a limited partnership (an open-ended type mutual fund) devoted exclusively to trading in platinum, palladium, and silver futures contracts. The public was invited to become limited partners upon payment of an initial offering price of $ 500 per unit. Once trading commenced, the offering price was the net asset value per unit (Comp. Ex. 13, p. 1, fn. 1). Mr. Economou was the promoter and only general partner of the Trading Syndicate. He had sole responsibility for the management of the Syndicate's affairs (Comp. Ex. 13, p. 10); he received an annual fee of 8% of the partnership's net asset value as a management fee and to cover expenses (Comp. Ex. 13, p. 1, fn. 4).

The Syndicate's Prospectus filed with the Securities and Exchange Commission states that in "respect of each unit of limited partnership interest purchased by the public, the Partnership will receive a contribution to its capital of 100% of the purchase price" (Comp. Ex. 13, p. 4), inasmuch as "Arthur N. Economou, the general partner and an original limited partner, has agreed to pay all of the offering and organization expenses of the Partnership, irrespective of whether any of the units offered hereunder are purchased" (Comp. Ex. 13, p. 1, fn. 4).

The Syndicate's Prospectus states that the respondent corporation "will at normal brokerage rates act as broker for the Partnership * * * for all of the Partnership's trades in precious metals futures" (Comp. Ex. 13, pp. 3-4; see, also, pp. 10, 14d). The limited partnership agreement executed on February 5, 1969, by Mr. Economou as General Partner and by the original limited partners, attached to the Trading Syndicate's Prospectus, specifically provides that "[e]ach limited partner hereby acknowledges and approves: that the general partner is the president of Arthur N.

Economou & Co., Inc. which will at normal brokerage rates act as broker for the Partnership in connection with the purchase and sale of platinum, palladium, and silver futures contracts" (Comp. Ex. 13, p. 14d, par. 22).

The Hearing Examiner's finding and conclusion that "there is no material, credible evidence that a contract existed" (Recommended Decision, p. 15) is not

properly supported by the evidence, considering the record as a whole. The complainant conceded at the oral argument that a valid contract (Resp. Ex. 1) was in existence (Oral Arg. pp. 304-309).

The respondents introduced a purported copy of an agreement dated February 25, 1969, signed by Mr. Economou as General Partner of the Trading Syndicate and signed again by Mr. Economou as President of the respondent corporation, providing that the Trading Syndicate will employ the respondent corporation as broker for all of the Syndicate's transactions (Resp. Ex. 1). Although Mr. Economou refused to show any contract (other than the Prospectus) to Mr. Fitzpatrick when he asked to see one in April of 1969 (Tr. 10-17, 36-37, 43-45, 86, 90-92), nonetheless the Syndicate's Prospectus dated March 20, 1969, clearly reveals that an agreement existed (Comp. Ex. 13, pp. 3-4, 10, 14d). There is no requirement in the regulations that such an agreement be in writing. Hence an oral agreement would suffice.

Moreover, the written Partnership Agreement executed February 5, 1969, by the General Partner and the Limited Partners of the Trading Syndicate states that the respondent corporation was to act as the broker for the Trading Syndicate (Comp. Ex. 13, p. 14d, par. 22). This would satisfy the requirement of a written agreement, even if there were such a requirement. Although the respondent corporation was not a party to that agreement, the respondent corporation provided the organizational costs of the Trading Syndicate, which were not to be repaid. The respondent corporation was a third party beneficiary under this legally-enforceable agreement. See *Corbin on Contracts* (1951), Vol. 4, § 782, p. 85; § 827, pp. 302-310; *In re Conay's Estate,* 121 N.Y.S. 2d 481, 483; *Fata* v. *S. A. Healy Co.,* 46 N.E. 2d 339, 340-342, 289 N.Y. 401; *McClare* v. *Massachusetts Bonding & Ins. Co.,* 195 N.E. 15, 15-18, 226 N.Y. 371; *Lewis* v. *Home Ins. Co.,* 181 N.Y.S. 839, 839-840, 110 Misc. Rep. 592; *Seaver* v. *Ransom,* 120 N.E. 639, 639-642, 224 N.Y. 233.

The record compels the conclusion that there was a contract existing between the two firms under which the respondent corporation was to be the exclusive broker for the Trading Syndicate.

The Hearing Examiner's finding and conclusion that this item was a "loan" is also not properly supported by the evidence, considering the record as a whole. The respondent corporation did not include this item on its financial reports under the heading "receivables" where loans would be listed (and where the loans previously discussed were listed). Instead, it was listed separately under the heading "Other current assets" (see, *e.g.,* Comp. Ex. 1, p. 1, item 15, and last page). In the supporting explanation for this item, the respondents made it plain that the item was not a loan to be repaid; it represented the "actual outlay or expenditure in helping to bring to fruition The Economou Precious Metals Futures Trading Syndicate," which resulted in an exclusive brokerage contract expected to yield substantial revenue (Comp. Ex. 1, last page). As shown above, the Trading Syndicate's Prospectus made it plain that there could be no repayment of such organizational costs, and the respondents' accountant advised Mr. Fitzpatrick that there could be no repayment of such organizational costs (Tr. 40).

To be sure, Mr. Economou at times inadvertently referred to the item as a "loan" or "debt" (Tr. 406, 460, 461, 471), and Mr. Fitzpatrick and Mr. Kirchhoff expressed the view that the "amount is unsecured and specifically excluded as a current asset by section 1.17(d)(2)(v) of the CEA regulations [which relates only to loans or advances to business affiliates]" (Comp. Ex. 3, pp. 2-3; Tr. 46-53; Comp. Exs. 9 and 10, p. 3; Tr. 135-137). But the weight of the evidence compels the conclusion that this item was not a loan. Hence I disagree with the Hearing Examiner's determination that the item was an unsecured loan excluded by § 1.17(d) (2) (v) of the regulations.

The Hearing Examiner's findings and conclusions (Recommended Decision, pp. 9-10, 15-16) that the item was not a "current asset" because it was not an asset or resource reasonably expected to be realized in cash during the next 12 months

(see 17 CFR 1.17(d)(2)), and that it was an "intangible asset" or a "deferred charge," neither of which is a "current asset," are supported by the testimony of Mr. Fitzpatrick (Tr. 35, 38-45, 97-98; Comp. Ex. 3, pp. 2-3; Tr. 46-53; see, also, Comp. Exs. 9 and 10, p. 3; Tr. 135-137). I agree with these findings and conclusions on the basis of Mr. Fitzpatrick's testimony.

The actual income received by the respondent corporation from the brokerage commissions paid by the Trading Syndicate was far below Mr. Economou's expectations. The Precious Metals Trading Syndicate item was included as a "current asset" beginning on March 31, 1969, in amounts varying from $ 6,016.80 to $ 9,304.97, but the brokerage commissions received by August of 1970 had only amounted to about $ 2,000 (Tr. 473; see, also, Tr. 405-406, 460-462). Similarly, The Economou Grain Futures Trading Syndicate item was included as a "current asset" in amounts ranging from $ 23.00 to $ 1,881.28, but by August of 1970 this Trading Syndicate had not yet been activated. Mr. Economou was still confident at the time of the hearing in August of 1970 that within a few months the Syndicate would become active (Tr. 471-474).

It is inferred that there was no reasonable basis for Mr. Economou's expectation, as of the relevant dates, that the brokerage commissions received in the next 12 months from hte newly created Trading Syndicates would equal the amount of the organizational costs. He did not have sufficient experience with these new ventures to form a reasonable opinion as to the brokerage that would be received. However, this inference is not essential to support the Hearing Examiner's conclusion. Even if there had been a reasonable basis for Mr. Economou's expectations, as of the relevant dates, that the exclusive brokerage contracts would result in income to the respondent corporation in the amount of the organizational costs, the organizational costs of the Trading Syndicates (acquisition cost of the contracts) would not be "assets or resources commonly identified as those which are reasonably expected to be realized in cash * * * during the next twelve months" (17 CFR 1.17(d)(2)) within the technical meaning of that phrase, as it is used in the regulations and in accounting terminology. This concept may be difficult to agree with in the absence of a detailed knowledge of accounting terminology and principles, but is demonstrated, *infra,* pp. 73-78, 89-90.

The conclusion that the organizational costs of the Trading Syndicates are not "current assets" is also supported by an inference adverse to the respondents drawn from the fact that Mr. Radcliffe, the respondents' Certified Public Accountant who spent five hours each week with the respondents (Tr. 395-396; Affidavit attached to Answer to Amended Complaint, p. 9), testified at the hearing in support of the respondents' position as to one of the issues involved in this case (Tr. 246-301) -- discussed *infra* in section V of this Decision -- but he was completely silent as to this

issue. The respondents did not ask him a single question as to this issue and, therefore, there was no cross-examination of Mr. Radcliffe as to this issue.

Mr. Fitzpatrick testified that he discussed this Trading Syndicate item with Mr. Economou and Mr. Radcliffe during his investigation (Tr. 37-44), and that no decision was reached by Mr. Economou and Mr. Radcliffe during that meeting as to how the item could be classified as a "current asset." Mr. Fitzpatrick testified that during the discussion with Mr. Economou and Mr. Radcliffe as to this item, Mr. Economou said that he thought the item would remain on the books forever, but Mr. Radcliffe explained that "if that was so, it woudn't be a current asset" (Tr. 41-42). Mr. Radcliffe further stated at the meeting that if the item was charged off against future income, it could be construed as a "deferred charge" (Tr. 42), which is excluded from "current assets" both under the regulations (17 CFR 1.17(d) (2) (ix)) and under general accounting principles (see *infra,* pp. 83, 88, 100).

In these circumstances, the failure of the respondents to have Mr. Radcliffe testify with respect to this matter gives rise to the strong inference that if he would have testified, his testimony would have been adverse to the respondents (see the authorities cited *supra,* pp. 36-37). n18

n18. Mr. Radcliffe was also completely silent at the hearing as to the issues discussed *supra* involving the loan to Mr. Economou allegedly secured by his car and the loan to The American Association of Commodity Traders allegedly secured by the Association's publications. Mr. Ratcliffe had previously participated in the discussion of these items with the complainant's accountants (Tr. 23-24, 31-33, 466), and his silence at the hearing as to those issues also gives rise to a presumption that his testimony would have been adverse to the respondents. However, the inference is not as strong as to those issues since they involved the question as to whether the items were secured, which is not primarily an accounting issue. But the issue as to whether the organizational costs of the Trading Syndicates were current assets is primarily an accounting issue.

Mr. Fitzpatrick's testimony that the item was an "intangible asset" or a "deferred charge," neither of which is a "current asset," is in accord with generally recognized accounting terminology and principles. This will be demonstrated in the following discussion analyzing the "current assets" regulations. Where relevant, particular comment will be made demonstrating that Mr. Fitzpatrick's testimony, in this respect, is sound.

The evidence (Tr. 134, 166, 471-474, 519-520; Comp. Ex. 12) and the Hearing Examiner's findings and conclusions as to The Economou Grain Futures Trading Syndicate (Recommended Decision, pp. 11, 16) reveal that this item is identical in nature to The Economou Precious Metals Futures Trading Syndicate except

that this Syndicate was to engage in trading in wheat, corn, rye and oats futures contracts. Hence this item should be excluded from "current assets" (see Finding of Fact 7) for the same reasons as discussed in connection with The Economou Precious Metals Futures Trading Syndicate.

B. The "Current Assets" Regulations

The financial requirement regulations are technical and complex. If one is to understand them, he must be familiar with futures trading, the records kept by futures commission merchants, and the basic principles of accounting. The futures commission merchants subject to the regulatory requirements have such knowledge or they obtain assistance, as needed, from persons with accounting experience. For example, the respondent, Mr. Economou, testified that a Certified Public Accountant, Mr. Radcliffe, "is in our office one full afternoon each week," and that "I depend upon him explicitly and implicitly for assistance in connection with our books" (Tr. 395-396).

Since this decision may be read or reviewed by persons who do not have a detailed knowledge of futures trading, records kept by futures commission merchants, and basic accounting principles, I will attempt to analyze the regulations in the light of sufficient background information to make the decision comprehensible to such persons.

BALANCE SHEETS AND WORKING CAPITAL

Balance Sheets

"The principal general-purpose accounting statements are the *balance sheet* and the *income statement."* n19

n19. Wixon, Kell, and Bedford, *Accountants' Handbook* (5th ed., 1970), § 2, p. 1.

"The balance sheet is essentially an exhibit of the basic accounting equation, which may be expressed as:

Assets = Liabilities + Shareholders' Equity." n20

n20. *Id.,* at § 2, p. 22.

"Assets" are subdivided into the following principal subdivisions: "current assets," "investments," "property, plant, and equipment," "intangibles," and "deferred charges and other assets." n21

n21. Wixon, Kell, and Bedford, *Accountants' Handbook* (5th ed., 1970), § 2, pp. 23-36.

"Liabilities" are subdivided into "current liabilities" and "long-term liabilities." n22

n22. *Id.,* at § 2, pp. 36-38.

Working Capital (Current Assets/Current Liabilities)

Of the foregoing categories, the financial regulations are concerned only with "current assets" and "current liabilities." The regulations define the term "working capital" as "the amount by which current assets exceed current liabilities" (17 CFR 1.17(d)(1)). Certain deductions are made from the "working capital" to give the "adjusted working capital" (17 CFR 1.17(d)(5)), and the regulations provide, with certain exceptions not relevant here, that "no person applying for registration as futures commission merchant shall be so registered unless he has adjusted working capital equal to or in excess of" a specified amount (17 CFR 1.17(a)). The Act provides that "each person so registered shall at all times continue to meet such prescribed minimum financial requirements" (7 U.S.C. § 6f(2)). n23

n23. The regulations also provide that "each person registered as futures commission merchant shall *at times* continue to meet such financial requirements" (emphasis supplied; 17 CFR 1.17(a)). The Notice of Proposed Rulemaking (33 F.R. 17632) and the document sent to the Federal Register to publish the final form of the rules included the word "all" between "at" and "times," but the word "all" was inadvertently omitted in the printing of the regulations in final form in the Federal Register (34 F.R. 599). This inadvertent omission is without consequence since the Act specifically requires the minimum financial requirements ot be met "at all times" (7 U.S.C. § 6f(2)). It is doubtful whether any futures commission merchant was aware of this omission inasmuch as the printed copies of the regulations distributed to the industry by the Commodity Exchange Authority contain the word "all." No issue in this respect has been presented by the respondents in this case.

The administrative concern with only a portion of a firm's financial condition, *i.e.,* the excess of its current assets over its current liabilities, or "working capital," is consonant with long standing accounting and business practices.

"Working capital * * * is represented by the excess of current assets over current liabilities and identifies the relatively liquid portion of total enterprise capital which constitutes a margin or

buffer for meeting obligations within the ordinary operating cycle of the business." n24

n24. American Institute of Certified Public Accountants, *Accounting Research and Terminology Bulletins* (Final ed., 1961), Accounting Research Bulletin No. 43, p. 20. In the field of accounting, unlike law, there is no "Supreme Court" to establish binding accounting principles (except insofar as governmental regulations control with respect to particular matters). One of the primary sources of authoritative pronouncements on accounting principles is the American Institute of Certified Public Accountants. Its 21-member Accounting Principles Board, established in 1959, is the sole group within the Institute having authority to make public pronouncements on accounting principles. Previously, the Institute had a Committee on Accounting Procedure which in 1953 revised, restated, or withdrew 42 prior bulletins and issued a new, superseding bulletin. Accounting Research Bulletin No. 43. When the Accounting Principles Board was established in 1959, it announced that Accounting Research Bulletin No. 43 and subsequent bulletins "should be considered as continuing in force" (see the Foreword to American Institute of Certified Public Accountants, *Accounting Research and Terminology Bulletins* (Final ed., 1961)). Accounting Research Bulletin No. 43 is cited throughout this Decision. Recently, the accounting profession has taken steps to organize an independent Financial Accounting Foundation, which will have a full time staff to make pronouncements on accounting principles.

"The working capital of a borrower has always been of prime interest to grantors of credit; and bond indentures, credit agreements, and preferred stock agreements commonly contain provisions restricting corporate actions which would effect a reduction or impairment of working capital." n25

The current classification as a description of operations has long been established in governmental fund accounting. The current assets and current liabilities are often set up as a separate fund, either in the accounts or in the statements or in both. * * *

* * *

The use of the concept of working capital as a partial description of enterprise operations is reflected in the practice of subtracting current liabilities from current assets in the balance sheet, a practice that gained considerable popularity in the 1940's and is commonly employed in the United States today [*i.e.,* 1970]. n26

n25. American Institute of Certified Public Accountants, *Accounting Research and Terminology Bulletins* (Final ed., 1961), Accounting Research Bulletin No. 43, p. 19.

n26. Hendriksen, *Accounting Theory* (Rev. ed., 1970), p. 293.

The "ratio of current assets to current liabilities is regarded as one of the most significant indicia of financial health." Grange, *Corporation Law for Officers and Directors* (1940 ed.), p. 602.

However, particularly in recent years, it is recognized that while "the conventional definitions of current assets and current liabilities do provide some information to users of financial statements,

they are far from perfect in meeting the desired objectives." n27 This imperfection is due, in part, to the fact that "working capital is a static concept and debt-paying ability is dynamic. Cash becoming available for the paying of debt arises primarily from operations, not from the liquidation of particular assets. Cash and other liquid assets available at a particular balance sheet date are likely to be used in operations for the payment of liabilities not yet incurred at balance sheet date (e.g., current payroll), rather than being held for the payment of the balance sheet liabilities as they mature." n28

n27. *Id.,* at p. 297; see, also, *id.,* at pp. 287-297.

n28. Hendriksen, *Accounting Theory* (Rev. ed., 1970), pp. 292-293.

Notwithstanding the imperfections of the working capital concept, there is a rational basis for its usage in setting forth minimum financial requirements under the Commodity Exchange Act. No better method has been devised as of this time. The working capital of a firm (current assets in excess of current liabilities) is the principal test used to determine whether a registrant under the Packers and Stockyards Act, 1921 (7 U.S.C. 181 *et seq.*) is adequately financed (9 CFR 203.10), and this test was upheld in *Bowman* v. *U.S. Department of Agriculture,* 363 F.2d 81, 84-85 (C.A. 5).

CURRENT ASSETS

The regulations define the term "current assets" as follows (17 CFR 1.17(d)(2)):

The term "current assets" means cash and other assets or resources commonly identified as those which are reasonbly expected to be realized in cash or sold during the next 12 months in the normal course of operation of the principal business of the applicant or registrant, and which are available for and intended for payment of current liabilities.

This definition is basically the same as the definition of "current assets" published by the American Institute of Certified Public Accountants, which is as follows: n29

For accounting purposes, the term *current assets* is used to designate cash and other assets or resources commonly identified as those which are reasonably expected to be realized in cash or sold or consumed during the normal operating cycle of the business.

* * *

A one-year time period is to be used as a basis for the segregation of current assets in cases where there are several operating cycles occurring within a year. n30

n29. American Institute of Certified Public Accountants, *Accounting Research and Terminology Bulletins* (Final ed., 1961), Accounting Research Bulletin No. 43, p. 20.

n30. *Id.,* at p. 21.

The words "cash and other assets or resources commonly identified as those which are reasonably expected to be realized in cash or sold" in the regulations are copied verbatim from the American Institute of Certified Public Accountants' definition. These words have acquired a technical meaning in the accounting field and, therefore, we must interpret the words according to that technical meaning. *Labor Board* v. *Coca-Cola Bot. Co.,* 350 U.S. 264, 269; *Barber* v. *Gonzales,* 347 U.S. 637, 641; *Tyng* v. *Grinnell,* 92 U.S. 467, 470; *Massachusetts Protective Ass'n.* v. *United States,* 114 F.2d 304, 310-311 (C.A. 1). See, also, *Order of Conductors* v. *Swan,* 329 U.S. 520, 525.

The American Institute of Certified Public Accountants sets forth the items included in and excluded from its definition of "current assets" as follows: n31

Thus the term comprehends in general such resources as (a) cash available for current operations and items which are the equivalent of cash; (b) inventories of merchandise, raw materials, goods in process, finished goods, operating supplies, and ordinary maintenance material and parts; (c) trade accounts, notes, and acceptances receivable; (d) receivables from officers, employees, affiliates, and others, if collectible in the ordinary course of business within a year; (e) installment or deferred accounts and notes receivable if they conform generally to normal trade practices and terms within the business; (f)

marketable securities representing the investment of cash available for current operations; and (g) prepaid expenses such as insurance, interest, rents, taxes, unused royalties, current paid advertising service not yet received, and operating supplies. Prepaid expenses are not current assets in the sense that they will be converted into cash but in the sense that, if not paid in advance, they would require the use of current assets during the operating cycle.

* * *

This concept of the nature of current assets contemplates the exclusion from that classification of such resources as:

(a) cash and claims to cash which are restricted as to withdrawal or use for other than current operations, are designated for expenditure in the acquisition or construction of noncurrent assets, or are segregated for the liquidation of long-term debts; (b) *investments in securities (whether marketable or not) or advances which have been made for the purposes of control, affiliation, or other continuing business advantage;* (c) receivables arising from unusual transactions (such as the sale of capital assets, or loans or advances to affiliates, officers, or employees) which are not expected to be collected within twelve months; (d) cash surrender value of life insurance policies; (e) land and other natural resources; (f) depreciable assets; and (g) *long-term prepayments which are fairly chargeable to the operations of several years, or deferred charges* such as unamortized debt discount and expense, bonus payments under a long-term lease, costs of rearrangement of factory layout or removal to a new location, and certain types of research and development costs (emphasis supplied).

n31. American Institute of Certified Public Accountants, *Accounting Research and Terminology Bulletins* (Final ed., 1961), Accounting Research Bulletin No. 43, pp. 20-21.

