May 27, 2010

Supervision Duties Under the Commodity Exchange Act

Barry R. Temkin, *New York Law School*

New York Law Journal
SERVING THE BENCH AND BAR SINCE 1888
WWW.NYLJ.COM

An ALM Publication
VOLUME 243—NO. 101
THURSDAY, MAY 27, 2010

Outside Counsel

Expert Analysis

Supervision Duties Under the Commodity Exchange Act

By **Barry R. Temkin**

Financial regulators, such as the Commodity Futures Trading Commission (CFTC), have traditionally prosecuted the perpetrators of fraud and market manipulation. Recently, futures regulators have increased their scrutiny of the supervisory procedures employed by registrants.[1]

The Commodity Exchange Act[2] itself contains no explicit duty to supervise. However, the CFTC imposes supervision duties on commission registrants through Rule 166.3, which "is intended to protect customers by insuring that their dealings with employees of a registrant will be reviewed by other officials in the firm."[3] This regulation provides:

> Each Commission registrant, except an associated person who has no supervisory duties, must diligently supervise the handling by its partners, officers, employees and agents (or persons occupying a similar status or performing a similar function) of all commodity interest accounts carried, operated, advised or introduced by the registrant and all other activities of its partners, officers, employees and agents (or persons occupying a similar status or performing a similar function) relating to its business as a Commission registrant.[4]

Under Rule 166.3, a registrant must have an adequate written supervisory system, including "procedures for the detection and deterrent of possible wrongdoing by its agents."[5] In addition, the registrant must actually enforce its supervisory program, and respond appropriately to complaints from customers and other sources.

The New York City Bar Committee on Futures and Derivatives Regulation has suggested that an effective program of supervision under Rule 166.3 should do three things: 1) "prevent and detect violations"; 2) "monitor and ensure" implementation of the supervisory compliance program; and 3) "promptly investigate" all complaints and other evidence of possible wrongdoing.[6]

Analysis of a registrant's supervisory system (and its implementation) can be highly fact-specific.

A supervisory violation may be detected in the course of an investigation or prosecution into outright fraud or other wrongdoing, as will be illustrated by the recent enforcement cases discussed below. In those contexts, the alleged supervisory violation is sometimes, but not always, coupled with a claim of control person or agency liability under the Commodity Exchange Act.[7] Enforcement actions by the CFTC show that analysis of a registrant's supervisory system (and its implementation) can be highly fact-specific.

The Broker's All-Nighter

In *In re MF Global Inc.*[8] a futures commission merchant agreed to pay a $10 million fine to the CFTC and undergo remedial training in order to enhance its supervision procedures. The culprit in *MF Global* was a rogue trader who borrowed money from his supervisor to trade wheat futures in his own account. The rogue trader, who was an associated person (AP) registered with MF Global, incurred initial trading losses, and agreed to pay back his supervisor through commissions gained on his own account, thereby creating a conflict of interest for the supervisor. The supervisor thought he was more likely to be repaid if he looked the other way while the trader generated commissions.

The rogue trader decided to pull an all-nighter. Working from his home in Memphis, and utilizing the company's trading software, he shorted 17,000 wheat futures contracts. The monster trade was not detected by the firm's single monitoring employee working the graveyard shift in New York. When the U.S. markets opened the following morning, the market rose "limit up," obliterating the AP's enormous position and obligating the firm to pay its clearinghouse for total losses of $141 million.

The CFTC, in a subsequent enforcement action, extracted a $10 million fine from MF Global, arguing that it should have had a risk control mechanism on its on-line trading system to prevent a rogue AP from placing such an enormous trade. Moreover, the CFTC contended that the firm failed adequately to train or supervise its local branch office manager in Memphis and enforce its own internal policies.