To digress briefly from the analysis of the regulations, the phrase "cash and other assets or resources commonly identified as those which are reasonably expected to be realized in cash" during the next 12 months does not, according to the American Institute of Certified Public Accountants, include the cost of investments in or advances to another firm for the purpose of continuing business advantage (subdivision (b) in the second paragraph of the immediately preceding quotation) or any money spent for other long-term purposes (subdivision (g) of such paragraph) notwithstanding the fact that such costs would ordinarily have been incurred with the reasonable expectation of profits to the firm spending the money.

Similarly, a firm ordinarily spends money for land (subdivision (e) in the second paragraph of the immediately preceding quotation) and depreciable assets (subdivision (f) of such paragraph) with the reasonable expectation of making profits from the expenditure, but the costs of such assets are not "current assets." The respondents' contention that the term "current assets" includes the cost of organizing new businesses, resulting in exclusive brokerage contracts reasonably expected to yield revenue, is foreign to the principles of accounting terminology and procedure. If such costs could be converted into "current assets" by the expedient

of procuring an exclusive contract, this would completely revolutionize the principles of accounting.

Of the seven items referred to in the first paragraph of the immediately preceding quotation, three items (*viz.,* items (c), (d), and (e)) relate to the same category, *i.e.,* receivables. Hence there are five major subcategories of "current assets" rather than seven.

Current assets are usually listed on the balance sheet in the order of their *expected conversion* into cash. Subdivisions within the current asset group include:

1. Cash
2. Marketable securities
3. Receivables
4. Inventories
5. Short-time prepayments. n32

n32. Wixon, Kell, and Bedford, *Accountants' Handbook* (5th ed., 1970), § 2, p. 23.

These five subcategories of current assets will be discussed *seriatim.*

Cash

"Cash (on hand and in bank) is classified as a current asset unless, as stated in ARB No. 43, it is 'restricted as to withdrawal or use for other than current operations, or designated for expenditure in the acquisition or construction of noncurrent assets, or [is] segregated for the liquidation of long-term debts.'" n33

n33. *Id.,* at § 2, p. 32.

Marketable Securities

"Marketable securities represent highly liquid assets that are expected to be converted into cash within the normal operating cycle of the business. Both criteria, *i.e., marketability* and *expected conversion,* must be fulfilled to justify the classification of securities and other short-term temporary investments as current assets. The AICPA (ARB No. 43) specifically excludes from the current group the 'investment in securities (whether marketable or not) or advances which have been made for purposes of control, affiliation, or other continuing business advantage.'" n34

[O]nce assets are committed by management for investment in specific long-term forms, they should not be classified as current assets. For example, cash, securities, or other assets committed by management for the later acquisition of plant and equipment or for other noncurrent uses should not be included among the current assets. The commitment need not be legally binding on management, but it should be explicit. The investment is not intended to become available for the current operations of the business nor for investment opportunities other than that for which it is allocated. It is necessary but not sufficient that the current assets be capable of being converted readily into cash or other monetary assets; they must also be free of commitment for long-term uses. The earlier reference to availability for conversion emphasized the liquidity of the assets, while the criteria of intent and commitment emphasized the operating aspects of the business. n35

n34. Wixon, Kell, and Bedford, *Accountants' Handbook* (5th ed., 1970), § 2, p. 32.

n35. Hendriksen, *Accounting Theory* (Rev. ed., 1970), pp. 294-295. At times, it is difficult to determine intent, and investments may be improperly classified as current assets because of the desire to make the working capital position appear more favorable. *Id.,* at p. 295.

Digressing again from the analysis of "current assets," Mr. Economou testified that the brokerage contracts could be sold (Tr. 461-462, 473), and he referred to the Precious Metals contract as a "very valuable piece potentially," explaining that "[i]f there should be a turn in the market, it could be a very valuable piece of property" (Tr. 462). The brokerage contracts were not highly liquid or marketable from an accounting standpoint, and, moreover, there was no testimony or claim by Mr. Economou that he expected to convert them into cash by selling them. The organizational costs were incurred for long-term, continuing business advantage. Such costs are not "current assets."

Receivables

"In the broad sense the term 'receivables' is a designation applicable to all claims held against others for the future receipt of money, goods, and services. * * * However, as noted by Simons and Karrenbrock (*Intermediate Accounting),* more commonly in accounting the term 'receivables' is used in a restricted sense as a designation for claims collectible in money in the relatively near future. Most frequently these arise out of the delivery of goods or the rendering of services. The following three types predominate:

1. Accounts receivable

2. Notes receivable

3. Accrued receivables" n36

n36. Wixon, Kell, and Bedford, *Accountants' Handbook* (5th ed., 1970), § 11, p. 1.

The following are the more usual types of accounts receivable: n37

1. Deposits made to other parties to cover potential damages, and deposits as a guaranty of performance of a contract or payment of an expense

2. Prepayments to others on purchases and expense contracts

3. Claims against creditors for damaged, or lost or returned goods

4. Claims against common carriers for lost or damaged goods

5. Claims against the government for rebates and the like

6. Claims against officers and employees

7. Claims against customers for return of containers (no deposit)

8. Advances to subsidiaries

9. Advances to officers and employees

10. Dividends receivable (declared)

11. Unexpended balances of working funds in the hand of agents

12. Claims against insurance companies for losses sustained

13. Claims in litigation

14. Unpaid calls on stock subscriptions (subscriptions receivable)

n37. *Ibid.*

"Notes receivable" originate in various ways, including "[l]oans or advances made to employees, officers, affiliated companies, and others" which are "evidenced by notes." n38 The American Institute of Accountants (now the American Institute of Certified Public Accountants) adopted a rule in 1934 stating that "[n]otes or accounts receivable due from officers, employees, or affiliated companies must be shown separately and not included under a general heading such as notes receivable or accounts receivable." n39

n38. Wixon, Kell, and Bedford, *Accountants' Handbook* (5th ed., 1970), § 11, p. 31.

n39. American Institute of Certified Public Accountants, *Accounting Research and Terminology Bulletins* (Final ed., 1961), Accounting Research Bulletin No. 43, p. 12. See, also, Wixon, Kell, and Bedford, *Accountants' Handbood* (5th ed., 1970), § 2, p. 33; § 11, p. 31.

"Accrued receivables" relate to such items as interest, rent, or commissions which have been earned as the time has elapsed or the service has been performed, and the amounts have accrued subsequent to the last cash receipts. n40

n40. Wixon, Kell, and Bedford, *Accountants' Handbook* (5th ed., 1970), § 11, p. 42.

Inventories

The American Institute of Certified Public Accountants defines the term "inventory" to "designate the aggregate of those items of

tangible personal property which (1) are held for sale in the ordinary course of business, (2) are in process of production for such sale, or (3) are to be currently consumed in the production of goods or services to be available for sale." n41

n41. American Institute of Certified Public Accountants, *Accounting Researching and Terminology Bulletins* (Final ed., 1961), Accounting Research Bulletin No. 43, p. 27.

"Inventories should, in general, be subdivided by broad classes and include merchandise, raw materials, goods in process, finished goods, operating supplies, and maintenance materials and parts." n42

n42. Wixon, Kell, and Bedford, *Accountants' Handbook* (5th ed., 1970), § 2, p. 34.

"By definition, inventories are current assets, because they will normally be converted into cash or other assets within the operating cycle of the business. Obsolete and unsalable merchandise, however, if material in amount, should be classified as noncurrent unless it can be disposed of in available markets within normal selling periods." n43

n43. Hendriksen, *Accounting Theory* (Rev. ed., 1970), p. 314.

Prepayments

"Prepayments arise in transactions in which the usual credit relationship is reversed: payment is made in advance of the receipt or utilization of goods and services. Insurance premiums, rent, prepaid wages and salaries, deposits on contracts, payments for season tickets, etc., are illustrative. Prepayment should not be classed with the typical receivables in the balance sheet but should be separately disclosed, since they usually represent items or a claim to items to be consumed in the conduct of the business." n44

n44. Wixon, Kell, and Bedford, *Accountants' Handbook* (5th ed., 1970), § 11, p. 48.

"Short-term prepayments of current operating expenses such as for rent, insurance, interest, and taxes, whether or not they possess value in liquidation, are properly included as current assets under the definition cited

above. The classification of short-term prepayments as *deferred charges* is not in harmony with the prevailing view of current assets. Most prepayments represent a legal right to collect the unexpired cost in the form of commodities or services. For this reason prepayments are sometimes termed 'services receivable.'" n45

n45. *Id.,* at § 2, p. 34.

"Prepaid expenses are benefits to be received by the firm in the future in the form of services. They include such items as office and factory supplies, prepaid rent, unexpired insurance, prepaid interest, and prepaid taxes." n46

n46. Hendriksen, *Accounting Theory* (Rev. ed., 1970), p. 305.

"While the various prepaid expenses have some common characteristics for classification purposes, they also have some major differences. Some represent specific tangible assets (e.g., supplies), others represent the right to use assets owned by others (e.g., prepaid rent), and still others are related quite closely to other assets or liabilities." n47

n47. *Ibid.*

"Prepaid expenses were included in the definition [of current assets] because if they had not been acquired, they would require the use of current assets in the normal operations of the business. But, in this regard, they are the same as inventories; both would require the use of current funds if they had not been acquired previously. The main reason for their inclusion is that they represent resources committed for only a short period -- the current operating cycle. Like inventories, they result in current funds becoming available for recommitment through the sale of the product or services and the collection of the proceeds." n48

n48. *Id.,* at p. 295.

"Prepaid expenses" and "deferred charges" are similar except that short-term items are referred to as "prepaid expenses" and are treated as current assets under general accounting principles, whereas similar long-term items are deferred to as "deferred charges" and are not treated as current assets (see, *infra,* p. 88).

"In the sense that any prepayment is a deferred or future charge to operations, it is a deferred cost. In fact, the cost of any asset that will be consumed in production is a deferred charge to future operations. In modern practice, however, the term 'prepaid expense' refers to a relatively short-term future charge to operations. Normally, it is a current asset. The term 'deferred charge,' particularly when it is used as a balance-sheet category, refers to the more long-term deferred charges, such as organization costs and bond discount." n49

n49. Wixon, Kell, and Bedford, *Accountants' Handbook* (5th ed.. 1970), § 11, p. 48; see, also, *id.,* at pp. 48-50.

Digressing from the analysis of "current assets," the foregoing quotation directly supports Mr. Fitzpatrick's testimony that the organizational costs of the Trading Syndicates were "deferred charges," which are not "current assets" (Tr. 35, 42, 45). Moreover, Mr. Fitzpatrick testified that "from an examination of Economou Corporation's general ledger I first learned that the $ 6,016.80 was entered in that ledger in an account described as 'deferred charges -- precious metals'" (Tr. 35). Hence the respondents correctly

classified the item as a non-current asset in the respondent corporation's general ledger.

ASSETS THAT ARE NOT "CURRENT ASSETS"

An understanding of "current assets" is facilitated by an understanding of those assets which are not "current assets." Where appropriate, particular mention will be made of the organizational costs issue.

Investments

Long-term investments are frequently valuable assets of a firm, but they are not classified as current assets. They are recorded on a balance sheet under the heading "Investments," frequently at their acquisition cost.

INVESTMENTS. This subdivision of assets includes long-term investments, or simply "investments," receivables not classified as current assets, noncurrent claims, special deposits and sinking funds, life insurance, investments in other companies, plant not used in the business (which may instead be shown as a separate item of plant and equipment), and other property -- real and personal. The different items or classes of items should be listed separately, and the bases upon which they are stated should be clearly shown. n50

While the above discussion has related specifically to temporary nonmonetary investments, much of the discussion is also relevant for long-term investments in common stocks. Such investments may be held for a variety of reasons, such as providing permanent financing to suppliers or customers, maintaining partial or complete control of subsidiaries, or obtaining diversification of the firm's investment. Because these investments are not classified as current assets and because the eventual sales price at some distant date is impossible of estimation, the conventional practice is to record these at cost and reduce them to a lower value only if a reduction in market price appears to be drastic and permanent. n51

n50. Wixon, Kell, and Bedford, *Accountants' Handbook* (5th ed., 1970), § 2, p. 34.

n51. Hendriksen, *Accounting Theory* (Rev. ed., 1970), p. 305.

Property, Plant, and Equipment

Other major assets which are not current assets are "property, plant, and equipment."

PROPERTY, PLANT, AND EQUIPMENT. In most industrial concerns land, buildings, and equipment constitute a substantial or even major portion of total assets. Yet they are often shown in the balance sheet as a single item, subject to the deduction of allowances ("reserves") for depreciation and depletion. It is preferable, however, to show some itemization. Principal subdivisions are:

1. Land
2. Natural resources
3. Buildings and structures
4. Machinery and equipment. n52

n52. Wixon, Kell, and Bedford, *Accountants' Handbook* (5th ed., 1970), § 2, p. 34

Intangibles

"Intangibles" are another group of assets that are not classified as current assets.

INTANGIBLES. ARB No. 43 [*i.e.,* Accounting Research Bulletin No. 43 published by the American Institute of Certified Public Accountants] broadly classifies intangibles into "(a) those having a term of existence limited by law, regulation, or agreement, or by their nature (such as patents, copyrights, leases, licenses, franchises for a fixed term, and goodwill as to which there is evidence of limited duration); and (b) those having no such limited term of existence and as to which there is, at the time of the acquisition, no indication of limited life (such as goodwill generally, going vaule, trade names, secret processes, subscription lists, perpetual franchises, and organization costs)."

Intangibles should be listed separately on the balance sheet. In general, the principles of valuation for intangibles are the same as those applicable to tangible fixed assets. Accordingly, *type (a) intangibles* should be shown at cost less amortization to date, preferably with the amounts of accrued amortization disclosed; and *type (b) intangibles* should be reflected at cost until such time as it becomes reasonably evident that the time of existence has become limited, when they in effect become type (a) intangibles and should then be amortized over the estimated period of usefulness. n53

ORGANIZATION COSTS. The costs of promoting and organizing a concern, together with the costs of raising capital,

are properly classified as an intangible asset under the title "Organization Costs." The costs of the various services employed to launch a business undertaking represent a bona fide asset rather than an expense or a loss. n54

Trademarks, trade names, organization costs, and goodwill are examples of intangibles generally considered to have no limited form of existence and no natural limited life. However, the economic life of each of these is definitely limited unless expenditures are continually made for maintenance and replacement. Even initial organization costs require periodic reorganization expenditures, most of which are interrelated with goodwill and current operations. But the time when the original asset value is completely replaced by additional expenditures cannot be determined even in retrospect. Therefore, the AICPA position is that the original cost should remain on the books and the costs of maintenance or replacement should be charged against current income. n55

Except for leaseholds and leasehold improvements, the most important single characteristic of intangibles is the high degree of uncertainty regarding the value of the future benefits to be received. In most cases, the possible values may range from zero to very large amounts. n56

n53. Wixon, Kell, and Bedford, *Accountants Handbook* (5th ed., 1970), § 2, p. 36.

n54. *Id.,* at § 19, p. 20. See also, Hendriksen, *Accounting Theory* (Rev. ed., 1970), pp. 186, 429.

n55. Hendriksen, *Accounting Theory* (Rev. ed., 1970), p. 429.

n56. *Id.,* at p. 423.

The foregoing quotations support Mr. Fitzpatrick's testimony that the organizational costs of the Trading Syndicates are properly classified as "intangible assets," which are not "current assets" (Tr. 44).

Deferred Charges

"Deferred charges and other assets" are also assets that are not classified as "current assets."

DEFERRED CHARGES AND OTHER ASSETS. Published balance sheets frequently include items described as "long-term prepayments" or "deferred charges."

Sometimes these items are classified as "intangible" assets. Whenever possible, such assets should be more clearly identified so as to indicate whether they should be included in the intangible or other categories. Costs frequently included in this classification with little further description to indicate their nature clearly relate

to research, deferred pensions and taxes, development and promotion, rearranging and moving of plant, leases and leasehold improvements, losses in a developmental period, and various financing costs including bond discount. n57

Deferred charges are generally assumed to include intangibles that will be amortized to expense or else debit items classified separately without a formal definition. Specific intangibles sometimes classified as deferred charges include organization costs and research and development expenses. Other items frequently classified as deferred charges include advertising expenditures, start-up costs, and special types of losses. The rationalization for including deferred charges among the assets of a firm is generally that they represent benefits to future periods, and that therefore they should be amortized to future periods as are nonmonetary tangible assets. n58

n57. Wixon, Kell, and Bedford, *Accountants' Handbook* (5th ed., 1970), § 2, p. 36.

n58. Hendriksen, *Accounting Theory* (Rev. ed., 1970), p. 442.

The foregoing authorities support Mr. Fitzpatrick's testimony that the organizational costs of the Trading Syndicates are properly classified as "deferred charges" or "intangible assets," neither of which are "current assets" (Tr. 35, 42, 44, 45).

Assets That Are Not to be Realized in Cash or Sold

In the light of the foregoing overview of assets that are not "current assets" and assets that are "current assets" because they are "commonly identified" as "those which are reasonably expected to be realized in cash or sold" during the next 12 months, it is appropriate to make a subtle, but vital, distinction between assets that are reasonably expected to be "realized in cash or sold," and assets that are merely going to result in or produce cash for a firm during the next 12 months.

To illustrate this distinction, a manufacturing firm that produces machinery, *e.g.,* sewing machines, might have two pieces of machinery side by side; one, a $ 200 sewing machine and the other a $ 200,000 machine that was used in the manufacture of the sewing machine. The $ 200 sewing machine is a "current asset" ("inventory"), but the machine worth 1,000 times as much, and that is reasonably expected to produce large amounts of cash for the firm in the next 12 months, is not a "current asset." It is classified as "equipment."

Similarly, a firm might have two contracts side by side; one, a $ 10 note payable within 12 months, and the other a contract (costing $ 10,000) made with another firm for continuing business advantage. The note is a "current asset" ("receivable") because the note itself will be "realized" in cash, but the contract worth 1,000 times as much, and that is reasonably expected to produce large amounts of cash for the firm in the next 12 months, is not a "current asset." It is an "intangible asset" or a "deferred charge." The contract will produce cash but it will not be "realized" in cash, so it is not a "current asset."

If the respondents' theory were correct, that the organizational costs of the Trading Syndicates (resulting in exclusive brokerage contracts) are current assets because they were expected to produce large amounts of cash, then all assets expected to produce revenue would be "current assets." This would include

all of the assets of most firms, *i.e.,* their property, plant, equipment, investments, intangibles, and deferred charges. This theory would destroy the present system of accounting used by government, the accounting profession, and the business community.

REGULATORY EXCLUSIONS FROM CURRENT ASSETS

There is no need for the administrative regulations to exclude from "current assets" such items as "long-term investments," "property, plant, and equipment," "intangibles," and "deferred charges" since they would not be regarded as current assets under the general definition of current assets set forth in the regulations (17 CFR 1.17(d)(2)). Nor would such items be regarded as current assets under general accounting principles. However, in some instances, the regulations expressly exclude such items, presumably to emphasize that such items are not "current assets."

The regulations, after defining the term "current assets," as set forth above, state that the "term 'current assets' excludes, *among other things,"* 12 items (emphasis supplied, 17 CFR 1.17(d)(2)). The respondents challenge the regulations because the phrase "among other things" is "so broad and all-encompassing that it could be used to denote any or every asset irrespective of intrinsic value" (Respondents' Suggested Findings and Brief, p. 27).

The complainant does not rely, in this case, on the phrase "among other things" in the regulations and, therefore, no issue is properly presented in this case as to what, if anything, is excluded

from "current assets" by the phrase "among other things." I suppose, without deciding, that the phrase is meaningless; *i.e.,* if an item comes within the definition of "current assets" set forth in the first paragraph of 17 CFR 1.17(d) (2), and does not come within any of the 12 items excluded, the item cannot be excluded under the phrase "among other things." But it will be time enough to decide that issue if the complainant ever attempts to exclude from "current assets" an asset which meets the definition of "current assets" and is not specifically excluded.

Each of the 12 specific exclusions from current assets will be discussed. Specific references to the issue involving the Trading Syndicates' organizational costs are made in connection with subsections six and nine of the exclusions.

1. The first item excluded from the category of "current assets" is (17 CFR 1.17(d)(2)(i)):

(i) Customer's regulated and nonregulated commodity futures accounts that liquidate to an unsecured deficit or contain unsecured debit balances and which accounts have been in such a condition for more than 30 consecutive days;

This exclusion relates to "receivables," *i.e.,* money owed by a customer to a futures commission merchant, arising in the customer's commodity futures account.

An account that liquidates to a deficit is one in which there would be a net loss in the account if all of the open futures contracts were closed out at the current market price. An account that contains a debit balance n59 is one in which losses from prior closed transactions exceed the amount of money deposited or credited to the account, resulting in a net loss in the account. In either case, the futures commission merchant has a claim against the customer (in accounting terms, a "receivable") which, unless specifically excluded, would come within the definition of "current assets."

n59. In the ledger of customer accounts, cash deposited by the customer and profits from completed futures transactions are "credit" items and realized losses are "debit" items.

This exclusion is an exception to the general rule that receivables collectable within the next 12 months are "current assets." Under this exception, if there is a loss in a customer's account which is "unsecured," and if the account has been in such a "loss" condition for more than 30 consecutive days, the claim against the customer is not a "current asset."

2. The second item excluded from the category of "current assets" is (17 CFR 1.17 (d) (2) (ii)):

(ii) Crop loans (loans made to farmers for the purpose of financing their crops or farm operations) which are not (a) due and collectible within 9 months after the respective dates of making of such loans, and (b) evidenced by legally enforceable written instruments in the possession of the registrant or applicant;

This is another exception to the general rule that receivables collectable within the next 12 months are "current assets." Under this exception, if the receivable arises from a crop loan, it is a "current asset" only if (i) the loan was due and collectable within nine months after the loan was made, and (ii) the loan is evidenced by a legally enforceable written instrument in the possession of the futures commission merchant, or applicant for registration.

3. The third item excluded from the category of "current assets" is (17 CFR 1.17(d)(2)(iii)):

(iii) All other unsecured receivables that are not due and collectable within 6 months from the respective dates of their inception;

This is another exception to the general rule that receivables collectable within the next 12 months are "current assets." Under this exception, if the receivable is unsecured, it is a current asset only if it is due and collectable within six months from the date of its inception.

The word "all" in this subparagraph is, at first blush, misleading inasmuch as you would infer from this subparagraph that *all* unsecured receivables that are not covered by the exclusions in subparagraphs (i) and (ii), *supra,* and that *are* collectable within six months from their inception, would be "current assets." But subparagraphs (v), (x), and (xi), discussed *infra,* also relate to unsecured receivables, and they have provisions relating to partners, officers, employees, or business affiliates of the registrant or applicant that are more restrictive than subparagraph (iii) under discussion. Hence when the regulations are read as a whole, as they must be (*Richards* v. *United States,* 369 U.S. 1, 11; *Power Comm'n* v. *Panhandle Co.,* 337 U.S. 498, 514; *United States* v. *American Trucking Ass'ns.,* 310 U.S. 534, 542-543), it is obvious that such an inference cannot be drawn in those instances where more restrictive exclusions relate specifically to unsecured receivables

involving partners, officers, employees, or business affiliates of the registrant or applicant. As a general rule, specific provisions prevail over general provisions in construing a statute or regulation. *Fourco Glass Co.* v. *Transmirra Corp.,* 353 U.S. 222, 228-229; *Ginsberg & Sons* v. *Popkin,* 285 U.S. 204, 208; *Atkins* v. *The Disintegrating Company,* 18 Wall. 272, 302. The specific provisions relating to partners, officers, employees, or business affiliates of the registrant or applicant (17 CFR 1.17(d)(2)(v), (x), and (xi)) prevail over any implication from this general exclusion.

4. The fourth item excluded from the category of "current assets" is (17 CFR 1.17(d)(2)(iv)):

(iv) Exchange membership, clearing house stocks and guaranty funds;

The exchange membership would not be reasonably expected to be realized in cash or sold during the next 12 months in the normal course of operation of the principal business of the applicant or registrant, and the clearing house stocks

and guaranty funds would be restricted as to withdrawal or use. Also, these items would not involve cash or resources expected to be realized within 12 months in cash that would be available for and intended for the payment of current liabilities. Hence these assets would not meet the definition of "current assets" (17 CFR 1.17(d(2)) even in the absence of a specific exclusion. This exclusion must, therefore, be intended merely to emphasize that these items are not "current assets."

5, 10. The fifth and tenth items excluded from the category of "current assets" are (17 CFR 1.17(d)(2)(v) and (x)):

(v) Unsecured advances and loans to any business affiliate that directly or indirectly controls, is controlled by, or is under common control with, the applicant or registrant;

* * *

(x) Unsecured loans and advances to partners, officers and employees of the applicant or registrant;

These are additional exceptions to the general rule that receivables collectable within the next 12 months are "current assets." Under these exceptions, unsecured advances and loans to business affiliates, partners, officers and employees of the applicant or registrant are excluded from "current assets."

The exclusions in subparagraphs (v) and (x) are more restrictive than the exclusion in subparagraph (iii). Under the exclusion in subparagraph (iii), discussed *supra,* an unsecured receivable is excluded from "current assets" only if it is not due and collectable within six months from its inception. But under subparagraphs (v) and (x), unsecured receivables arising from loans and advances to business affiliates, partners, officers and employees of the applicant or registrant are excluded from "current assets" even if they are due and collectable within six months from the date of their inception.

The differentiation in treatment of receivables due from partners, officers, employees or business associates of the registrant or applicant is consonant with generally accepted accounting principles. It has long been the practice to subdivide receivables into various categories, showing notes or accounts receivable due from officers, employees, or affiliated companies separately, see, *supra,* p. 79.

6. The sixth item excluded from the category of "current assets" is (17 CFR 1.17(d)(2)(vi)):

(vi) Unrealized commissions on open futures contracts;

In commodity futures transactions, unlike stock or bond transactions, the commission to the futures commission merchant is not paid (or debited to the account of the customer) until the futures transaction is closed (Comp. Ex. 13, p. 6). For example, if on January 15 a customer buys one contract of November egg futures, he has an open long position of one contract. If he closes that position by selling one contract of November egg futures on March 15, liquidating his futures position, the entire commission for the purchase on January 15 and the sale on March 15 is not paid to the futures commission merchant (or debited to the account of the customer) until March 15.

Under this exclusion, where a customer has an open futures position which must be closed out at a later date, the futures commission merchant cannot include as a "current asset" any part of the commission which he will later realize when the open futures position is liquidated.

It would indeed be anomalous if the organizational costs of Trading Syndicates, resulting in brokerage contracts expected to yield commissions from futures contracts not yet initiated, were classified as current assets when unrealized commissions on futures

contracts already initiated (but not closed out) are excluded from current assets.

7. The seventh item excluded from the category of "current assets" is (17 CFR 1.17 (c) (2) (vii)):

(vii) Cash and claims to cash which are restricted as to withdrawal, such as customers' segregated funds;

Cash and claims to cash which are restricted as to withdrawal would not be available for and intended for payment of current liabilities and, therefore, would not come within the definition of "current assets" in 17 CFR 1.17(d)(2). This exclusion must, therefore, be intended merely to emphasize that these items are not "current assets."

8. The eighth item excluded from the category of "current assets" is (17 CFR 1.17(d)(2) (viii)):

(viii) Land, buildings, furniture and fixtures, improvements to real property and other fixed assets;

These assets would not be resources reasonably expected to be realized in cash or sold during the next 12 months in the normal course of operation of the principal business of the applicant or registrant, and they would not provide cash available for and intended for the payment of current liabilities. Hence these assets would not meet the definition of "current assets" (17 CFR 1.17(d)(2)) even in the absence of a specific exclusion. This exclusion must, therefore, be intended merely to emphasize that these items are not "current assets."

9. The ninth item excluded from the category of "current assets" is (17 CFR 1.17 (d) (2) (ix)):

(ix) Prepaid expenses and deferred charges;

Under general accounting principles, short-term prepayments "of current operating expenses such as for rent, insurance, interest, and taxes, whether or not they possess value in liquidation, are properly included as current assets" (Wixon, Kell, and Bedford, *Accountants' Handbook* (5th ed., 1970), § 2, p. 34; see, also, *id.,* at p. 23).

Long term prepayments are referred to under general accounting principles as "deferred charges" which are sometimes classified as "intangible" assets, and sometimes set forth separately as "deferred charges." They are not regarded as "current assets" under general accounting principles (see Wixon, Kell, and Bedford, *Accountants' Handbook* (5th ed., 1970), § 2, pp. 23-36). Costs frequently included in the category of "deferred charges" relate to "research, deferred pensions and taxes, development and promotion, rearranging and moving of plant, leases and leasehold improvements, losses in a developmental period, and various financing costs including bond discount" (*id.,* at p. 36).

"Specific intangibles sometimes classified as deferred charges include organization costs and research and development expenses" (Hendriksen, *Accounting Theory* (Rev. ed., 1970), p. 442).

Subparagraph (ix) sets forth an exception to the general rule that would otherwise prevail as to short term prepaid expenses, but is consistent with the general rule as to deferred charges. Under this exclusion in subparagraph (ix), short term prepaid expenses and long term prepaid expenses (*i.e.,* "deferred charges") are specifically excluded from "current assets."

The organizational costs of The Precious Metals Trading Syndicate were entered in the respondent corporation's ledger as "deferred charges" (Tr. 35). This was a proper classification of the item. The specific exclusion in the regulations as to deferred charges is squarely applicable to the item.

11. The eleventh item excluded from the category of "current assets" is (17 CFR 1.17(d) (2) (xi)):

(xi) Unsecured debit balances and unsecured deficits in accounts owned by the applicant or registrant or in accounts of partners, officers and employees of the applicant or registrant;

This item is similar to the first subparagraph excluding certain receivables from the category of "current assets." This item relates to accounts of partners, officers and employees of the applicant or registrant and contains provisions more restrictive than those in the first subparagraph relating to customers' accounts. Under the first subparagraph, a receivable resulting from an unsecured "loss" in a customer's account is excluded as a "current asset" only if the account has been in a "loss" condition for more than 30 consecutive days, but under this subparagraph (xi) an unsecured "loss" in an account of a partner, officer, or employee of the applicant or registrant is excluded as a "current asset" even if the account has not been in a "loss" condition for more than 30

consecutive days. Hence this exclusion is another exception to the general rule that receivables collectable within the next 12 months are "current assets."

12. The twelfth item excluded from the category of "current assets" is (17 CFR 1.17(d)(2)(xii)):

(xii) Securities without a ready market.

"Marketable securities represent highly liquid assets that are expected to be converted into cash within the normal operating cycle of the business. Both criteria, i.e., *marketability* and *expected conversion,* must be fulfilled to justify the classification of securities and other short-term temporary investments as current assets." Wixon, Kell, and Bedford, *Accountants' Handbook* (5th ed., 1970), § 2, p. 32. Hence this exclusion merely states the rule that would be in effect in any event, namely, that securities without a ready market are not "current assets." This exclusion must, therefore, be intended merely to emphasize that such securities are not "current assets."

The respondents contend (Respondents' Suggested Findings and Brief, pp. 28-29) that the regulations are uncertain and confusing because the Commodity Exchange Authority's financial form (i) requires that securities be described and classified as to type, *e.g.,* whether they are preferred stocks, common stocks, commercial bond, etc., (ii) requires that segregated securities be shown under the schedule for segregated funds rather than as current assets, (iii) provides that the same securities should not be shown more than once, and (iv) provides that securities available as capital under a subordination agreement must be supported by a copy of the agreement, and the agreement must comply with the regulations. There is nothing confusing or uncertain about these provisions on the form, and they are consistent with the provisions of the regulations.

To conclude the analysis of the "current assets" regulations and the Trading Syndicates issue, I believe that the regulations are not perfectly written, but they are adequately written to be understood by futures commission merchants and other persons knowledgeable in the field of accounting. There is no basis whatever, either under the regulations or under general principles of accounting, for regarding as "current assets" organizational costs of the Trading Syndicates resulting in exclusive brokerage contracts expected to yield substantial revenue.

V. *Respondent Corporation's Obligation to The Economou Financial and Development Corp. ("Reserve" Account); Analysis of "Current Liabilities" Regulations*

As previously stated, an understanding of the remaining accounting issue requires an understanding of the "current liabilities" regulations and, therefore, the remaining accounting issue and the regulations will be discussed together in this section of the Decision.

A. The "Reserve" Account

As a result of the investigation of the respondent corporation's books and records as of March 31, 1970, the complainant treated an item of $ 13,621.51 as a "current liability" (Comp. Ex. 14) due to The Economou Financial and Development Corp. (hereinafter referred to as the Financial Corporation) which the respondents contend is a "reserve" that is not a "current liability" (Answer to Amended Complaint, pp. 3-4). The item is shown as $ 11,162.97 on the respondent corporation's balance sheet, and since the complainant admits that some minor changes in the amount might properly have occurred after the complainant's audit (Tr. 206), the respondents' figure will be accepted as correct.

The Financial Corporation was organized by Mr. Economou and his wife to engage in developing new enterprises in the commodities, securities and investment communities (Comp. Ex. 11, p. 5). The primary initial enterprise to be developed was The American Board of Trade, Inc., and its affiliates, which were organized by Mr. Economou to form a new commodities and securities exchange complex (Comp. Ex. 11, p. 6). The Financial Corporation was to offer shares of stock to the public in May of 1970 under which Mr. and Mrs. Economou would retain 95.3% of the outstanding shares for which they paid $ 6,000, and the public would be offered 4.7% of the outstanding shares for $ 300,000 (Comp. Ex. 11, p. 3).

Since October of 1969, the respondent corporation functioned largely as a service organization on behalf of the Financial Corporation and The American Board of Trade complex being organized by the Financial Corporation (Tr. 254, 291-292, 523-524). The Financial Corporation had no staff or facilities to pay its own bills, so the respondent corporation paid them on its behalf (Tr. 291-292, 523-524).

Initially, the bills paid by the respondent corporation were greater in amount than the reimbursements received from the Financial Corporation. At that time, the Financial Corporation owed money to the respondent corporation, which was reflected on the respondent corporation's books as a "debit balance" (*i.e.,* a receivable which was a "current asset").

Later, as the respondent corporation needed more funds, the Financial Corporation paid $ 11,162.97 more to the respondent corporation than was owed, so the account became a "credit balance" on the respondent corporation's books (Tr. 167, 181, 186, 249, 253, 256, 265, 267, 280, 287). This was reflected on the respondent corporation's ledger in an account labeled "Expenses charged to Economou Financial & Development Corporation and Deposits to Cover Same; Credit Balance to Cover Accruing Expenses" (Tr. 267).

Each month the respondent corporation would reduce the amount of the account (*i.e.,* reduce the "credit balance") by the amount of money paid by the respondent corporation on behalf of the Financial Corporation (Tr. 195, 198-199, 204-205, 253). On its balance sheet as of March 31, 1970, the respondent corporation shows the $ 11,162.97 in a separate classification, appearing between the liabilities and the capital (or stockholders' equity), labeled "Reserves to cover accruing expenses." The relevant entries on the respondent corporation's balance sheet as of March 31, 1970, are as follows (Answer to Amended Complaint, p. 4):

Balance Sheet, March 31, 1970

Total Assets	$ 52,268.23	Total Liabilities	$ 14,091.70

Reserve, Surplus & Capital	
Reserves to cover accruing expenses	11,162.97
Capital and Capital Surplus	27,373.56
Total Liabilities & Capital	$ 52,628.23

The Financial Corporation treated this overpayment of $ 11,162.97 on its books and on the Prospectus filed with the Securities and Exchange Commission as a "current asset," designated as a "prepaid expense" (Tr. 185, 252, 257; Comp. Ex. 11, p. 14).

Mr. Radcliffe, the respondents' accountant, testified that the "reserve" account reflects a "one-way flow of money" from the Financial Corporation to the respondent corporation, "and then

the [respondent] corporation turns it out and pays the necessary expenses that are involved" for the Financial Corporation (Tr. 250; see, also, Tr. 107, 181, 186). He testified that the "prepaid expenses" were "in anticipation of future expenses" (Tr. 252). Since Mr. Economou controlled both corporations, he, of course, did not require the respondent corporation to hold the Financial Corporation's money in trust, but permitted the respondent corporation to use the money as its own until it was needed to pay the Financial Corporation's expenses (Tr. 167-168).

For example, as of March 31, 1970, the respondent corporation had only $ 510.41 cash on hand from all sources (Answer to Amended Complaint, p. 4). The remainder of the $ 11,162.97 had been loaned to Mr. Economou or to his affiliated corporations or had been used to pay some of the respondent corporation's current liabilities (Tr. 275-283).

The respondents contend that the "reserve" account could have been liquidated by the performance of services by the respondent corporation for the Financial Corporation, *i.e.,* the respondent corporation could have charged a management fee to the Financial Corporation, liquidating all or part of the reserve (Tr. 210-211, 253-256, 294, 297). This was purely a theoretical possibility. There is no contention by the respondents that a determination had been made to liquidate all or any portion of the reserve by the respondent corporation charging a management fee to the Financial Corporation. In fact, at the hearing, when Mr. Economou was questioning his accountant as to this possibility, and as to how the bookkeeping entries would be handled, Mr. Economou stated (Tr. 298):

Make it clearer to me, because conceivably we might want to do it. It would be enlightening as to how to handle the transaction.

Moreover, the record establishes that the account was liquidated almost exclusively by paying expenses of the Financial Corporation other than management fees of the respondent corporation. Of the $ 59,900 that flowed from the Financial Corporation to the respondent corporation from October of 1969 through July of 1970 (Tr. 257-258), only about $ 1,600 was liquidated by charging a management fee to the Financial Corporation for management services rendered by the respondent corporation (Tr. 255-256). In addition, the expenses of the Financial Corporation were averaging

about $ 5,000 to $ 6,000 per month, n60 so the $ 11,162.97 would have been charged off by payinb expenses to third persons in about two months. Hence, although the "reserve" theoretically could have been liquidated by the respondent corporation charging a management fee to the Financial Corporation, the inference is inescapable that as of March 31, 1970, all, or almost all, of the $ 11,162.97 was to be liquidated by payments to others for the expenses of the Financial Corporation -- not by charging a management fee.

n60. During January, February and March of 1970, $ 18,250 flowed into the respondent corporation from the Financial Corporation (Tr. 257-258), and the credit balance in the reserve account (*i.e.,* the money not yet spent for expenses of the Financial Corporation) increased by only $ 928.47 (the difference between $ 10,234.50 and $ 11,162.97; Answer to Amended Complaint, p. 4), showing that $ 17,321.53 (the difference between $ 18,250 and $ 928.47) was used during those three months by the respondent corporation to pay the expenses of the Financial Corporation. This is an average of $ 5,773.84 per month ($ 17,321.53/3) used by the respondent corporation to pay the expenses of the Financial Corporation. A similar analysis of the money flowing from the Financial Corporation to the respondent corporation from October of 1969 through July of 1970 (Tr. 257.258) shows that these three months were not abnormal.

When asked his opinion of the "reserve" account, Mr. Radcliffe, the respondents' accountant, testified (Tr. 258-259):

I would say this: We have to consider the intent behind an operation to reflect what goes on. By no stretch of the imagination can I see that it would be an account payable.

Q An account payable from whom?

A From the corporation.

Q To E F & D?

A Yes. Rather, it is a fund made available to handle the expenses.

Mr. Radcliffe, being a Certified Public Accountant, was well aware of the fact that, under accepted accounting principles, the term "current liability" is broader than the term "account payable," *i.e.,* that an "account payable" is only one of a half dozen or more types of "current liabilities," but as shown *infra,* pp. 123-126, there are other types of "current liabilities." Significantly, he did not testify that the reserve account was not a "current liability;" he testified only that it was a reserve account that was not an "account payable" from the respondent corporation to the Financial Corporation. This choice of terminology by an expert accountant must be regarded as deliberate. His failure to testify that the item was not a "current liability" must also be regarded as deliberate.

The complainant's accountant, Mr. Gross, testified that the item was an obligation of the respondent corporation which was a "current liability" under the regulations (Tr. 166-168, 209-214). He testified that when he discussed the item with Mr. Radcliffe, the respondents' accountant, Mr. Radcliffe "indicated that this was a liability of Economou & Co., Inc." (Tr. 166). Mr. Radcliffe did not, in his testimony, contradict that testimony by Mr. Gross. The fact that this "liability" was a "current" liability is demonstrated by the fact that the other side of the transaction is shown on the Financial Corporation's balance sheet filed with the Securities and Exchange Commission as a "prepaid expense" (Comp. Ex. 11, p. 14), which, as we have shown, includes only short-term prepayments for goods or services to be received during the current period. Also, the respondents concede that the respondent corporation paid all of the expenses of the Financial Corporation (Tr. 291-292, 523-524), and as we have shown, at the rate the expenses were being paid, the $ 11,162.97 would have been paid out by the respondent corporation in about two months. Hence the item was clearly a "current liability."

Mr. Richard Kirchhoff, Deputy Director, Registration and Audit Division, Commodity Exchange Authority (Tr. 126), also testified that the "reserve" item was a "current liability" under the regulations (Tr. 209-210).

The respondents admit that the respondent corporation received $ 11,162.97 more from the Financial Corporation than it spent on its behalf and that this

money was used to increase the respondent corporation's assets or to decrease its liabilities (Tr. 275-283). Since the Financial Corporation also properly treated the $ 11,162.97 as a "current asset," *i.e.,* a prepaid expense, Mr. Economou's two corporations would be getting the benefit of $ 22,325.94 in working capital ($ 11,162.97 x 2) out of a single $ 11,162.97, if the respondents' contention were correct that the item is a "reserve" rather than a "current liability" of the respondent corporation.

The Hearing Examiner found and concluded that the item was a "current liability" (Recommended Decision, pp. 12-14, 17-19) because "it represents an obligation of respondent corporation meeting the definition of a current liability, in section 1.17(d)(3) of the regulations under the Commodity Exchange Act" (Recommended Decision, p. 17).