'Interactive Brokers'

Another recent CFTC prosecution, *In re Interactive Brokers, LLC*,[9] resulted in a consent decree in which a futures commission merchant agreed to pay a fine of $175,000 to compensate foreign investors defrauded in a Ponzi scheme operated by an unregistered commodity pool operator. The culprit in *Interactive Brokers* was a Canadian commodity pool operator, Kevin Steele, who lost $4 million trading commodities, and, wearying of the tedious work of trading futures, stole an additional three million dollars from twenty customers, one of which was a money manager.

The pool operator opened an individual trading account in his own name at the futures commission merchant. Although Steele had represented that the account was for his own personal trading and that his liquid net worth was approximately $175,000, his account was funded with over 100 third party wire transfers totaling

BARRY R. TEMKIN *is counsel to Mound Cotton Wollan & Greengrass, chair of the New York County Lawyers' Association Professional Ethics Committee and a member of the Board of Arbitrators of FINRA Dispute Resolution. He can be reached at Btemkin@moundcotton.com.*

$7.7 million. Although the funds had been wired into his account from other sources, the futures commission merchant permitted Steele to wire over $3 million out of the firm's account and into his personal bank account. While the firm did notice the individual large deposits, withdrawals and losses, its investigation solely consisted of telephoning the trader and accepting at face value his explanation that he had earned the money from real estate deals.

In its consent order, the CFTC determined that the futures commission merchant failed to investigate or monitor the source of funds coming into the trader's account, thereby missing an opportunity to have prevented the misappropriation of customer funds. According to the CFTC, the numerous withdrawals and deposits into the trader's account were "red flags" which should have prodded the firm into more significant action. *Interactive Brokers*, it should be noted, was a consent decree and not a finding of fact or determination after a contested hearing. As such, it is of limited precedential value.

Theories of Liability

In addition to liability under 17 C.F.R. §166.3, a futures industry registrant can be subject to liability under theories of control person or agency liability. The Commodity Exchange Act provides that a person who "directly or indirectly controls any person who has violated any provision of this act may be held liable for such violation in any action brought by the CFTC to the same extent as the controlled person."[10] In addition, the act provides respondeat superior liability for the conduct of a registrant's agent acting within the scope of his employment.[11]

Rosenthal and Co. v. CFTC,[12] involved a futures commission merchant which entered into an agreement with a commodity pool operator named Pinckney. Pinckney and Rosenthal shared office space and commissions, and Pinckney was identified in subscription agreements as a "commodity solicitor with Rosenthal & Company, the futures commission merchant through which the commodity pool will execute most of its trades."[13]

Pinckney solicited investors for his commodity pool. In order to calm the frazzled nerves of jittery investors, Pinckney intentionally delayed sending them the actual subscription agreements "because the agreement contained alarming language required by the Commodity Futures Trading Commission about how risky speculation in commodities futures is."[14] The failure to disclose the level of risk involved in futures trading was fraud.

The primary issue before the court was whether the commodity pool operator's fraud could be imputed to the firm as a principal. The court found that the relationship between Pinckney and the firm was sufficient to establish agency liability, given the sharing of office space and commissions, and the wording of the subscription agreement. Moreover, the firm should have investigated Pinckney before contracting with him.

In *CFTC v. Gibraltar Monetary Corp.*,[15] the court rejected the Commission's attempts to impose agency liability on a futures commission merchant for the conduct of its introducing broker. Gibraltar was an unregistered introducing broker whose principals had previously been disciplined by the CFTC. Without learning of the prior regulatory infractions of Gibraltar's principals, FXCM, a futures commission merchant, entered into an introducing broker agreement with Gibraltar; Gibraltar would introduce customers to FXCM, which would pay a commission to Gibraltar once those customers executed trades.

The written introducing broker agreement provided that FXCM would not "(c) train, supervise or discipline Gibraltar employees; (d) control, develop, or supervise the trading strategies of Gibraltar;… (e) control, develop or supervise Gibraltar's marketing practices…"[16] Gibraltar's marketing materials optimistically de-emphasized the risks of forex investing, extolled the potential for lucrative gains, and omitted any mention of the prior disciplinary history of the firm's principals.