As we shall show, this finding and conclusion is sound. However, later in his discussion of this issue, I believe the Hearing Examiner misunderstood the respondents' argument because of the ambiguous nature of the term "reserve."

The term "reserve" is one of the most ambiguous words used in accounting. The Committee on Terminology of the American Institute of Certified Public Accountants recognized in the 1940's that "the term *reserve* was being used in accounting in a variety of different and somewhat conflicting senses. * * * In accounting practice the term has been used in at least four senses," with some reserves being "reflected in the asset section of the balance sheet" and other reserves being "included in the *liability* section of the balance sheet, or in a section immediately below the ordinary liabilities, or in the *proprietary* section" (see, also, Tr. 196). n61

n61. American Institute of Certified Public Accountants, *Accounting Research and Terminology Bulletins* (Final ed., 1961), Accounting Terminology Bulletin No. 1, pp. 26-27. (Note: This book is a compilation of a number of Bulletins, and there are three different sections of the book containing the same page numbers as those cited in this footnote.)

The Hearing Examiner must have understood the respondents to be arguing that the $ 11,162.97 is an *asset* "reserve." The Hearing Examiner refuted that supposed argument (Recommended Decision, pp. 17-19), explaining that the $ 11,000 was used to buy things or it was spent in various ways, and he stated that "you cannot say that an amount of money is a reserve for future expenses and at the same time say that it has been spent for past expenses" (Recommended Decision, p. 19).

However, this misses the point of the respondents' argument. The respondents concede that the $ 11,162.97 is not an asset (Tr. 280). The respondents concede that the $ 11,162.97 is a "credit" item which is in the same section of the balance sheet as the liabilities and stockholders' equity (Tr. 253, 256, 265, 267, 280, 287; Answer to Amended Complaint, pp. 3-4). But the respondents contend that the $ 11,162.97 item should not appear as part of "current liabilities," but rather in a separate "reserve" category between "current liabilities" and stockholders' equity.

As we shall show, that argument by the respondents is not sound. We shall also show that even if the money had not been spent by the respondent corporation, as long as the money was commingled with the respondent corporation's own money, thereby adding to the respondent corporation's current assets, the respondent

corporation would have to include the amount of the money as a current liability.

B. The "Current Liabilities" Regulations

The regulations define the term "current liabilities" as follows (17 CFR 1.17(d) (3)):

The term "current liabilities" means obligations that are or will become due and payable in the next 12 months, *or* the liquidation of which is reasonably expected to require the use of existing resources classifiable as current assets or the creation of other current liabilities (emphasis supplied).

The word "or" in the definition should be given its normal disjunctive meaning (*Gay Union Corp.* v. *Wallace,* 112 F.2d 192, 197, fn. 15 (C.A.D.C.), certiorari denied, 310 U.S. 647) and, therefore, it is sufficient that the obligation was due and payable in the next 12 months irrespective of whether its liquidation would require the use of existing current assets or the creation of other current liabilities.

We will discuss later the respondents' contention that the "reserve" account could have been liquidated by the performance of services by the respondent corporation for the Financial Corporation. Even under the hypothetical assumption that the obligation was to be liquidated by the performance of services, the term "current liabilities," under settled accounting principles, includes obligations to deliver *services* as well as obligations to pay money, see, *infra,* pp. 122-132. One of the "basic characteristics of liabilities," under accepted accounting principles, is that they are "obligations or duties of the enterprise to provide money, goods, *or services* to a person, firm, or other organization outside of the enterprise at some time in the future" (emphasis supplied; Hend-riksen, *Accounting Theory* (Rev. ed., 1970), p. 449). Hence the unqualified word "obligations" in the regulations was obviously used in its ordinary signification under accepted accounting terminology and includes obligations due and payable in money, goods, or services. This construction receives additional support from the fact that the second part of the definition, following the word "or," relates to obligations not to be liquidated by the performance of services, *i.e.,* those that require for their liquidation money (or other assets) or the borrowing of money (*i.e.,* the creation of other current liabilities).

The uncontroverted evidence reveals that the respondent corporation was obligated to the Financial Corporation to pay money on its behalf or deliver services to it within the next 12 months. This is decisive of the "reserve" issue, and it is not necessary to pursue the matter further. It falls squarely within the first part of the definition of "current liabilities."

To the extent that the "reserve" account was to be liquidated by paying the expenses of the Financial Corporation to third persons, it is not necessary that we know the exact persons who were to receive the money. That, perhaps, was not known as of March 31, 1970. It is sufficient that we know that the money was paid in advance to the respondent corporation to provide money for the payment of the Financial Corporation's expenses during the next 12 months.

Although no further discussion of the "reserve" issue is necessary, for the sake of completeness, we will consider the more abstruse ramifications of this issue, together with other aspects of the regulations relating to "current liabilities."

C. The "Kiting" of Assets under the Respondents' Contention

A few hypothetical balance sheets will demonstrate the absurdity of the respondents' contention as to the "reserve" issue.

First, assume that the respondent corporation's total assets consist of $ 2,000 in cash, and that it owes $ 1,000 payable in 12 months. Its balance sheet would be as follows:

Balance Sheet No. 1

Current	Assets	Current Liabilities
Cash	$ 2,000	$ 1,000
		Capital

$ 1,000

Its working capital (excess of current assets over current liabilities) would be $ 1,000 ($ 2,000-$ 1,000).

Now assume that the corporation borrows an additional $ 11,000 payable in 12 months. Its balance sheet would be as follows:

Balance Sheet No. 2

Curren Assets		Current Liabilities
Cash	$ 13,000	$ 12,000
		Capital
		$ 1,000

Its working capital would still be $ 1,000 ($ 13,000-$ 12,000). In other words, you cannot increase your working capital by borrowing money that must be repaid in the next 12 months.

Referring back to Balance Sheet No. 1, assume that instead of borrowing $ 11,000, the respondent corporation receives $ 11,000 from the Financial Corporation to pay the future expenses of the Financial Corporation, and holds the money in a trust account (not commingled with its own funds) under a trust agreement. Its balance sheet would be as follows:

Balance Sheet No. 3

Current Assets		Current Liabilities
Cash	$ 2,000	$ 1,000
Reserve		
Reserve	$ 11,000	$ 11,000
		Capital
		$ 1,000

Its working capital would still be $ 1,000 ($ 2,000-$ 1,000). In other words, you cannot increase your working capital by receiving money held in trust for a particular purpose.

Finally, referring back to Balance Sheet No. 1 again, assume that the respondent corporation receives $ 11,000 from the Financial Corporation to pay the Financial Corporation's expenses, and commingles the $ 11,000 with its own money. Under the complainant's contention, the respondent corporation's balance sheet would be as follows:

Balance Sheet No. 4

Current Assets		Current Liabilities
Cash	$ 13,000	$ 12,000
		Capital
		$ 1,000

Under this classification, the respondent corporation's working capital would still be $ 1,000 ($ 13,000-$ 12,000).

But under the respondents' contention, its balance sheet would be as follows:

Balance Sheet No. 5

Current Assets		Current Liabilities
Cash	$ 13,000	$ 1,000
		Reserve
		$ 11,000
		Capital
		$ 1,000

Under the respondents' contention, its working capital would be increased to $ 12,000 ($ 13,000-$ 1,000). In other words, by the simple expedient of receiving money to pay another firm's expenses, the respondents contend that the respondent corporation's working capital is increased by the amount of the money received. n62

n62. Balance Sheets 4 and 5 illustrate that even if the respondent corporation had not spent most of the $ 11,162.97 for its own purposes as of March 31, 1970, but instead still had all of the cash on hand, nonetheless, if the respondent corporation commingled the $ 11,162.97 with its own funds, thereby increasing its current assets by that amount, it would have had to include the same amount as a "current liability," as in Balance Sheet 4.

Needless to say, the respondents' contention would completely destroy the utility of the working capital concept and the current asset concept. General Motors and Ford could "kite" their current assets and their working capital by immense sums merely by an arrangement under which each paid expenses for the other.

Under the Commodity Exchange Act regulations, the "kiting" opportunities would stop at this point since prepaid expenses are not regarded as "current assets." 17 CFR 1.17(d)(2)(ix). But prepaid expenses are regarded as current assets under generally accepted accounting principles and, therefore, under the respondents' contention, the "kiting" opportunities would continue indefinitely for the general business community.

For example, assume that we start again with the Balance Sheet No. 1 situation, and that the principles of accounting applicable to the general business community are controlling (*i.e.,* prepaid expenses are current assets). The respondent corporation has total assets of $ 2,000 in cash. Assume that the Financial Corporation has total assets of $ 11,000 in cash, *or total assets of $ 13,000 for the two firms.* Now assume that the Financial Corporation gives the $ 11,000 to the respondent corporation to pay the expenses of the Financial Corporation. The Financial Corporation properly

shows this $ 11,000 prepaid expense as a current asset. Under the respondents' contention, the respondent corporation's balance sheet is as shown in Balance Sheet No. 5, *i.e.,* $ 13,000 in current assets, *or a total of $ 24,000 in assets for the two firms,* without any increase in the respondent corporation's current liabilities.

At this stage, the respondent corporation has $ 13,000 in cash and, with a little ingenuity, the Financial Corporation agrees that it will pay some of the future expenses of the respondent corporation. The respondent corporation then prepays these expenses, *i.e.,* gives the $ 13,000 to the Financial Corporation, and the $ 13,000 is shown on the respondent corporation's books as a current asset (prepaid expense). The Financial Corporation now shows $ 11,000 on its books from the original prepaid expense, plus $ 13,000 in cash, for a total of $ 24,000 in assets for the Financial Corporation. Adding the Financial Corporation's $ 24,000 in assets to the respondent corporation's $ 13,000 (prepaid expense) *makes a total of $ 37,000 in assets for the two firms,* without any increases in either firm's current liabilities, under the respondents' theory.

The Financial Corporation now has $ 13,000 in cash and we are ready to start the process all over again, arranging to give the $ 13,000 to the respondent corporation as prepayment for different expenses. The money could be passed back and forth continuously as long as different items of expense could be prepaid, and the current assets and working capital of each firm would be continuously inflated, since under the respondents' theory, the firm receiving the money (as a prepaid expense of the second firm) counts the money as an asset, but does not show a corresponding liability.

It goes without saying that such "kiting" is not permissible under generally accepted accounting principles. A person receiving money in advance as a result of another person's prepayment of expenses must include the amount of the advance payment as a current liability.

C. "Current Liabilities," "Deferred Revenue," and "Deferred Income"

The American Institute of Certified Public Accountants defines "current liabilities" as follows: n63

The term *current liabilities* is used principally to designate obligations whose liquidation is reasonably expected to require the use of existing resources properly classifiable as current assets, or the creation of other current liabilities.

n63. American Institute of Certified Public Accountants, *Accounting Research and Terminology Bulletins* (Final ed., 1961), Accounting Research Bulletin No. 43, p. 21.

This definition is practically identical to the second half of the definition of "current liabilities" in the regulations, following the word "or." As we have shown, the inference is inescapable that as of March 31, 1970, the respondent corporation was to liquidate the "reserve" account by paying expenses (to third persons) for the Financial Corporation. The money received by the respondent corporation from the Financial Corporation had already been commingled with the respondent corporation's cash, thereby increasing the respondent corporation's current assets (or decreasing its current liabilities), so the payment of the expenses of the Financial Corporation to third persons would have required the use of the respondent corporation's existing resources properly classifiable as current assets, or the creation of other current liabilities. Hence the "reserve" account fits squarely within the second half of the definition of "current liabilities" in the regulations.

Since, as we have shown, the inference is inescapable that the $ 11,162.97 was to be liquidated by the payment of money to others rather than by the respondent corporation charging a management fee, it is unnecessary to consider whether the item would be a "current liability" if the prepayment of expenses was to be liquidated by the future n64 performance of management services by the respondent corporation. But even under that assumption, the "reserve," as of March 31, 1970, would still have been a "current liability."

n64. The services would have to be performed after March 31, 1971; otherwise, the Financial Corporation, which had already paid for the services, could not have listed them on its balance sheet as "prepaid expenses." Prepaid expenses, as we have shown, relate only to payment for services to be performed in the future.

One of the "basic characteristics of liabilities," under accepted accounting principles, is that they are "obligations or duties of the enterprise to provide money, goods, *or services* to a person, firm, or other organization outside of the enterprise at some time in the future" (emphasis supplied; Hendriksen, *Accounting Theory* (Rev. ed., 1970), p. 449).

The American Institute of Certified Public Accountants sets forth the items included in "current liabilities," as follows: n65

As a balance-sheet category, the classification is intended to include obligations for items which have entered into the operating cycle, such as payables incurred in the acquisition of materials and supplies to be used in the production of goods or in providing services to be offered for sale; *collections received in advance of the delivery of goods or performance of services;* n2 and debts which arise from operations directly related to the operating cycle, such

as accruals for wages, salaries, commissions, rentals, royalties, and income and other taxes. Other liabilities whose regular and ordinary liquidation is expected to occur within a relatively short period of time, usually twelve months, are also intended for inclusion, such as short-term debts arising from the acquisition of capital assets, serial maturities of long-term obligations, amounts required to be expended within one year under sinking fund provisions, and agency obligations arising from the collection or acceptance of cash or other assets for the account of third persons (emphasis supplied).

> n65. American Institute of Certified Public Accountants, *Accounting Research and Terminology Bulletins* (Final ed., 1961). Accounting Research Bulletin No. 43, pp. 21-22.
>
> n2 *Examples of such current liabilities are obligations resulting from advance collections on ticket sales, which will normally be liquidated in the ordinary course of business by the delivery of services.* On the contrary, obligations representing long-term deferments of the delivery of goods or services would not be shown as current liabilities. Examples of the latter are the issuance of a long-term warranty or the advance receipt by a lessor of rental for the final period of a ten-year lease as a condition to execution of the lease agreement. [Footnote in the original; emphasis supplied.]

Hence the American Institute of Certified Public Accountants specifically regards as a current liability collections received in advance for the performance of services.

Payments received in advance of the performance of services or the delivery of goods are referred to under generally accepted accounting principles as "deferred income" or "deferred revenue," which is recognized as a current liability.

Deferred revenues appear when collection is made in whole or part prior to the actual furnishing of goods or services. A common example is found in the insurance field, where premiums are regularly collected in advance. Tickets, tokens, and certificates are other types of deferred revenue items. n66 Current liabilities thus consist of two main classes, corresponding

to "receivables" and "prepayments" under current assets: (1) payables and (2) deferred revenue or income. * * *

Deferred revenue includes advances from customers and such items as rentals received in advance and outstanding tickets and tokens. Deferred revenue is sometimes listed as a separate group of liabilities, apart from current or fixed. n67

Classes of Current Liabilities. The principal classes of current liabilities are:

1. Accounts payable and accrued expenses
2. Short-term notes payable
3. Dividends payable
4. *Deferred income*
5. Advances and deposits
6. Withheld amounts
7. Estimated liabilities n68

DEFERRED REVENUES. Advances by customers or clients that are to be satisfied by the future delivery of goods or performance of services are liabilities and should be shown as such. These items have often been labeled "deferred revenues" or "deferred credits." It is more appropriate to provide a title that

clearly describes the nature of the item, such as *"advances from customers."* A common characteristic of such accounts is that they are payable in goods or services rather than in cash and that as a rule a margin of profit will emerge in making such payment. Generally speaking, these items should not be offset against outstanding receivables. n69

RESERVES. Published reports now less frequently show a reserve section between liabilities and shareholders' equity. The heterogeneous nature of the reserve section unnecessarily complicates the interpretation of the balance sheet, for it tends to distract the asset, liability, and capital elements. The AAA in Supplementary Statement No. 1 (Accounting and Reporting Standards for Corporate Financial Statements) has taken a definite stand on this matter by recommending that the reserve section be eliminated and its elements classified

as deductions from assets, estimated liabilities, or a subdivision of retained earnings. The AICPA (ATB No. 1), likewise, has taken a stand against the presentation of "reserves" of this category by recommending that the items be designated as liabilities. It will be noted (see Fig. 1) that the SEC's Regulation S-X continues to recognize this classification. n70

n66. Wixon, Kell, and Bedford, *Accountants' Handbook* (5th ed., 1970), § 20, p. 4.

n67. *Id.,* at § 2, p. 37.

n68. *Id.,* at § 20, p. 4 (emphasis supplied).

n69. Wixon, Kell, and Bedford, *Accountants' Handbook* (5th ed., 1970), § 20, p. 25.

n70. *Id.,* at § 2, p. 38.

The use of the word "deferred" in the phrase "deferred income" or "deferred revenue" may be somewhat misleading to persons not familiar with accounting terminology. They might think of such income as "advance" income rather than "deferred" income. But the term "deferred" is used because even though the money or income has been received, it will not be counted as income on the income statement until a later date.

Many accountants regard Hendriksen, *Accounting Theory* (Rev. ed., 1970), as the leading text on accounting theory. In this text, Hendricksen explains (pp. 309-311) that deferred income is a current liability, as follows:

Nonmonetary Current Liabilities

Nonmonetary current liabilities are those obligations to provide goods or services of specified quantity and quality. They usually arise from the advance payment for services by customers. Subscriptions to periodicals and season tickets are good examples. Other obligations arise from advances by customers for special merchandise. *It should be noted, however, that not all advances are nonmonetary in nature. Some advances represent a given number of dollars that may be applied against a future purchase or purchases at the prices existing when the advance is liquidated. These are monetary advances because they represent the obligation to repay a given number of dollars or the equivalent in goods or services at a future date.* The nonmonetary obligations are expressed in terms of predetermined or agreed prices for specific goods or services. Thus, the monetary value of the goods and services may change but the quantity and quality would not.

These nonmonetary obligations have frequently been classified as *"deferred income" or "deferred credits."* Technically, deferred income represents income items received by the firm but not yet reported as income. However, it is also used to refer

to revenue that would normally have been included in income but where the recognition is deferred until later expenses can be matched with it -- frequently referred to as deferred revenue. The term "deferred credit" is frequently used synonymously with deferred income and deferred revenue, but it is also used in a broader sense including monetary advances by customers.

These terms do not have clear meanings because they include a heterogeneous group of items and they are not consistently classified in the balance sheet. Some of the deferred income and deferred credit items found in published annual reports are classified as current liabilities, others are classified as noncurrent liabilities, a few are reported as "unearned revenue" in the stockholders' equity section, and a majority are found listed as an unclassified item between the liabilities and the stockholders' equity section of the balance sheet. [Footnote citation omitted.] *The latter presentation is partly a carry-over from a former classification in a "reserve" category.* However, it is frequently rationalized on the ground that it represents amounts that will be added to income in a subsequent period but excluded in the current period, for one of several reasons. The deferred income concept apparently arose from the idea that the "realization" of income is closely related to the receipt of cash, but that when the services have not yet been performed or when the amount is likely to be reduced because of subsequent related expenses or losses, the income reporting should be deferred. *However, the separate classification of "deferred income" does not indicate the nature of the items included in the classification and it is subject to abuse, just as was the former "reserve" classification.*

Frequently, the advance payments for goods or services by customers have been considered to represent a mixture of liabilities and profit. If cost is the predominant element, the entire amount could be considered a liability; but if cost is only a small part of the total, *it is argued* that the whole may be considered a deferred credit to income (gross income) rather than a current liability, presumably classified as unearned income in the stockholders' equity section of the balance sheet. If the advance payment represents both costs and income, *it is argued* that it may be divided between the amount of prospective cost which should be included among

the current liabilities and the amount representing prospective income, which should be classified as "unearned income." n17

n17 Eric L. Kohler, *A Dictionary for Accountants* (2d ed.; Englewood Cliffs, N. J.: Prentice-Hall, Inc., 1957), p. 160 [footnote in the original].

This separation of the advance payment into the cost element and the part representing prospective profit stems from the traditional reliance upon the cost concept and the reporting of revenue only after all services have been performed and when all expenses can be measured and matched with the associated revenues. However, it may be more relevant to report the obligation to perform services or provide goods in terms of the output (sales price) of such goods or services. The important consideration is that unless the funds are returned to the customer, the advance payment does not represent an outflow of cash in the future. Regardless of how it is measured, it cannot be identified with specific goods or services to be acquired in the future and used in operations. Some of the services will have been acquired in the past in the form of plant and equipment and thus will be classified as noncurrent assets; others will represent inventories and prepaid expenses classified as current assets; and many of the associated expenses will represent goods and services not yet acquired at the time of the receipt of the advance. Therefore, the advance cannot be associated with costs incurred or to be incurred.

Accounting Research Bulletin No. 43 (page 22) specifically includes among the current liabilities advances for the delivery of goods or the performance of

services in the normal course of operations. However, such obligations extending over long periods in the future are specifically excluded from the current liability classification, although *Bulletin No. 43* does not state how these long-term obligations should be classified. *This treatment of the advance as a current liability is correct for two reasons: (1) The advance is a current financing transaction rather than a revenue-producing one.* n18

n18 See William A. Paton, "'Deferred Income' -- A Misnomer," *Journal of Accountancy,* Vol. CXII (September, 1961), p. 38; and for a criticism, see Robert W. Hirschman, "A Look at 'Current' Classifications," *Journal of Accountancy,* Vol. CXXIV (November, 1967), p. 55. [Footnote in the original; the Hirschman article refers to widespread disagreement and confusion regarding the classification of advance payments.]

While other reasons may give rise to the advance, such as an attempt to avoid bad debt losses, the result is an aid in the financing of the operations of the enterprise. (2) *The obligation to provide goods or services is generally a part of current operations.* Only in the case of incidental transactions would the advance generally represent an obligation extending beyond the normal operating cycle of the business.

While value is added to the firm during the entire process of production, selling, and collection, revenue is generally reported at a single point in time, as discussed in Chapter 6 above. If the critical event in the operations is the providing of the goods or services rather than the collection of the cash, no profit, deferred or current, should be reported at the time of the receipt of the advance. *The entire amount is a liability, regardless of whether it is to be repaid in cash or in goods or services.* Accounting terminology would therefore be improved if the term "advances from customers" were substituted for the term "deferred income."

There are a few cases, however, where the reporting of "deferred income" arises for reasons other than an advance from a customer. In these cases, the services have been provided and the revenue-producing operations have been completed, but the reporting of the income is deferred because of uncertainties in the collection of the receivables or because of uncertainties regarding additional expenses. These so-called "deferred credits" are not liabilities, as there is no obligation to the customers. They should be included in the income of the current period, less the estimated additional expenses and uncollectible receivables. [Emphasis supplied.]

As shown in the immediately preceding quoted material, Hendriksen recognizes that deferred income resulting from the advance payment for goods or services is a current liability, either monetary or nonmonetary in nature. Hendriksen believes that the inclusion of either nonmonetary assets or nonmonetary liabilities as current assets or current liabilities is one of the major disadvantages of the working capital concept. He explains in his text: n71

One of the major disadvantages of the working capital concept of funds is that nonmonetary assets, such as inventories

are prepaid expenses, and a few nonmonetary liabilities, such as advance receipts for services to be performed by the firm in the future (frequently referred to as "unearned income" or "deferred credits to income"), are included.

n71. Hendriksen, *Accounting Theory* (Rev. ed., 1970), p. 246.

Nonetheless, he recognizes that such items are classified as current assets and current liabilities under generally accepted accounting principles. In the present case, the record does not reveal whether, assuming that the "reserve"

was to be liquidated by the performance of services, the respondents' obligation as to the $ 11,162.97 "reserve" was monetary or nonmonetary in nature (see the first paragraph of the quoted material from Hendriksen's text, *supra,* p. 127), but this is immaterial since, in either event, it is recognized as a current liability.

William A. Paton, a noted authority in the field of accounting, explains in the article relied on by Hendriksen, *supra,* p. 130, fn. 18, that from an accounting standpoint, payment received in advance for goods or services is in the nature of a loan, and the amount of the "debt" should appear as a current liability even though the "debt" may not be repaid in money but will be offset by the delivery of goods or the performance of services.

The regulations of other federal agencies as to the balance sheet classification of deferred income or deferred credits resulting from payments received in advance for goods or services are not uniform. Such items are classified separately from current liabilities (*i.e.,* as deferred credits) under the regulations of the Federal Power Commission (18 CFR (1972), Part 101, pp. 172-173, and 228 (item No. 253)) and the Rural Electrification Administration of the United States Department of Agriculture (*Uniform System of Accounts prescribed for Electric Borrowers of the Rural Electrification Administration,* REA Bulletin 181-1, U.S.D.A. (Jan. 1 1972), pp. REA-10, 101-36 (item 253)). The Securities and Exchange Commission's regulation allows such items to be treated either as current liabilities or in a separate "deferred income" classification. The SEC regulation provides (17 CFR (1971) 210.3-14):

Items due and payable within one year shall in general be classed as current liabilities. However, generally recognized trade practices may be followed with respect to the exclusion of items such as customers' deposits and deferred income, provide [*sic*] an appropriate explanation of the circumstances is made.

The Civil Aeronautics Board, on the other hand, requires such items to be classified as current liabilities. The Board's regulation states: "Current liabilities shall include * * * collections received in advance of performance of services" (14 CFR (1971), Part 241, § 5.6).

In summary, the most that can be said on behalf of the respondents is that even if the $ 11,162.97 "reserve" was to have been liquidated by the charging of a management fee for services rendered by the respondent corporation for the Financial Corporation, the item would be classified separately from "current liabilities" under the regulations of some agencies. But under generally accepted accounting principles applicable in the absence of regulations, such a prepayment for services would plainly be a current liability.

The definition of "current liabilities" in the Commodity Exchange Act regulations is consonant with, and even broader than, the definition published by the American Institute of Certified Public Accountants, under which money received in advance of the performance of services is a current liability. Hence the "reserve" item would plainly be a "current liability" under the Commodity Exchange Act regulations, even if it were a prepayment for management services to be rendered by the respondent corporation.

D. Regulatory Exclusions from "Current Liabilities"

The regulations, after defining the term "current liabilities," state that the "following amounts may be excluded from current liabilities" (17 CFR 1.17(d)(3)):

(i) The amount of money, securities and property due to commodity customers of the applicant or registrant which is held in segregated account in compliance with the requirements of section 4d(2) of the Act and the regulations thereunder: *Provided, however,* That such exclusion may be taken only if the applicant or registrant has also excluded such money, securities, and property held in segregated account from current assets in computing his working capital; and (ii) The amount of indebtedness subordinated to the claims of all general

creditors of the applicant or registrant pursuant to a satisfactory subordination agreement, as hereinafter defined.

The first subparagraph under this subsection makes it clear that segregated funds belonging to customers are not current liabilities if the applicant or registrant has excluded such funds from current assets. The proviso would seem to be unnecessary since the regulations expressly provide that the term "current assets" excludes "[c]ash and claims to cash which are restricted as to withdrawal, such as customers' segregated funds" (17 CFR 1.17 (d) (2) (vii)). Hence under no circumstances may segregated funds belonging to customers be treated as "current assets" and, therefore, there are no circumstances under which an applicant or registrant would have to treat the segregated funds belonging to commodity customers as a "current liability."

The second subparagraph provides for excluding from "current liabilities" the amount of indebtedness subordinated to the claims of all general creditors if there is a satisfactory subordination agreement. The regulations spell out in detail the terms which must be set forth in the subordination agreement and provide that two copies of such agreement and of any notes or written instruments evidencing the indebtedness must be filed within 10 days with the Commodity Exchange Authority, together with a statement of the name and address of the lender and the business relationship of the lender to the registrant or applicant (17 CFR 1.17(d)(4)).

The respondents are critical of the regulations since they spell out in great detail the requirements for a subordination agreement but do not specify requirements as to agreements or written instruments necessary for various items to qualify as "current assets" (Respondents' Suggested Findings and Brief, pp. 26-27). However, this lack of specificity does not handicap the respondents. In the absence of any specific requirements, the complainant cannot require that loans, advances, or other receivables be evidenced by any particular form of agreement or that they be filed in any particular location.

Concluding this section of the Decision, the respondents' expert witness carefully refrained from testifying that the "reserve" item was not a "current liability." Two expert witnesses for the complainant testified that it was a "current liability." The "reserve" item fits squarely within the definition of "current liabilities" in the regulations and is a "current liability" under generally accepted accounting principles, whether payable in cash or services.

VI. *The Respondents' Violations Were Wilful*

The respondents received no written notice, prior to the original complaint issued in this case, that the respondent corporation failed to meet the minimum financial requirements under the Act and regulations. Section 9(b) of the Administrative Procedure Act (5 U.S.C. 558(c)) states that:

Except in cases of willfulness or those in which public health, interest, or safety requires otherwise, the withdrawal, suspension, revocation, or annulment of a license is lawful only if, before the institution of agency proceedings therefor, the licensee has been given --

(1) notice by the agency in writing of the facts or conduct which may warrant the action; and

(2) opportunity to demonstrate or achieve compliance with all lawful requirements.

The Hearing Examiner's determination that the respondents' violations were wilful is well supported by the facts and the law.

A violation is wilful, within the meaning of the term in a regulatory statute, if the violator "1) intentionally does an act which is prohibited, -- irrespective of evil motive or reliance on erroneous advice, or 2) acts with

careless disregard of statutory requirements" (*Goodman* v. *Benson,* 286 F.2d 896, 900 (C.A. 7)). *Accord: United States* v. *Illinois Cent. R. Co.,* 303 U.S. 239, 242-244; *Gearhart & Otis, Inc.* v. *Securities & Exch. Com'n.,* 348 F.2d 798, 802-803 (C.A.D.C.); *Eastern Produce Co.* v. *Benson,* 278 F.2d 606, 609 (C.A. 3); *Riss & Company* v. *United States,* 262 F.2d 245, 247-251 (C.A. 8); *United States* v. *Gris,* 247 F.2d 860, 864 (C.A. 2); *Trenton Chemical Co.* v. *United States,* 201 F.2d 776, 777-780 (C.A. 6), certiorari denied, 345 U.S. 994; *Dennis* v. *United States,* 171 F.2d 986, 990-991 (C.A.D.C.), affirmed on other grounds, 339 U.S. 162; *American Surety Co.* v. *Sullivan,* 7 F.2d 605, 606 (C.A. 2); *Chicago, St. P., M. & O. Ry. Co.* v. *United States,* 162 Fed. 835, 840-842 (C.A. 8), certiorari denied, 212 U.S. 579; *Schwebel* v. *Orrick,* 153 F.Supp. 701, 705 (D.C.D.C.), affirmed on other grounds, 251 F.2d 919 (C.A.D.C.), certiorari denied, 356 U.S. 927; *In re David G. Henner,* 30 Agriculture Decisions 1151, 1260-1263; *In re American Fruit Purveyor's, Inc.,* 30 Agriculture Decisions 1542, 1587. See, also, *Great Western Food Distributors* v. *Brannan,* 201 F.2d 476, 484 (C.A. 7), certiorari denied, 345 U.S. 997.

Wilfulness means "no more than that the person charged with the duty knows what he is doing," and it "does not mean that, in addition, he must suppose that he is breaking the law." *Townsend* v. *United States,* 95 F.2d 352, 358 (C.A.D.C.), certiorari denied, 303 U.S. 664; *Fields* v. *United States,* 164 F.2d 97, 100 (C.A.D.C.), certiorari denied, 332 U.S. 851. It is only in statutes involving turpitude that "wilful" includes evil purpose, criminal intent, or the like. *Spies* v. *United States,* 317 U.S. 492, 497-499.

In *Trenton Chemical Co.* v. *United States,* 201 F.2d 776, 777-780 (C.A. 6), certiorari denied, 345 U.S. 994, the Court held that a company which exceeded its quota, under a regulatory order establishing quotas as to grain used by distillers, "willfully" violated the quota restriction, subjecting it to criminal prosecution. The defendant contended that it used grain products, not grain, and "that it had been advised by its attorney that it was not illegal to use grain products in its distilling operations," but the "District Judge declined to permit the * * * [Company] to show at the trial that it acted in good faith and on advice of counsel that its acts were not illegal, in using the materials in question" (201 F.2d at 778, 779). In sustaining the judgment of the District Court, the Court of Appeals held that inasmuch as the regulatory statute did not proscribe acts "in themselves wrong," evidence of "bad faith or evil purpose on the part of the defendant was not necessary to constitute a violation of the act, but it was sufficient if the prohibited act was intentional or voluntary" (201 F.2d at 780).

Similarly, in *Chicago, St. P., M. & O. Ry. Co.* v. *United States,* 162 Fed. 835, 840-842 (C.A. 8), certiorari denied, 212 U.S. 579, the Court upheld the conviction of the defendants under the Elkins Act on the ground that they "willfully" granted rebates to a shipper, notwithstanding the reliance by the defendants on decisions by the Interstate Commerce Commission which, according to the Court, "might well have afforded ground for belief by defendants that their act * * * was justifiable and lawful" (162 Fed. at 840-841). The Court said that to "hold that the belief of an individual concerning the legality of his action should constitute a standard of innocence or guilt would establish an uncertain and dangerous doctrine. It would in many cases justify a violation of statutes expressive of public policy concerning which there may obviously be and frequently are as many different opinions as there are different individuals affected by them" (*id.,* at 842). See, also, *Sinclair* v. *United States,* 279 U.S. 263, 299;

Armour Packing Co. v. *United States,* 209 U.S. 56, 70-71, 85-86; *United States* v. *Union Pac. R. Co.,* 169 Fed. 65, 67 (C.A. 8).

It was held in *Dennis* v. *United States,* 171 F.2d 986, 990-991 (C.A.D.C.), affirmed on other grounds, 339 U.S. 162, that in order to prove a wilful failure

to appear before a Congressional Committee, it is not necessary to show that the act of refusal was done from a bad purpose or an evil motive. The Court held that the mere fact that the defendant claimed to have followed the advice of counsel "is no defense," and that "[i]f it were, many corporations, organizations and even individuals would maintain counsel permanently for the purpose of advising them against doing anything that they do not wish to do" (171 F.2d at 991).

In *Capitol Packing Company* v. *United States,* 350 F.2d 67, 78-79 (C.A. 10), the Court interpreted wilfully more narrowly, requiring a showing of "an intentional misdeed or such gross neglect of a known duty as to be the equivalent thereof." The court stated (350 F.2d at 79):

This interpretation receives support from the legislative history of the Administrative Procedure Act. As stated in the House Report on the Act, in discussing § 9(b):

"The exceptions to the second sentence, regarding revocations, apply only when the demonstrable facts fully and fairly warrant their application. Wilfulness must be manifest." H.R.Rep. No. 1980, 79th Cong., 2d Sess. 41 (1946).

See also, S.Rep.No. 752, 79th Cong., 1st Sess. 25 (1945), 92 Cong.Rec. 5654 (remarks of Congressman Walter).

I do not find the support for the meaning of wilfulness in the legislative history that the Court found. For the legislative history to show that "[w]ilfulness must be manifest" does not help me in defining wilfulness. Once I know the definition of wilfulness, then I know from the legislative history that it must be manifest, but I find nothing in the legislative history to shed light on the definition of wilfulness.

I believe that the many cases set forth above correctly interpret the Congressional intent as to wilfulness, as used in the Administrative Procedure Act. In view of the legislative history relied on by the Court in the *Capitol Packing Company* case *supra,* a finding of wilfulness should be made if it is manifest from the record

that a person has intentionally done an act which is prohibited -- irrespective of evil motive or reliance on erroneous advice, or acted with careless disregard of statutory requirements.

In this case, however, the conduct of the respondents was wilful under the most narrow meaning of the term. It is manifest from the record that the respondents knowingly, intentionally, and deliberately failed to meet the minimum financial requirements of the Act and regulations.

The respondent corporation included the loans or advances to Mr. Economou and to The American Association of Commodity Traders as current assets, claiming that they were "secured" receivables. Yet the inference is inescapable that Mr. Economou knew that they were not secured. He testified that he consulted an attorney, who prepared initial drafts of various documents (Tr. 401, 442, 450-451). Mr. Economou contends that taking the initial steps to prepare drafts of the required documents is evidence of lack of wilfulness (Tr. 450-451). However, the drafts were never finalized. The evidence compels the inference that Mr. Economou knew that certain steps must be taken to secure a loan or advance, but failed to complete that action. Hence he knowingly, intentionally, and deliberately failed to complete the action required to classify these items as current assets as of the relevant dates.

The respondent corporation claimed as current assets the organizational costs of the Trading Syndicates resulting in exclusive brokerage contracts. As we have shown, (i) such organizational costs could not remotely qualify as current assets, under any stretch of the imagination by anyone familiar with accounting principles; (ii) when this matter was discussed by the complainant's auditor with Mr. Economou and his accountant, Mr. Radcliffe, Mr. Radcliffe could not

think of any theory to support a classification of these items as current assets; and (iii) Mr. Radcliffe's complete silence as to this matter at the hearing gives rise to the inference that he still could not think of any basis for classifying these items as current assets at the time of the hearing.

The respondents rely on the alleged advice of their attorney that the organizational costs could be claimed as current assets. One of the complainant's auditors testified at the hearing that Mr. Economou told him during the investigation that he (Mr. Economou) relied on his attorney's advice as to these items (Tr.

36). But Mr. Economou did not testify in this respect at the hearing. And although Mr. Economou mentioned several times at the hearing that he expected his attorney to testify (Tr. 349-350, 401, 406-407, 442), the attorney never appeared. In these circumstances, a finding that the respondents relied on their attorney's advice is not warranted. But even if such advice were given, what training the attorney had in accounting, if any, is not known. Unless the attorney was knowledgeable as to accounting terminology and principles, it would not show good faith to accept the view of an attorney as to an accounting issue rather than the view of the Certified Public Accountant who handled the respondent's books.

In the circumstances, I infer that Mr. Economou knowingly, intentionally, and deliberately included the organizational costs of the Trading Syndicates as current assets with the full realization that they were not current assets.

These items are large enough that even if none of the other issues were involved in this case, the respondent corporation would have been underfinanced as of December 31, 1969, and March 31, 1970, solely as a result of reclassifying these items as non-current assets.

The respondent corporation failed to include as a current liability as of March 31, 1970, the "reserve" item of $ 11,162.97 which was obviously a current liability. The respondent corporation had received the money from its affiliate, the Financial Corporation, for the purpose of paying the expenses of the Financial Corporation. The respondent corporation used the money as its own, spending all but about $ 500 of the money. The respondents' accountant, Mr. Radcliffe, testified that the item was not an "account payable," but he did not testify that the item was not one of several other types of "current liabilities." These circumstances give rise to an inference that Mr. Economou knowingly, intentionally, and deliberately failed to regard this item as a current liability, with full realization that it was a current liability.

The inference as to the "reserve" issue is not quite as strong as it is for the other issues because, assuming that Mr. Economou intended to liquidate this obligation by the respondent corporation's performance of management services for the Financial Corporation (which I have found was not his intention), then under some accounting regulations (but not those of the Commodity Exchange Authority), the item would not be a current liability.

But since the evidence supports the view that as of March 31, 1970, this item was to be liquidated largely, if not entirely, by paying money to other persons for the Financial Corporation's expenses, I infer that Mr. Economou knew that the item was properly classifiable as a current liability under the regulations. But in any event, the respondent corporation was underfinanced as of March 31, 1970, even without considering the "reserve" as a current liability.

The only item that was, perhaps, unintentionally classified erroneously by the respondents was the loan or advance of $ 846 to The American Board of Trade. This was included as a "current asset" under the heading "unsecured receivables due and collectable within 6 months of inception." The regulations plainly exclude this item fom "current assets" since it was an unsecured loan to a

business affiliate under common control with the respondent corporation. Hence the respondents' conduct as to this item was wilful, within the generally accepted meaning of the term. But if conduct is not wilful merely because a person misunderstands plain regulatory requirements, then the respondents' conduct as to this item might not have been wilful. The respondent corporation was underfinanced as of June 30, 1969, by only $ 800.38, so this item is essential to a finding of wilfulness as of that date.

The respondents contend that a lack of wilfulness is shown by the fact that during a discussion with one of the complainant's auditors in February of 1969, before the respondents filed the first financial report on March 31, 1969, the auditor telephoned Mr. O'Brien, Director of the complainant's Registration and Audit Branch in Washington, D. C., as to certain items, and Mr. O'Brien suggested that the respondents submit an explanation of the items with the first financial report (Tr. 6-8). The respondents contend that it would be improper to regard their conduct as wilful when they were told by a government official to file a financial report explaining the items more fully.

It seems likely that Mr. O'Brien did not fully learn all of the details as to the items from the telephone conversation, and decided to withhold a determination as to the items until he had a full explanation of the items in the financial report (Tr. 6-9). Since (i) the respondents had full knowledge of all of the relevant facts as to the items, and (ii) the respondents' classification of the items was erroneous under the plain terms of the regulations,

the respondents' conduct in being underfinanced on March 31, 1969, was wilful within the generally accepted meaning of the term notwithstanding Mr. O'Brien's suggestion to explain the items in the report that was to be filed.

Under the *Capitol Packing Company* doctrine, *supra,* the wil-fulness issue would be borderline as to the underfinancing on March 31, 1969, but I would conclude that the respondents' conduct was wilful even under that doctrine since (i) the respondents' classification of the items was so clearly erroneous, and (ii) the respondents had worked closely with a Certified Public Accountant who did not testify in support of the respondents' position as to any of the items relating to March 31, June 30, or December 31, 1969. (He testified only as to the "reserve" item which relates to March 31, 1970; and as we have shown, even as to the "reserve" issue, he did not testify that the item was not a "current liability.")

The strongest evidence of wilfulness even under the *Capitol Packing Company* doctrine relates to the violation on March 31, 1970, when the respondent corporation's underfinanced condition amounted to $ 22,434.84 (see Finding 9, *supra,* p. 22). The violation on March 31, 1970, was after the formal complaint was filed on February 19, 1970, challenging the respondents' classification of the Trading Syndicates' organizational costs and the loans to Mr. Economou and to The American Association of Commodity Traders.

The respondents contend that the filing of the complaint did not prove that their classification of the items was erroneous, but it was certainly the strongest expression possible of the complainant's view as to the items. The respondents' violation after formal notification of the complainant's position expressed in the complaint filed on Febuary 19, 1970, is clearly wilful conduct even under the *Capitol Packing Company* doctrine.