At a minimum, a member firm must have an adequate written supervisory policy which it should convey to its employees and agents.

The CFTC argued that FXCM was vicariously liable for the introducing broker's fraud. There was some evidence that FXCM monitored and was aware of Gibraltar's misleading marketing materials. For example, one FXCM officer wrote: "[W]e have already discussed the need for you guys to monitor your marketing advertising methods…. As these complaints reflect on the way we do business, I must now ask you to give me a written description of the kind of advertising/marketing methods you are using, include a copy of any material you may use."[17]

Nonetheless, the Court found that FXCM was not vicariously liable for Gibraltar's conduct since, under common law principles of agency, FXCM neither consented to an agency relationship nor controlled Gibraltar. Both the introducing broker agreement and new account applications expressly disclaimed the existence of any agency relationship between FXCM and Gibraltar; FXCM shared no employees or market research with Gibraltar, and the firms split no commissions.[18] Moreover, FXCM did not supervise or control Gibraltar's trading strategies and had no right to inspect its books and records.

In *In re U.S. Securities & Futures Corp.*,[19] the CFTC affirmed an administrative decision that imposed sanctions on U.S. Securities & Futures Corp. (USSFC), a futures commission merchant, and on several other U.S. respondents, for "willingly or recklessly" casting "blind eyes" toward a fraudulent trade allocation scheme perpetrated by Currency and Commodity Broker GmbH (CCB), a German commodity broker.[20] During its fraud investigation of the omnibus account that the German company held with USSFC, the Commission's Division of Enforcement discovered evidence of reporting violations and violations of Regulation 166.3, which led it to bring additional charges against the FCM and several other respondents.

In their defense, USSFC and its officers noted that previous regulatory audits had not uncovered the fraud. The Commission rejected the respondents' attempt to deflect responsibility, pointing out that periodic audits are "no substitute for [the] vigilant supervision" of experienced commodity professionals and that the precise type of fraud at issue "is much more likely to be discovered through onsite monitoring than through the sampling procedures employed in an audit."[21]

Assessment of a registrant's supervisory duties is highly fact-specific. At a minimum, a member firm must have an adequate written supervisory policy which it should convey to its employees and agents. Moreover, the registrant must diligently ensure compliance with its written supervisory procedures.

1. The CFTC has delegated the registration function to the National Futures Association (NFA), a designated self-regulatory organization (DSRO).
2. 7 USC §1-25 (2009).
3. 2 Philip Johnson & Thomas Hazen, Derivatives Regulation, §3.11[7] (2004).
4. 17 C.F.R. §166.3 (2009).
5. *Samson Refining Co. v. Drexel Burnham Lambert Inc.* [1987-1990 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶24,596 at 36,566 (1990).
6. The Committee on Futures Regulation, Secondary and Supervisory Liability Under the Commodity Exchange Act: An Update, 56 The Record 240, 256 (2001).
7. See 7 USC §4.
8. 2009 CFTC LEXIS 87 (Dec. 17, 2009), http://www.cftc.gov/lawandregulation/enforcementactions/2009/index.htm.
9. 2007 CFTC LEXIS 52 (July 17, 2007), available at http://www.cftc.gov/lawandregulation/enforcementactions/2007/index.htm.
10. 7 USC §13(c)(b) (2009).
11. 7 USC §4.
12. 802 F.2d 963 (7th Cir. 1986).
13. 802 F.2d at 968.
14. 802 F.2d at 966.
15. 575 F. 3d 1180 (11th Cir. 2009).
16. 575 F. 3d. at 1183.
17. 575 F. 3d. at 1184.
18. While the two firms did not share commissions, FXCM and Gibraltar each earned a commission for every trade made by a customer introduced by Gibraltar.
19. CFTC Docket No. 01-01, 2009 CFTC LEXIS 70 (Oct. 7, 2009), available at http://www.cftc.gov/lawandregulation/enforcementactions/2009/index.htm.
20 Id. at 19.
21 Id.