In addition, the filing of the formal complaint would satisfy the notice requirements of the Administrative Procedure Act as to the March 31, 1970, violation even if notice were required (see *Shuck* v. *Securities and Exchange Commission,* 264 F.2d 358, 360 (C.A.D.C.); *American Air Transport and Flight School, Inc.,* Enforcement Proceeding, 2 Pike & Fisher Ad.L.2d 213, 216 (C.A.B.); same case, Revocation Proceeding, 2 Pike & Fisher

Ad.L.2d 733, 737). n72 But since the violations as to each of the dates involved in this proceeding were wilful, no notice was required.

n72. If notice were required, this notice (the formal complaint) would not have satisfied the requirements of the Administrative Procedure Act as to the December 31, 1969, violation because even though the financial reports as to that date were filed after the complaint was issued, it would have been too late for the respondents to have achieved compliance as of that date by improving the financial condition of the respondent corporation.

VII. *The Respondents Were Not Deprived of Their Rights Under the Due Process Clause of the Constitution and the Applicable Statutory and Regulatory Provisions*

The respondents contend that, at all stages of the administrative proceeding, they were deprived of their rights under the Due Process Clause of the Constitution and the applicable statutory and regulatory provisions.

The respondents contend that they were prejudiced because the Commodity Exchange Authority officials delayed handling their request for exemption from the minimum financial requirements under § 1.31a of the regulations. Under the regulations (17 CFR 1.17(c); 1.31a), the minimum financial requirements were not applicable to any futures commission merchant "who transmits all customers' commodity futures orders, together with all money, securities, and property received to margin, guarantee or clear the trades or contracts of such customers, to another futures commission merchant for execution or clearance, and the latter renders confirmations and statements of purchase and sale and transmits remittances, direct to such customers" (17 CFR 1.31a). n73

n73. These provisions were subsequently revoked. 36 F.R. 22810.

The possibility of the respondent corporation being exempt from the financial requirements under § 1.31a was suggested to Mr. Economou by the Regional Director of the complainant's New York office in April or May of 1969 (Tr. 119-121). The Regional Director "described to him what would be required in that respect. He would have to give up his customers' accounts on a fully-disclosed basis to another brokerage firm" (Tr. 121). Mr. Economou was "surprised" and interested in this possibility (Tr. 121).

The respondents admittedly took no steps to implement coming under § 1.31a until February of 1970, when they asked Mr. Coopersmith, the Assistant Regional Director in New York, for specific details as to coming under § 1.31a (Tr. 434-435, 501).

They also asked Mr. Coopersmith to arrange a meeting between Mr. Economou and the Administrator of the Commodity Exchange Authority. The meeting was held on April 1, 1970, and the Administrator instructed Mr. Coopersmith to "follow through" on the respondents' desire to come under § 1.31a (Tr. 503). The respondents were advised that they would "have to refund the remaining accounts" on their books, which they completed on April 24, 1970 (Tr. 506). In August of 1970, the respondents petitioned the Secretary to direct the Commodity Exchange Authority to "restructure" the respondent corporation under § 1.31a (Tr. 506, 509).

The record is not clear as to whether complainant unduly delayed handling the respondents' request to come under § 1.31a of the regulations. Respondents were told as early as April or May of 1969 that the corporation would have to refund all of its customers' money before it could come under § 1.31a. This admittedly was not done until April 24, 1970.

The regulations told the respondents what form to file to come under § 1.31a, *viz.,* "Form 3-R" (17 CFR 1.14). n74 The form was not signed by respondents until August 19, 1970, and the respondents were notified on August 24, 1970, that "[y]our new status permits you to operate only in accordance with section 1.31a of the regulations" (Comp. Ex. 15 and 16, officially noticed at oral argument). Whether respondents requested a copy of Form 3-R previously and were not furnished it until August 19, 1970, is not shown by this record. But in any event, the § 1.31a issue is totally irrelevant to this administrative proceeding because the respondents are not charged with being underfinanced after March 31, 1970, and they admittedly did not refund all customers' money -- which was a necessary step to come under § 1.31a -- until April 24, 1970.

n74. The regulations provide: "Each registrant shall file promptly with the Commodity Exchange Authority a statement on Form 3-R to * * * report any change * * * [as to] whether or not the operation is conducted under section 1.31a" (17 CFR 1.14(a); 1.14(a)(1), Item 3).

The respondents also contend that the minimum financial requirements did not apply to the respondent corporation after they made application in February of 1970 to be exempt under § 1.31a of the regulations, but that argument is without merit. The respondent corporation was a registrant -- not an applicant for registration -- within the meaning of the regulations (17 CFR 1.17 (c)).

The respondents contend (i) that the complainant's auditors failed to answer adequately questions raised by the respondents as to the meaning of the minimum financial requirement regulations, (ii) that after the complainant's audit of the March 31, 1969, financial report, the auditors failed to advise the respondents specifically as to their findings, and (iii) that no written notice was given to the respondents, prior to the formal complaint, advising them that the respondent corporation was underfinanced. The respondents contend that after previous audits, they were specifically advised of any discrepancies by the complainant's auditors. In this case, the respondents state that they did not know that the complainant differed with their classification of the various items until the formal complaint was issued.

The complainant contends that during and after the audit as to the March 31, 1969, financial report, its auditors advised the respondents that the various items were not properly classifiable as current assets. However, *based on the evidence in this record,* I find the respondents' specific and definite contentions (Tr. 386-389, 417-419, 428, 432-433, 477) more convincing than the complainant's vague testimony as to this matter (Tr. 22-43, 97-98, 222-223, 315, 385, 387). The record shows that the complainant's auditor questioned or expressed doubt as to the classification of the various items as current assets, but the record supports the respondents' contentions that they were not *definitely* advised prior to the issuance of the complaint that the items were not properly classifiable as current assets. n75

n75. The respondents request a ruling as to when the various current assets were disallowed. Such a ruling is irrelevant, but it is clear that they were at least questioned when the first audit was made of the respondent corporation's books, and notice was given to the respondents that they were definitely disallowed when the complaint was issued on February 19, 1970.

Also, as discussed in the preceding section of this decision, the Chief of the complainant's Registration and Audit Branch suggested before the first financial statement was filed that the respondents include an explanation of the items with the first financial report. The respondents contend that this was entrapment, and that it was unfair to bring an action against them in these circumstances.

However, the foregoing circumstances do not preclude the institution of this disciplinary action. They are bound to comply with the regulations published in the Federal Register. Even where a government official gives erroneous information to a

regulated person, that does not estop the government from bringing an action against the person for a violation. It is relevant only in determining the sanction (see *Nichols & Co.* v. *Secretary of Agriculture,* 131 F.2d 651, 658-659 (C.A. 1); *Nelson* v. *Secretary of Agriculture,* 133 F.2d 453, 455 (C. A. 7); *Goodman* v. *Benson,* 286 F.2d 896, 900 (C.A. 7), all under the Commodity Exchange Act). See, also, *United States* v. *Globe Indemnity Co.,* 94 F.2d 576, 578 (C.A. 2), certiorari denied, 304 U.S. 575.

The respondents contend that the complainant had insufficient evidence to warrant issuing the complaint, and that the complaint was issued maliciously to damage the respondents and their affiliates. Even if these contentions were not based on fact, they would be immaterial in this proceeding. The complainant made no effort -- and was not required -- to prove what facts were available in its investigatory file at the time the complaint was issued. It is only required that any order issued in this case be adequately supported by the record considered as a whole and proper inferences drawn from the record. Also, if the evidence in the record substantiates the allegations of the complaint, it is not the function of the Judicial Officer to question the motives of the administrative officials responsible for the institution of the proceeding. n76

n76. One of the circumstances relied on by the respondents to show maliciousness is the additional audit conducted in May of 1970 of the respondent corporation's books as of March 31, 1970. This occurred after the complaint had been issued, and resulted in an amended complaint adding allegations that the respondent corporation was underfinanced on December 31, 1969, and March 31, 1970. However, it is a customary practice under the Department's regulatory programs to conduct additional investigations, particularly in financial requirements cases, to determine the respondent's financial position at a more current date.

But assuming, *arguendo,* that the respondents' contentions are relevant, they are based solely on suspicion and surmise that is insufficient to rebut the presumption of regularity supporting the actions of government officials. See *United States* v. *Chemical Foundation,* 272 U.S. 1, 14-15; *Lawson Milk Company* v. *Freeman,* 358 F.2d 647, 649 (C.A. 6); *Barnard and Burk* v. *City of Pulaski,* 327 F.2d 911, 912 (C.A. 6); *Donaldson* v. *United States,* 264 F.2d 804, 807 (C.A. 6); *Reines* v. *Woods,* 192 F.2d 83, 85 (Emerg. C.A.); *National Labor Relations Board* v. *Bibb Mfg. Co.,* 188 F.2d 825, 827 (C.A. 5); *Woods* v. *Tate,* 171 F.2d 511, 513 (C.A. 5); *Pasadena Research Laboratories* v. *United States,* 169 F.2d 375, 381 (C.A. 9), certiorari denied, 335 U.S. 853; *Laughlin* v. *Cummings,* 105 F.2d 71, 73 (C.A.D.C.).

The respondents contend that the Hearing Examiner erred in refusing to issue a subpoena for Mr. Murray Wolkis, who was the

chief of the complainant's Registration and Audit Branch in New York in early 1969. Mr. Economou requested that he be subpoenaed so that he could be examined with respect to the nature of any post-audit report given to Mr. Economou at the conclusion of the initial audit of the respondent corporation's books (Tr. 384-394, 413-414).

The respondents did not request the subpoena until the third day of the four-day hearing. Also, Mr. Fitzpatrick, who conducted the audit and talked to Mr. Economou, was subject to cross-examination by the respondents, but Mr. Economou failed to cross-examine him as to any post-audit report. In addition, the respondents have no right of discovery as to the complainant's investigative

files, except perhaps under the *Jencks* doctrine (see *Fairbank* v. *Hardin,* 429 F.2d 264, 268 (C.A. 9)), which is inapplicable here. Moreover, the respondents seemingly were trying to elicit information from Mr. Wolkis indicating that they were not definitely advised in any post-audit interview that various items were being disallowed as current assets, and I have found that the respondents' contention in this respect is correct, but irrelevant.

The Hearing Examiner has wide latitude as to all phases of the conduct of the hearing and the manner in which the hearing will proceed (*Radio Corp.* v. *United States,* 341 U.S. 412, 420; *Wallace Corp.* v. *Labor Board,* 323 U.S. 248, 253; *Cella* v. *United States,* 208 F.2d 783, 789 (C.A. 7), certiorari denied, 347 U.S. 1016; *National Labor R. Board* v. *Premo P. Laboratories,* 136 F.2d 85, 86 (C.A. 2); *National Labor Relations Bd.* v. *Algoma Plywood & V. Co.,* 121 F.2d 602, 604-605 (C.A. 7); *Jefferson Electric Co.* v. *National Labor Relations Bd.,* 102 F.2d 949, 955 (C.A. 7); *National Labor R. Board* v. *American Potash & C. Corp.,* 98 F.2d 488, 491-492 (C.A. 9), certiorari denied, 306 U.S. 643). The Examiner did not err in refusing the respondents' request for a subpoena.

The respondents contend that they were disadvantaged by the fact that the prehearing conference lasted only a few minutes. Admittedly, no objection to the scope of the prehearing conference was made at the time. Whether or not a prehearing conference is held is within the discretion of the Hearing Examiner (17 CFR 0.15), and although it might have saved more time in the long run to have held an extensive prehearing conference, the failure to do so was not reversible error.

The respondents contend that the Hearing Examiner did not conduct the hearing in a fair and impartial manner, consistently upholding the complainant's position and disagreeing with the respondents' position. They contend that he prevented them from fairly presenting their case. A careful reading of the entire record demonstrates that these contentions are without merit.

It has consistently been held that resolving all disputed issues in favor of one party is no proof of bias. *Labor Board* v. *Pittsburgh SS Co.,* 337 U.S. 656, 659-660; *Fairbank* v. *Hardin,* 429 F.2d 264, 267-268 (C.A. 9); *Sardis Luggage Co.* v. *National Labor Rel. Bd.,* 234 F.2d 190, 193 (C.A. 5); *National Labor Rel. Bd.* v. *Houston & North Tex. M.F.L.,* 193 F.2d 394, 396-397 (C.A. 5); *National Labor Rel. Bd.* v. *Robbins Tire & Rubber Co.,* 161 F.2d 798, 800 (C.A. 5).

The Hearing Examiner admitted that he became impatient with Mr. Economou's handling of the case (Tr. 453), and he made a number of injudicious statements, *e.g.,* telling Mr. Economu that "[f]rom your pleadings and what you have tried to put in here today, I know you are going to try to put in a lot of things that will be objected to and the objection will be sustained" (Tr. 354). The Examiner's impatience and prognostication were justified, based on the respondents' presentation of their case, but he should not have expressed such views or feelings. However, a reading of the entire record demonstrates that the respondents were not prejudiced by the Examiner's conduct.

Mr. Economou wanted to present his case in a "leisurely fashion" (Tr. 453), and he could not understand why the Hearing Examiner wanted to hurry the hearing (Tr. 187-188). The Examiner wanted to hear the facts with respect to whether the items alleged in the complaint and amended complaint were properly classified, but Mr. Economou seemed to be interested in presenting everything but the facts as to those issues. The Hearing Examiner was continuously looking for "[m]ore matter, with less art," n77 but he got very little in the way of evidentiary "matter" from the respondents. Mr. Economou repeatedly tried to present argument at the hearing, through cross-examination and direct testimony, which the Hearing Examiner properly indicated should be discussed in his brief.

n77. The quotation is from the Queen's comment to Polonius in Shakespeare's *Hamlet,* Act 2, Scene 2.

The respondents contend that they were prevented from introducing evidence at the hearing by the Hearing Examiner, but at no time did the respondents make an offer of proof which, under the rules of practice, would have been included in the transcript and would have been considered a part of the transcript if the Judicial Officer determined that the Hearing Examiner's ruling in excluding the evidence was erroneous (17 CFR 0.11(e)(8)). No significant, relevant testimony was excluded; but if it had been excluded, the failure of the respondents to make an offer of proof would preclude them from claiming prejudicial error.

The respondents contend that their cross-examination of Mr. Jackson, a "key" witness (Tr. 321), was unduly curtailed (Tr. 320-327). However, Mr. Jackson testified that his audit of the respondent corporation's records related to whether the respondent corporation was complying with the segregation requirements of the Act and regulations (Tr. 311, 320, 327-328), which is totally irrelevant to the issues involved in this case.

The respondents contend that it was error to receive hearsay evidence in the administrative proceeding. The complainant's auditor testified as to statements (Tr. 37-40) made by the respondents' accountant, Mr. Radcliffe (Tr. 395-396; Affidavit attached to Answer to Amended Complaint, p. 9), in Mr. Economou's presence (Tr. 37, 40), during the investigation in this case. It is settled that such responsible hearsay is admissible in an administrative proceeding (*Opp Cotton Mills* v. *Administrator,* 312 U.S. 126, 155; *National Labor Rel. Bd.* v. *Imparato Stevedoring Corp.,* 250 F.2d 297, 302-303 (C.A. 3); *Phelps Dodge Refining Corp.* v. *Federal Trade Com'n.,* 139 F.2d 393, 397 (C.A. 2); *Ellers* v. *Railroad Retirement Board,* 132 F.2d 636, 639 (C.A. 2); *International Ass'n., Etc.* v. *National Labor R. Board,* 110 F.2d 29, 35 (C.A. D.C.), affirmed, 311 U.S. 72; *National Labor Relations Board* v. *Remington Rand, Inc.,* 94 F.2d 862, 873 (C.A. 2), certiorari denied, 304 U.S. 576). Moreover, the respondents' accountant, Mr. Radcliffe, testified at the hearing, and although he did not remember the details of the conversation referred to in the hearsay evidence, he did not contradict the hearsay evidence.

The respondents contend that they were deprived of their rights because the Hearing Examiner failed to consider all of the issues in the case and, except for the first three pages of the Recommended Decision, the Hearing Examiner merely Xeroxed the Government's brief filed in this proceeding. It would have been

much better practice for the Hearing Examiner to have independently written his Recommended Decision in this case. However, since the respondents' contentions are so completely without merit, the Xeroxing of the Government's brief was not reversible error in this case. See *United States* v. *Crescent Amusement Co.,* 323 U.S. 173, 184-185; *United States* v. *Cornish,* 348 F.2d 175, 181, fn. 8 (C.A. 9); *Chicopee Manufacturing Corp.* v. *Kendall Company,* 288 F.2d 719, 724-725 (C.A. 4), certiorari denied, 368 U.S. 825; *Mississippi Valley Barge Line Co.* v. *Cooper Terminal Co.,* 217 F.2d 321, 322-323 (C.A. 7); *Tanker Hygrade No. 24* v. *The Dynamic,* 213 F.2d 453, 456 (C.A. 2); *Dearborn Nat. Casualty Co.* v. *Consumers Petroleum Co.,* 164 F.2d 332, 333 (C.A. 7); *O'Leary* v. *Liggett Drug Co.,* 150 F.2d 656, 667 (C.A. 6), certiorari denied, 326 U.S. 773; *Schilling* v. *Schwitzer-Cummins Co.,* 142 F.2d 82, 83-84 (C.A.D.C.); *In re American Fruit Purveyor's, Inc.,* 30 Agriculture Decisions, 1542, 1575-1576. The Examiner's report adequately reflects his findings and conclusions with respect to the significant issues involved in this proceeding.

The respondents contend that they were damaged by the complainant's issuance of a press release with respect to the complaint and the amended complaint. In accordance with the Department's customary practice, the complaint and amended complaint were made available to the press (and to others, such as Dun & Bradstreet, Inc), and a cover sheet summarizing the complaint was attached to the original complaint. It is not known whether such a cover sheet was attached to the amended complaint. The cover sheet to the complaint states: "The issuance

of a complaint under the Commodity Exchange Act does not constitute proof of violation of the law. Such violation is established only when the Judicial Officer of the Department has made a determination that the evidence substantiates allegations in the complaint" (see the Complainant's Response to Item 13, Judicial Officer's "Questions for Oral Argument" filed March 22, 1972). The issuance of a press release based on administrative complaints is a customary practice in the Department of Agriculture and other Federal regulatory agencies. Such practice has been held to be proper. *F.T.C.* v. *Cinderella Career & Finishing Schools, Inc.,* 404 F.2d 1308, 1312-1314, 1317-1323 (C.A.D.C.); *Bowman* v. *United States Department of Agriculture,* 363 F.2d 81, 86 (C.A. 5).

The respondents claim that they were particularly damaged because the amended complaint and the news coverage of the amended

complaint indicated that the respondent corporation's financial position was deteriorating by about $ 4,000 per month during the first quarter of 1970. The amended complaint charges that the respondent corporation lacked approximately $ 6,000 as of March 31, 1969, $ 700 as of June 30, 1969, $ 13,000 as of December 31, 1969, and $ 24,893.38 as of March 31, 1970, of having enough funds to meet the minimum financial requirements of the Act and regulations. The respondents contend that there was very little change in the respondent corporation's financial condition between December 31, 1969, and March 31, 1970, and they would have preferred to have had the amended complaint allege that it was underfinanced on December 31, 1969, by about $ 23,000, rather than $ 13,000, so that there would not have been an indication of such a rapid deterioration in the respondent corporation's financial condition during the first quarter of 1970. The respondents contend that the news coverage as to this matter was disastrous to a new business venture being initiated at that time.

The amended complaint reclassified the "reserve" item, discussed *supra,* as a current liability as of March 31, 1970, but not as of December 31, 1969. The respondents contend that the same "reserve" item appeared on its books as of December 31, 1969, in approximately the same amount as on March 31, 1970 (Answer to Amended Complaint, p. 4), and that the complainant maliciously reclassified the "reserve" item as of March 31, 1970, but not December 31, 1969, so as to indicate to the public that the respondent corporation's financial position was rapidly deteriorating.

Even if true, this would not be the appropriate proceeding to challenge such malicious action. It is the function of the Judicial Officer to determine whether or not the evidence in the record supports the complainant's allegations that the respondents violated the Act -- not to question the motives of the complainant in making such allegations.

But assuming the relevancy of the respondents' argument, the complainant's witnesses testified that at the time the amended complaint was issued, they did not audit the respondent corporation's records as of December 31, 1969, and they did not know that the same "reserve" item should have been classified as a current liability as of December 31, 1969 (Tr. 180-182, 189-192, 200-210). The respondents have no one but themselves to blame for the complainant's failure to allege that the respondent corporation was underfinanced on December 31, 1969, by the additional amount

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of the "reserve" item. The "reserve" item was shown in the amount of $ 10,234.50 on the respondent corporation's financial report as of December 31, 1969, under the classification of capital funds appropriated for contingencies (Comp. Ex. 7). This was a false and deceptive classification of the "reserve" item. It was clearly a current liability and should have been classified as such by the respondent corporation in its financial report. Even in the respondents' amended answer, p. 4, they do not classify the "reserve" as part of

their "capital." They have a heading entitled "Reserve, Surplus & Capital," under which the "Reserves to cover accruing expenses" is set forth separately from the "Earned Surplus" and the "Capital and Capital surplus." Hence the classification of the item on the December 31, 1969, financial report as capital funds appropriated for contingencies was completely false and deceptive.

The respondents contend that they were prejudiced by having to proceed with the oral argument while their court action instituted in February of 1972 against officials of the Department for damages was pending. The oral argument was voluntarily stayed for approximately eight months to afford the District Court an opportunity to rule on the respondents' request for an injunction and a stay order. When the court denied the respondents' request, it was proper to proceed with the oral argument. The Due Process Clause of the Constitution is not violated by forcing a person to proceed with litigation in one case notwithstanding any alleged embarrassment or problems created for such person in another suit involving the same subject matter. See *United States* v. *Kordel,* 397 U.S. 1, 11-13; *United States* v. *Simon,* 373 F.2d 649, 650-654 (C.A. 2), vacated as moot, 389 U.S. 425.

I infer that Mr. Economou refused to discuss the four current assets issues during the oral argument for the same reason that I infer his accountant failed to discuss them at the hearing -- nothing can be said in support of the respondents' position as to these issues. Similarly, I infer that Mr. Economou was willing to discuss the current liabilities issue only in part during the oral argument for the same reason that I infer his accountant discussed the issue only in part at the hearing -- a full discussion leads to only one conclusion, *viz.,* that the "reserve" item was a current liability.

The respondents contend that they were unable to present effective oral argument because they did not know what position the

complainant would take. The complainant's position had previously been set forth in its brief. Moreover, the Judicial Officer offered to let the respondents present their oral argument as to the detailed questions posed by the Judicial Officer after the complainant's argument, but this offer was rejected (Oral Arg., pp. 118-124, 136). The respondents were afforded a total of 11 hours for presenting their oral argument, which included a week-end recess to prepare a rebuttal to the complainant's oral argument. It is concluded that the respondents had a fair opportunity to present their contentions during the oral argument. In addition, the respondents were afforded an opportunity to file a brief within two weeks after the oral argument (Oral Arg., pp. 317-319), but no such brief was filed, and no request for an extension of time was made.

The respondents object to the use of authoritative accounting textbooks by the Judicial Officer, but official notice may be taken of such textbooks. *Parker* v. *Brown,* 317 U.S. 341, 363. It has been the Judicial Officer's practice for 30 years to rely on authoritative textbooks in deciding issues under the Department's complex regulatory statutes. On judicial review of the Judicial Officer's decisions, the courts have frequently relied on such textbooks (see, *e.g., Irving Weis & Co.* v. *Brannan,* 171 F.2d 232, 234 (C.A. 2); *Great Western Food Distributors* v. *Brannan,* 201 F.2d 476, 479 (C.A. 7), certiorari denied, 345 U.S. 997; *United States* v. *Grady,* 225 F.2d 410, 415, fn. 9 (C.A. 7), certiorari denied, 350 U.S. 896; *Corn Products Refining Co.* v. *Benson,* 232 F.2d 554, 563, fn. 5 (C.A. 2); *Volkart Brothers, Inc.* v. *Freeman,* 311 F.2d 52, 56, 58, 59 (C.A. 5); all under the Commodity Exchange Act). In the *Corn Products Refining Co.* case, *supra,* the court relied on 14 textbooks and two volumes of a Federal Trade Commission study of the grain trade (232 F.2d at 563, fn. 5). But in any event, the textbooks relied on in this case merely support the conclusions of the complainant's accountants which are set forth in the record. The same decision would be reached without any reliance on the accounting textbooks.

In short, there is no basis whatever to the respondents' contentions that they were deprived of their rights under the Due Process Clause of the Constitution and the applicable statutory and regulatory provisions. Procedural

due process of law "has never been a term of fixed and invariable content." *Communications Comm'n.* v. *WJR,* 337 U.S. 265, 275. "No particular form of procedure

is required to constitute due process in administrative hearings." *National Labor Relations Board* v. *Prettyman,* 117 F.2d 786, 790 (C.A. 6). *Accord: Inland Empire Council* v. *Millis,* 325 U.S. 697, 710; *Labor Board* v. *Mackay Co.,* 304 U.S. 333, 351.

VIII. *The Sanction*

The administrative proceeding in this case does not partake of the essential qualities of a criminal proceeding. In permitting the respondents to trade on the commodity markets, the Government has, in effect, granted them a privilege. Suspension of the privilege for failure to comply with the statutory standard "is not primarily punishment for a past offense but is a necessary power granted to the Secretary of Agriculture to assure a proper adherence to the provisions of the Act." *Nichols & Co.* v. *Secretary of Agriculture,* 131 F.2d 651, 659 (C.A. 1). *Accord: Kent* v. *Hardin,* 425 F.2d 1346, 1349 (C.A. 5); *Blaise D'Antoni & Associates, Inc.* v. *Securities & Exchange Com'n.,* 289 F.2d 276, 277 (C.A. 5), certiorari denied, 368 U.S. 899; *Eastern Produce Co.* v. *Benson,* 278 F.2d 606, 610 (C.A. 3); *Cella* v. *United States,* 208 F.2d 783, 789 (C.A. 7), certiorari denied, 347 U.S. 1016; *Irving Weis & Co.* v. *Brannan,* 171 F.2d 232, 235 (C.A. 2); *Helvering* v. *Mitchell,* 303 U.S. 391, 399; *Nelson* v. *Secretary of Agriculture,* 133 F.2r 453, 456 (C.A. 7); *Board of Trade of City of Chicago* v. *Wallace,* 67 F.2d 402, 407 (C.A. 7), certiorari denied, 291 U.S. 680; and *Farmers' Live Stock Commission Co.* v. *United States,* 54 F.2d 375, 378 (E.D. Ill.). See, also, *Ex Parte Wall,* 107 U.S. 265, 287-290; *Hawker* v. *New York,* 170 U.S. 189, 190-200; *Steuart & Bro.* v. *Bowles,* 322 U.S. 398, 406-407; *Brown* v. *Wilemon,* 139 F.2d 730, 731-732 (C.A. 5); Chamberlain, Dowling, and Hays, *The Judicial Function in Federal Administrative Agencies* (1942), pp. 93-95.

The function of an administrative sanction is "deterrence rather than retribution" (Schwenk, "The Administrative Crime, Its Creation and Punishment by Administrative Agencies," 42 *Mich. L. Rev.* (1943) 51, 85).

Under the foregoing authorities, the sanction should, *inter alia,* be adequate to deter the respondents from future violations.

In *Beck* v. *Securities and Exchange Commission,* 430 F.2d 673, 675 (C.A. 6), the Court questioned, without deciding, whether a suspension order may also be used to deter others in the regulated industry from committing similar violations. As far as I know, this is the only case in which the use of an administrative sanction

to deter others has been questioned. Previously, the use of an administrative sanction to deter others had been assumed to be proper. See, *e.g., American Air Transport and Flight School, Inc., Enforcement Proceeding,* 2 Pike & Fisher Ad. L. 2d 213, 215 (C.A.B.). See, also, the dissenting opinion in *Beck* v. *Securities and Exchange Commission,* 413 F.2d 832, 834 (C.A. 6).

In cases arising under the Civil Aeronautics Act, it has been expressly held that the Civil Aeronautics Board has the power to "impose a suspension as a 'sanction' against specific conduct or because of its 'deterrence' value -- either to the subject offender or to others similarly situated." *Pangburn* v. *C.A.B.,* 311 F.2d 349, 354 (C.A. 1). Accord: *Hard* v. *Civil Aeronautics Board,* 248 F.2d 761, 763-765 (C.A. 7), certiorari denied, 355 U.S. 960; *Wilson* v. *Civil Aeronautics Board,* 244 F.2d 773, 773-774 (C.A.D.C.), certiorari denied, 355 U.S. 870.

The remedial provisions of a regulatory program would be drastically affected if the agency could consider the effect of sanctions only on the respondents and

not on others. It is well recognized that persons regulated by a governmental agency keep abreast of administrative proceedings. All futures commission merchants are on the complainant's mailing list to receive copies of all Decisions and Orders issued under the Act. The actions of potential violators could be significantly affected by the sanctions imposed against other persons. Eight years' experience in the administration of a regulatory program has convinced me that it is necessary to consider, as a major factor, the effect of a sanction in a particular case not only on the violator, but on other potential violators, as well.

In the field of criminal law, it is settled beyond question that one of the primary purposes of the penalty imposed on a particular violator is to deter other potential violators.

* * * punishment * * * is used not to prevent future violations on the part of the criminal alone, but in order to instill lawful behavior in others. n78

sanctions are * * * also * * * intended to deter others from the performance of similar acts * * *. n79

* * * deterrence * * * is aimed at the protection of society. By making a certain action a punishable offense, we expect that people will refrain from committing the offense through fear of punishment.

The purpose of punishment as a deterrent * * * is also to demonstrate to the potential offender the consequences if he violates the law. n80

* * * the deterrent value of a correctional system is not restricted to those who come into direct contact with it but applies to the whole population. n81

* * * it is a primarily preventive consideration -- having an eye to what is necessary to keep the people reasonably law-abiding -- which today's legislators have in mind * * * when they define crimes and stipulate punishments. n82

* * * regulations which are such commonplaces in modern times: traffic ordinances, building codes * * * regulations governing commerce, etc. Here there is no doubt that punishment for infraction has primarily a general -- preventive function. Here nearly all of us are potential criminals. n83

The purpose of punishment be it a criminal sentence, a civil penalty, or punitive damages, is not to inflict suffering or to impose a loss on the offender. Its object is to act as a deterrent: * * * to discourage the offender himself from repeating his transgression; and * * * to deter others from doing likewise. n84

Sentencing is * * * an exacting task in which the Court undertakes to * * * impose a sentence which will best protect society, deter others * * *. n85

More controversial but certainly no less important [than deterrence of the individual violator] is the need for *deterrence,* "general prevention," of potential criminals who may be dissuaded from crime by the threat and the administration of penalties. n86

* * *

Penalties are not provided as a punishment for the individual who has gone wrong. Their imposition is alone justified for the effect the punishment may have upon the convict in preventing him from a continuance in crime, and in teaching him that "the way of the transgressor is hard." But a still greater object to be attained is the deterrent effect the sentence may have upon those who may be inclined to follow the criminal course upon which the convict has embarked. n87

* * * deterrence looks primarily at the potential criminal outside the dock [of the courtroom] * * *. n88

Punishment can protect society by deterring potential offenders * * *. n89

One of these goals [of law] is deterrence by means of punishment. We punish in order to deter people from engaging in the undesirable conduct which we call crime.

* * * deterrence * * * addresses itself * * * both to the individual himself * * * and to the entire community. n90

n78. Andenaes, "The General Preventive Effects of Punishment," 114 *University of Pennsylvania Law Review* (1966), 949, 982.

n79. Schwartz & Skolnick, "Two Studies of Legal Stigma," 10 *Soc. Problems* (1962), 133, 133.

n80. Gardiner, "The Purposes of Punishment," 21 *Mod. L. Rev.* (1958), 117, 121.

n81. Gould and Namenwirth, "Contrary Objectives: Crime Control and the Rehabilitation of Criminals," in *Crime and Justice in American Society* (1971), 245, 246.

n82. Andenaes, "General Prevention -- Illusion or Reality?," 43 *Journal of Criminal Law, Criminology and Police Science* (1952), 176, 177.

n83. Andenaes, "General Prevention -- Illusion or Reality?," 43 *Journal of Criminal Law, Criminology and Police Science* (1952), 176, 182.

n84. *Collins* v. *Brown.* 268 F.Supp. 198, 201 (D.C.D.C.).

n85. *U. S.* v. *Mandracchia,* 247 F.Supp. 1, 4 (D.N.H.).

n86. Tappan, *Crime, Justice and Correction* (1960), p. 243.

n87. *Id.,* at p. 243, fn. 5, quoting from *People* v. *Gowasky,* 219 App. Div. 19, 219 N.Y.S. 373, 380, affirmed, 244 N.Y. 451, 155 N.E. 737.

n88. Williams, *Salmond on Jurisprudence* (12th ed., 1966), § 15, p. 94.

n89. *Id.,* § 15, p. 94.

n90. Puttkammer, *Administration of Criminal Law* (1953), 8.

Perhaps the most salient authority for the proposition that the primary end of punishment is to serve as a deterrent to the general public is Chief Justice William Howard Taft's statement written in 1928:

* * * the chief purpose of the prosecution of crime is to * * * deter others tempted to do the same thing from doing it because of the penal consequences. n91

n91. Menninger, *The Crime of Punishment* (1968), 190, 194. The original statement of Chief Justice Taft's position appeared in his article, "Toward a Reform of the Criminal Law," in *The Draft of Civilization* (1929).

Johannes Andenaes, a leading authority from the University of Oslo, makes the same point, as follows: "From the point of view of sheer logic one must say that general prevention -- i.e., assurance that a minimum number of crimes will be committed -- must have priority over special prevention -- i.e.; impeding a particular person from future offenses." n92

n92. Andenaes, "The General Preventive Effects of Punishment," 114 *University of Pennsylvania Law Review* (1966), 949, 952.

Whether punishment achieves the objective of deterring others from violating the law is questioned by some authorities, but affirmed by others.

As an argument for the abolition of the deterrent doctrine, it is often maintained that neither the threat nor application of penalties does prevent crime. This position reflects the simplistic notion, too commonly prevailing in

matters of social action, that nothing has been achieved merely because not everything is accomplished that we should like. It is sometimes said that high crime rates prove that sanctions do not deter or that penalties actually invite the crimes of men who seek punishment to dissolve their feelings of guilt. With tiresome frequency the illustration is cited of the pickpockets who actively plied their trade in the shadow of the gallows from which their fellow knaves were strung. These assertions have a superficial relevance but they do not dispose of the issue by any means.

Persons with a will to believe in the efficacy of an exclusively individualistic and positivistic correctional system often quote the words of Warden Kirchwey. His patent oversimplifications of man's behavioral motivations should be noted, for this sort of loose thinking and naive criminological idealism pervert the ends of correction. n93

n93. Tappan, *Crime, Justice and Correction* (1960), p. 245.

[Next paragraph continues from same source.]

* * *

It is true, certainly, that the Classical doctrine of deterrence appears crudely oversimple in the light of modern conceptions of human behavior. In terms of reasonable goals for today it proposed to accomplish both too much and too little. This doctrine of deterrence was substantially more sound, however, than the position taken by those who deny any preventive effect to criminal sanctions. It is maintained here that the penal law and its application do in fact deter; indeed, with the declining efficacy of other forms of social control, it must be relied upon increasingly to maintain standards of behavior that are essential to the survival and security of the community. A complete failure of legal prevention cannot be inferred from the serious crimes committed by a small percent

of the population any more than can its success by the law obedience of the great preponderance of men. The matter is not so simple. n94

n94. Tappan, *Crime, Justice and Correction* (1960), p. 246.

* * * [as to studies indicating the death penalty is ineffective as a deterrent to murder], their very broad interpretation has rendered a disservice to the more general issue of punishment as a deterrent to all kinds of criminal behavior. Such an expansive conclusion is obviously not justified since murder is * * * a unique kind of offense often involving very strong emotions. n95

n95. Chambliss, "The Deterrent Influence of Punishment," 12 *Crime & Delinquency* (1966), 70, 71.

* * *

It is naive to suppose that punishment exists in a vacuum and is unrelated to the specific kinds of acts and the meaning which the punishment has for the actor. n96

n96. *Id.,* at p. 75.

That sanctions do, in fact, serve as a deterrent to "white-collar" violations is evidenced by a number of studies.

As Sutherland's analysis of white-collar crime has shown, violators of the Sherman Antitrust law are relatively free from criminal prosecution, though the imposition of punishment would be *maximally effective* with this type of offense. n97

An intensive study of parking violators indicates that * * * an increase in the severity and certainty of punishment does act as a deterrent to further violation. These findings suggest the necessity for a reappraisal of current thinking. Studies demonstrating the ineffectuality of punishment as a deterrent to certain types of offenses should not be interpreted to mean that punishment is ineffective in deterring all types of offenses. n98

n97. Chambliss, "Types of Deviance and the Effectiveness of Legal Sanctions," 1967 *Wisconsin Law Review* 703, 716 (emphasis supplied).

n98. Chambliss, "The Deterrent Influence of Punishment," 12 *Crime & Delinquency* (1966), 70.

Since one of the main purposes of a criminal law sentence is to deter other potential violators from committing similar violations, it follows, *a fortiori,* that one of the main purposes of an administrative law sanction is to deter other potential violators. In criminal law, "[r]etribution or social retaliation, though persistently

criticized by modern advocates of a progressive penology, continues to be a major ingredient of our penal law and of our correctional system." n99 "The principle of retribution was formulated in the *lex talionis,* the Mosaic doctrine expressed in *Deuteronomy,* 19:21: 'Thine eye shall not pity, but life shall go for life, eye for eye, tooth for tooth, hand for hand, foot for foot.'" n100 But retribution or social retaliation is not one of the objectives of administrative sanctions -- they are to "assure a proper adherence to the provisions of the Act" (*supra,* p. 169). Hence deterrence -- both as to the individual violator, and as to other potential violators -- is the primary, if not the only, objective of an administrative sanction.

n99. Tappan, *Crime, Justice and Correction* (1960), p. 241.

n100. *Id.,* at p. 241, fn. 3.

To serve as an effective deterrent to potential violators of a regulatory statute, I believe that administrative sanctions should be severe; sanctions which are too lenient, rather than being a deterrent, will serve as a catalyst for violations by others. Not all criminologists, sociologists, or jurists share this view; but many noted authorities do.

* * * one natural strategy for increasing the deterrent efficacy of threats is to increase the severity of threatened consequences. The theory of increased penalties as a marginal deterrent is simple and straightforward: all other things being equal, an increase in the severity of consequences threatened should reduce the number of people willing to run the risk of committing a particular * * * act * * *. n101

* * * when penalties for criminal activity that many people find attractive are quite low, thereby making * * * crime a reasonable alternative to legitimate means of obtaining gratification for many persons, even a high probability of apprehension may leave a high rate of the threatened behavior, and increases in the severity of threatened consequences can be expected to have a more substantial marginal deterrent effect than if the level of consequences threatened is already quite high in relation to the benefits obtainable through * * * [illegal] means. n102

* * * the risk of a high penalty provides more incentive to avoid crime than the risk of a low penalty. n103

* * * it is likely that increases in the severity of threatened consequences are more or less significant, depending on the relationship between size of penalty increase and size of base penalty. n104

If we are hopeful of the curative effects of a threat, we have to make the threat unpleasant, which is another way of saying that we have to be severe. n105

Generally speaking * * * deviance decreases as the sanctions become stronger. n106

* * * perhaps the main justification for imposing severe penalties on those who violate the law is that such punishments serve as a specific deterrent to future violations by the offender and as a general deterrent to violations by others who might be tempted to follow his lead. n107

As long as every one believes in their deterrent effects, severe sanctions represent a powerful tool for authorities in meeting their responsibilities, and a sign to the broader community that they are taking those responsibilities seriously. n108

n101. Zimring, *Perspectives on Deterrence,* National Institute of Mental Health -- Center for Studies of Crime and Delinquency, Washington, D. C. (1971), 83-84.

n102. *Id.,* at p. 84.

n103. *Id.,* at p. 85.

n104. Zimring, *Perspectives on Deterrence,* National Institute of Mental Health -- Center for Studies of Crime and Delinquency, Washington, D. C. (1971), at p. 89.

n105. Puttkammer, *Administration of Criminal Law* (1953), 16-17.

n106. Salem and Bowers, "Severity of Formal Sanctions as a Deterrent to Deviate Behavior," 5 *Law and Society Review* (1970), 21, 25.

n107. *Id.,* at p. 21.

n108. *Id.,* at 21, 37.

Dr. Zimring, a noted authority, capsulizes this concept in his statement that "since the goal of all legal threats is to keep the population law abiding, the potential effectiveness of variations in severity of threatening consequences should be used to create the widest possible distinction between criminal and non-criminal behavior by threatening all types of serious crime with penalties which are as severe as possible." n109

n109. Zimring, *Perspectives on Deterrence,* National Institute of Mental Health -- Center for Studies of Crime and Delinquency, Washington, D. C. (1971), 90.

Johannes Andenaes, of the University of Oslo, regarded by many as one of the most distinguished of the modern scholars writing about deterrence, is adamant in his contention that the "simplest way to make people more law-abiding, therefore, is to increase the punishment." n110 Mr. Andenaes is a firm believer in Feuerbach's formula of psychological coercion: "the risk for the lawbreaker must be made so great, the punishment so severe,

that he knows he has more to lose than he has to gain from his crime." n111 "(E)conomic crimes," to utilize his epithet, are clearly within the purview of the foregoing severity doctrine, such crimes being violations of "governmental regulation of the economy: price violations, rationing violations * * * disregard of quality standards, and so on." n112

n110. Andenaes, "General Prevention -- Illusion or Reality?," 43 *Journal of Criminal Law,* Criminology and Police Science (1952), 176, 191.

n111. *Id.,* at pp. 178-179.

n112. *Id.,* at p. 184.

The applicability of severe sanctions to economic violation is succintly treated by Andenaes:

A large number of the people who are affected by economic regulations * * * feel no strong moral inhibition against infraction. They often find excuses for their behavior in political theorizing: they oppose the current government's regulative policies * * * yet the matter of obedience or disobedience can often have important economic consequences * * *. In this area, at any rate, Feuerbach's law of general prevention has a certain validity; it is necessary that consideration as to the risk involved in breaking the law should outweigh consideration of the advantage to breaking the law. n113

n113. Andenaes, "General Prevention -- Illusion or Reality?," 43 *Journal of Criminal Law, Criminology and Police Science* (1952), at p. 185.

"If we think first of the purely deterrent value of * * * punishment * * * it is clear that deterrence depends not simply on the risk of being punished, but also on the nature and magnitude of punishment." n114 Andenaes is careful to note that severity of punishment has a more salient effect on crimes, like economic violations, "committed after careful consideration * * * than for crimes which grow out of emotions or drives which overpower the individual." n115

n114. *Id.,* at p. 191.

n115. *Id.,* at p. 192.

My views with respect to the necessity for severe sanctions for serious violations, in order to achieve the Congressional purpose, were set forth in *In re Sy B. Gaiber & Co.,* in a Ruling on Petition for Reconsideration, as follows (31 Agriculture Decisions 843, 851-852 (1972)):

Congress enacted the remedial regulatory programs administered by the Department because of a need for economic law and order in the marketplace. The administrative sanctions imposed against violators of such regulatory programs should tend to achieve that purpose.

Persons who engage in a regulated business have been granted a privilege. Suspension or revocation of the privilege for failure to comply with the statutory standards is a necessary power granted to the Secretary to assure a proper adherence to the regulatory program (see the cases cited in the Decision and Order herein, p. 47). Just as a lawyer may lose his privilege to practice law if he embezzles a client's funds or engages in other serious violations, a futures commission merchant, broker, or trader who manipulates a futures market or engages in other serious violations may lose his privilege to engage in futures trading.

The House Report on the 1968 amendments to the Commodity Exchange Act states that it is the view of the committee that serious violations "should be subject to severe penalties" (H. Rep. No. 743, 90th Cong., 1st Sess., p. 5). The administrative sanctions should be severe enough to serve as a deterrent to future similar violations by the respondents and by other persons.

It is the general administrative practice under the Department's regulatory programs to institute formal actions only as to violations regarded as serious or repeated. Many minor violations are disposed of with a warning letter or an informal stipulation. Hence it is to be expected that the relatively few formal cases which are instituted will generally warrant relatively severe sanctions.

In the present case, in all likelihood, the only practical effect of any sanction will be the deterrent effect on other persons inasmuch as the

respondents are no longer trading in regulated commodities for themselves or for others, and they do not plan to engage in regulated trading in the future (Oral Arg., pp. 403-409). n116 The respondents contend that the issuance of any sanction would be disastrous to their non-regulated business ventures because of the damage to their reputation. But any such damage would occur even from a one-day's suspension. Hence the number of days of the suspension order, which is of major importance in most cases, is of little or no importance in this case. In these circumstances, in order to achieve the purpose of the Act, the nature and length of the sanction will be considered as if the respondents were still

engaged in regulated futures trading so that it may serve as a deterrent to others. n117

n116. However, it would be poor administrative policy to issue no suspension order in such cases inasmuch as a violator's plans could easily change.

n117. Theoretically, of course, the respondents, if not subject to a suspension, could immediately request a new license as a futures commission merchant, or begin trading for their own accounts. Ordinarily, if a futures commission merchant commits a serious violation and is no longer trading for others when the sanction is imposed, the length of the sanction must be substantial to serve as a deterrent because the denial of personal trading privileges merely suspends one's "gambling" privileges in regulated commodities (see *In re Louis Romoff,* 31 Agriculture Decisions 158, 177-180 (1972); *In re Sy B. Gaiber & Co.,* 31 Agriculture Decisions 474, 506-507 (1972)). But the complainant has not requested a lengthy suspension of personal trading privileges in this case.

Deliberately engaging in business as a futures commission merchant without meeting the minimum financial requirements is a serious violation of the Act and regulations. Although the respondent corporation completely refunded all of the money owing to customers when it phased out of the regulated futures trading business, a substantial sanction is still necessary to effectuate the purposes of the Act and to serve as a deterrent to others.

The financial requirements at issue here are similar in purpose to those under the Securities and Exchange Act, under which it has been held that the financial requirements are not "merely to protect investors against 'continuing' injury at the hands of those guilty of misconduct. This interpretation is far too narrow: the Act is also designed to protect the investing public against undue financial risks and future violations" (*Blaise D'Antoni & Associates, Inc.* v. *Securities & Exch. Com'n.,* 290 F.2d 688, 689 (C.A. 5)). The financial requirements are "to assure confidence and safety to the investing public. The question is not whether actual injuries or losses were suffered by anyone." *Blaise D'Antoni & Associates, Inc.* v. *Securities & Exch. Com'n.,* 289 F.2d 276, 277 (C.A. 5), certiorari denied, 268 U.S. 899.

Futures commission merchants handle large sums of money belonging to customers. The value of all of the futures contracts regulated under the Commodity Exchange Act in fiscal 1972 was $ 148 billion. n118 Brokerage firms on the New York Stock Exchange have been failing financially in record numbers recently. n119 The

Congressional Record for March 15, 1972, refers to several brokerage firms handling customers' accounts in non-regulated commodity futures that failed owing customers large sums of money (118 Cong. Rec. S3995). It has been the duty of the Commodity Exchange Authority, since the Act was amended in 1968 (7 U.S.C. 6f), to prevent financial collapses of firms handling regulated futures contracts. This duty cannot be met unless regulated firms are deterred from

deliberately operating while underfinanced. See *In re Sy B. Gaiber & Co.,* 31 Agriculture Decisions 474, 502 (1972).

n118. USDA Press Release No. 2315-72 dated July 14, 1972. Futures commission merchants, of course, handle only a fraction of that amount.

n119. The Evening Star, Washington, D. C., February 24, 1972, p. A-19, reports as follows:

The New York Stock Exchange, continuing to foot a huge bill for the collapse of member firms in the securities industry's financial crisis of recent years, incurred a $ 16.7 million loss in 1971, the exchange disclosed in its annual report.

* * *

Ironically, the exchange last year chalked up a record $ 18.7 million operating profit, but this was offset by $ 35.4 million of charge for assistance to customers at financially distressed member houses.

This news item accurately reflects the *New York Stock Exchange, Inc., Annual Report 1971,* p. 30. Official notice is taken of the Annual Report under 17 CFR 0.11(e) (7). See *Parker* v. *Brown,* 317 U.S. 341, 363; *Colonial Airlines* v. *Janas,* 202 F.2d 914, 919, fn. 1 (C.A. 2); *United States* v. *Rice,* 176 F.2d 373, 374, fn. 3 (C.A. 3).

The sanctions imposed under a regulatory Act against different violators for similar violations should be reasonably uniform, n120 and there should be a reasonable relation between the sanction and the unlawful practices found to exist (*i.e.,* the more serious the violation, the more severe the sanction). *In re American Fruit Purveyor's, Inc.,* 30 Agriculture Decisions 1542, 1595-1596, and cases cited therein.

n120. This uniformity necessarily applies only to contested cases. Consent orders issued without a hearing will be given no weight whatsoever in determining the sanction to be imposed in a litigated case. In a case where a consent order is agreed to by the parties, there is no record or argument to establish the basis for the sanction. It may seem less severe than appears warranted because of problems of proving the allegations of the complaint or because of mitigating circumstances not revealed to the Hearing Examiner or to the Judicial Officer. Conversely, it may seem more severe than appears warranted because of aggrevated circumstances not revealed by the complaint. Although it is my intention to impose sanctions as uniform as possible for similar violations unless there are adequate reasons for a change of policy (see *In re American Fruit Purveyor's Inc.,* 30 Agriculture Decisions 1542, 1595-1596), a respondent has no inherent right to a sanction no more severe than that applied to others. See *Hiller* v. *Securities and Exchange Commission.* 429 F.2d 856, 858-859 (C.A. 2); *G. H. Miller & Co.* v. *United States,* 260 F.2d 286, 296 (C.A. 7), certiorari denied, 359 U.S. 907. Specifically, in "any case in which the Judicial Officer determines that the sanctions previously imposed for similar violations are not adequate under present circumstances to effectuate the purposes of the regulatory program, a more severe sanction will be imposed in that case, rather than merely announcing that in future cases the sanction will be increased. An administrative agency is free to reconsider sanctions previously imposed without prior notice (see *In re Louis Romoff,* 31 Agriculture Decisions, 158, 186, and cases cited therein), and such practice will be routinely followed. Persons who intentionally violate a regulatory program are not playing a game under which they are entitled to consider the sanctions previously imposed for similar violations and determine whether they want to run the risk of detection and the imposition of such a sanction. They run the distinct risk that a more severe sanction will be imposed against them." *In re Sy B. Gaiber & Co.,* Ruling on Reconsideration, 31 Agriculture Decisions 843, 850 (1972).

In the only other contested case in which an order has been issued involving a violation of the minimum financial requirements, the order denied all trading privileges to the respondents for two years. *In re Sy B. Gaiber & Co.,* 31 Agriculture Decisions 474.

The violations in that case were more flagrant than here because in the *Gaiber* case the respondents were definitely notified that they were underfinanced and afforded an opportunity to achieve compliance with the regulations. Instead, they substantially increased their underfinanced condition and submitted false statements and gave false information to the Department in an attempt to continue to operate while underfinanced.

The sanctions provided in the Act for violations of the minimum financial requirements are cease and desist orders, orders denying all trading privileges on contract markets, and suspension or revocation orders as to registants. 7 U.S.C. 9, 13b. The complainant recommends the issuance of a cease and desist order, an order denying all trading privileges to the respondents for 90 days, and a suspension of the respondent corporation's registration as a futures commission merchant for 90 days. These sanctions seem appropriate in this case to serve as a deterrent to others, and will be ordered.

The recommendation of the officials charged with the responsibility for administering a federal regulatory program is entitled to considerable weight in determining the sanction that should be imposed against a violator. Such administrative officials, during the day-to-day administration of a regulatory program, develop a "feel" for the severity of sanctions needed to serve as a deterrent to violations that cannot be developed by the Hearing Examiners or the Judicial Officer, who come in contact with only a small part of the regulatory program.

The recommendation of the complainant is not, of course, controlling. For example, if some of the allegations are not proven or if there are mitigating circumstances not taken into consideration by the administrative officials, the sanction may be considerably less than that recommended by them. See, *e.g., In re American Fruit Purveyor's, Inc.,* 30 Agriculture Decisions 1542.

In the present case, there are no mitigating circumstances that would warrant reducing the sanction recommended by the complainant. The respondent corporation knowingly, intentionally, deliberately, and wilfully engaged in business for a year while being underfinanced.

At the most, the respondents may have been lulled into a false sense of security, believing that the Commodity Exchange Authority would not institute a formal complaint without a written notice

telling them to cease violating the minimum financial requirements. The respondents were on the complainant's mailing list to receive all Decisions and Orders by the Judicial Officer. Many of the decisions refer to written warning letters which were sent by the complainant before instituting a formal action (see, *e.g.,* the cases cited in the Respondent's Suggested Findings and Brief, pp. 30-33).

Why such a warning letter was not sent in this case is not known. The administrative officials may have determined that a formal action would be the only way to convince the respondents to comply with the minimum financial requirements. Mr. Economou admittedly told the complainant's officials prior to filing the first financial report that in view of the uncertainties in the regulations, which were not answered to his satisfaction, he decided to "do the job on our own, to the best of our ability, and then let the government come to us and give us this particular reaction" (Tr. 433). When one of the complainant's auditors questioned Mr. Economou's classification of one of the items involved in this case, Mr. Economou became "heated" and ordered him out of

the office (Tr. 17, 22, 94, 114-115, 427, 430, 432, 455-456, 511). Also, the respondents continued to violate the minimum financial requirements after the formal complaint was issued.

The formal complaint in this case was one of 13 formal actions instituted since 1969 against firms for failure to comply with the minimum financial requirements (see CEA Dockets 160, 163, 165, 167, 168, 171, 173, 179, 180, 185, 186, 190, and 191). It would seem that the administrative officials determined that vigorous, formal action was necessary to prevent a financial crisis in the regulated brokerage industry.

The respondents knew that they were phasing out of the regulated futures trading business and undoubtedly planned to meet all of their obligations to customers in full. However, they needed their assets for other business ventures (Tr. 433-434), and did not want to tie up any more money than necessary to meet the complainant's requirements. The complainant requires a safety margin in addition to current assets sufficient to meet current liabilities.

It may well be that if the respondents knew that the complainant planned a formal action, they would have taken steps to meet the minimum financial requirements. For example, the security agreements could have been finalized, the obligation to the Financial

Corporation could have been subordinated to other creditors, and additional funds could have been added to the respondent corporation's assets.

But this is not a mitigating circumstance that warrants lessening the sanction. When the respondents knowingly and intentionally violate the Act, thinking that no formal action will be instituted before they are definitely notified of their violation, they run the risk that no such notice will be given.

The circumstances here are quite different from those in *In re American Fruit Purveyor's, Inc.,* 30 Agriculture Decisions 1542, 1582-1587, 1597, where the respondent had a reasonable basis for believing that it was not violating the Act and the administrative officials failed, as far as the record showed, to advise the respondent that it was violating the Act notwithstanding repeated letters from the respondent explaining its practices and belief.

The respondents contend that their past reputation was excellent. This is not questioned, but is of no help here. The sanction in this case is not increased because of any prior violations.

The Department must, in order to protect the public, impose the same financial requirements on firms with excellent reputations as those with lesser reputations. The memory is still fresh of an individual, regulated by the Department under a different program, who was regarded by the Junior Chamber of Commerce as one of the 10 most outstanding young businessmen in the country, but when his empire collapsed, his creditors lost many millions of dollars.

In discussing the proposed amendment of the Act to add minimum financial requirements (H.R. 13094, 90th Congress), the Report of the Senate Committee on Agriculture and Forestry states: "The danger to the public from such financial irresponsibility is obvious. The underfinanced brokerage firms have been found to be most likely to dip into customers' funds or resort to sharp trading practices to bolster their money needs" (Sen. Rep. No. 947, 90th Cong., 2d Sess.). This is not quoted to imply that the respondents in this case intended to defraud any customers. As I have stated, I believe that they fully intended to pay all customers in full. But the complainant cannot differentiate between those underfinanced firms with good reputations and those with bad reputations. Complainant must act forcefully to impose the requirements on all firms.

In this case, an order denying all trading privileges to the respondents for 90 days would have the same effect as an order suspending the respondent corporation's registration as a futures commission merchant for 90 days. For this reason, the notice provisions of the Administrative Procedure Act may be regarded as revelant to the order denying trading privileges to the respondents. But since their violations were wilful, the notice requirement is not applicable.

Although the issue is not involved here, it is worth mentioning that I do not believe that the notice provisions of the Administrative Procedure Act apply to an order denying all trading privileges to a person who is not a registrant under the Act. The notice provisions apply only to licensees. All persons in all countries are free to trade on the commodity markets without a license, and persons from many foreign countries trade on such markets. Congress did not intend the notice provisions of the Administrative Procedure Act to apply to every person in the world -- only to licensees. Hence if nonregistrants violate the Act, an order denying their trading privileges may be issued without regard to the notice provisions of the Administrative Procedure Act. See *In re Webster E. Collins,* 28 Agriculture Decisions 106, 111-112; *In re Benedict K. Goodman,* 18 Agriculture Decisions 1121, 1128, fn. 1, affirmed on other grounds, *Goodman* v. *Benson,* 286 F.2d 896, 900 (C.A. 7).

There remains for consideration the issue as to whether an order suspending the respondent corporation's registration can be issued since its license expired prior to the issuance of this order. The respondent corporation "resigned" as a futures commission merchant on December 3, 1970 (Comp. Ex. 17, officially noticed during Oral Arg.). Also, all registrations expire on December 31 of each year, subject to renewal (7 U.S.C. 6f), and no request for renewal was made.

The Act provides that if the Secretary determines that a person has violated the Act or regulations, he may require all contract markets to refuse such person all trading privileges thereon and, "if such person is registered as futures commission merchant or as floor broker hereunder, may suspend, for a period of not to exceed six months, or revoke, the registration of such person." 7 U.S.C. 9.

The Department has taken what I regard as an anomalous position in prior cases respecting the power to suspend or revoke a

license which was operative at the time of the violation, but expired before the order was issued. It has been held that it can revoke (*In re L. L. L. Produce Co.,* 29 Agriculture Decisions 849, 856; *In re Turner Produce,* 25 Agriculture Decisions 87; *In re Cloud & Hatton Brokerage,* 18 Agriculture Decisions 547, 550; *In re Port Compress Company,* 10 Agriculture Decisions 246, 254-256), but not suspend, such expired licenses (*In re Dunbeath-Hagen Corp.,* 26 Agriculture Decisions 465, 466; *cf., In re Mandell, Spector, Rudolph Co.,* 24 Agriculture Decisions 897, 897-898).

The reason for revoking an expired license is so that the Department can, in appropriate circumstances, prevent the person from becoming a licensee in the future (see *In re Port Compress Company,* 10 Agriculture Decisions 246, 254-256, and cases cited therein). But the same reason applies, for a more limited period, to suspending an expired license. The Act provides that an expired license "shall be renewed upon application therefor unless the registration has been suspended (and the period of such suspension has not expired) or revoked after notice and hearing as prescribed in this Act." 7 U.S.C. 6f(1). Hence the difference in administrative need between suspending or revoking an expired license is a matter of degree, not kind.

Also, the statutory authority to suspend is identical to the statutory authority to revoke, *i.e.,* the Secretary may suspend or revoke "if such person is registered as futures commission merchant or as floor broker hereunder." 7 U.S.C. 9. In order to achieve the purposes of this remedial Act, it must be

interpreted to read "if such person is registered *at the time of the violation"* rather than "if such person is registered *at the time of the issuance of the order."* Remedial statutes should be liberally construed to achieve the Congressional purpose. *Sunshine Coal Co.* v. *Adkins,* 310 U.S. 381, 392; *McDonald* v. *Thompson,* 305 U.S. 263, 266; *Piedmont & Northern Ry.* v. *Comm'n.,* 286 U.S. 299, 311-312; *Bruhn's Freezer Meats* v. *U. S. Department of Agriculture,* 438 F.2d 1332, 1336 (C.A. 8); *Fulford* v. *Forman,* 245 F.2d 145, 153 (C.A. 5); *Adler* v. *Northen Hotel Co.,* 175 F.2d 619, 620-621 (C.A. 7). See, also, *Black* v. *Magnolia Liquor Co.,* 355 U.S. 24, 26. "Remedial statutes should be liberally construed and should be interpreted (when that is possible) in a manner tending to discourage attempted evasions by wrongdoers." *Westinghouse Electric Corp.* v. *Pacific Gas & Electric Co.,* 326 F.2d 575, 580 (C.A. 9), quoting from *Scarborough* v. *Atlantic Coast Line R.R.Co.,* 178 F.2d 253, 258 (C.A. 4), certiorari denied, 339 U.S. 919.

Hence I conclude that a registration under the Act can be suspended even though it expires before the order is issued.

Under the Commodity Exchange Act, this issue is not as important as under other regulatory statutes since a denial of all trading privileges prevents a futures commission merchant or floor broker from acting in such capacity irrespective of whether he has a license. But under other statutes, it may be important to suspend a person whose license has expired in order to prevent him from applying for a new license and operating during the suspension period. The issue would be important under the Commodity Exchange Act if the Judicial Officer wanted to suspend a registrant's license without issuing an order denying trading privileges. n121 In that event, it would be important to suspend an expired license to prevent the person from registering during the suspension period.

n121. Under such an order, the person could trade for himself or for other persons in certain circumstances, such as in a controlled account (see, *e.g., In re Douglas Steen,* 21 Agriculture Decisions 1076), but he could not engage in business as a futures commission merchant or floor broker.

All contentions presented in the record have been considered and whether or not specifically mentioned herein, any contentions inconsistent with this decision are found to be without merit.

ORDER

1. Respondent Arthur N. Economou and Co., Inc., shall cease and desist from operating as a futures commission merchant within the meaning of the Commodity Exchange Act while failing to meet the minimum financial requirements established by section 4f of the Commodity Exchange Act and section 1.17 of the regulations issued by the Secretary of Agriculture thereunder.

2. Respondent Arthur N. Economou shall cease and desist from wilfully aiding, abetting, counseling, commanding, inducing or procuring respondent Arthur N. Economou and Co., Inc., or any other futures commission merchant, to engage in the practice from which the said firm is directed to cease and desist by this order.

3. The respondents, Arthur N. Economou and Arthur N. Economou and Co., Inc., are prohibited from trading on or subject to the rules of any contract market for a period of 90 days and all contract markets shall refuse all trading privileges to the respondents during this period. Such prohibition and refusal shall apply to all trading done and positions held directly by the said respondents or any of them, either for their own accounts or as the agents or

representatives of any other person or firm, and also to all trading done and positions held indirectly through persons or firms owned or controlled by the said respondents or either of them, or otherwise.

4. The registration of respondent Arthur N. Economou and Co., Inc., as a futures commission merchant under the Commodity Exchange Act is suspended for a period of 90 days.

5. The cease and desist provisions of this order, set forth in the first two paragraphs hereof, shall become effective upon the date of service of this order upon the respondents. The period of denial of trading privileges set forth in the third paragraph of this order and the period of suspension of registration set forth in the fourth paragraph of this order shall become effective on the 30th day after the date of this order.

6. A copy of this Decision and Order shall be served on each of the parties and on each contract market.

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LOAD-DATE: March 16, 2009