UNITED STATES OF AMERICA
Before the
COMMODITY FUTURES TRADING COMMISSION

JOHN HUSSAIN	:	
	:	CFTC Docket No. 98-R153
v.	:	
	:	OPINION AND ORDER
SAUL STONE & CO., L.L.C.	:	

Complainant John Hussain ("Hussain") appeals from a decision that dismissed his complaint for a failure of proof and awarded $56,822.29 to respondent Saul Stone & Company, L.L.C. ("Saul Stone") on its counterclaim. Hussain focuses his challenges on the Administrative Law Judge's ("ALJ") factual assessments. He contends that the ALJ's findings are contrary to the record and the product of bias. Saul Stone urges the Commission to affirm the ALJ's decision in all respects. As explained below, we affirm the dismissal of the complaint and the entry of judgment on Saul Stone's debit balance counterclaim.

BACKGROUND

I.

Many of the facts material to the parties' claims are undisputed. Hussain opened a futures and options account at Saul Stone in March 1998. At that time, he submitted a customer account agreement disclosing that he had been employed as a stockbroker and had 15 years' experience trading futures and options. Saul Stone permitted Hussain to communicate his trading instructions directly to its employees on the trading floor and did not assign an associated person to assist him. Prior to the opening of the market on trading days, Saul Stone faxed

Hussain a report disclosing the trades executed for his account on the previous day, as well as related financial information, such as the account's margin status.

Hussain's account suffered substantial losses between April 27 and May 8, 1998. At the beginning of this period, the account's cash balance was $195,823.86 and the liquidation value disclosed on the account statements was approximately $60,000.

Hussain traded both June NYSE Index futures contracts and May NYSE put options on Monday, April 27, 1998. At the close of trading, his account included an 18-contract short position in June NYSE Index futures and an 18-contract short put position in May NYSE Index options. Six of the put options had a strike price of 570 and twelve others had a strike price of 580.

Hussain lost $15,000 liquidating positions that day. Moreover, both his open futures and option positions had accrued substantial losses by the end of the day. Because the total accrued loss exceeded the cash balance of the account by $31,622.22, there were no funds available to margin the open positions.

On the following morning, Tuesday, April 28, 1998, Saul Stone faxed Hussain a report indicating that his account was in deficit and that he owed $79,825 in margin. Prior to the opening of trading, Hussain had a telephone conversation with Geoffrey Thompson ("Thompson"), a Saul Stone risk manager. Hussain informed Thompson that he could not pay the pending margin call at that time. Hussain and Thompson also discussed how Saul Stone would respond to Hussain's failure to pay the margin call. Their conflicting versions of this portion of the conversation are reviewed below.

Following this conversation, Thompson began entering trades in Hussain's account without consulting him in advance or obtaining his specific authorization. Specifically,

Thompson liquidated six contracts of an 18-contract short NYSE Index futures position, and then sold an additional contract. A loss of $28,000 on the liquidation trades increased the account's deficit to $33,839.85. At the close of trading, the account included a 13-contract short position in NYSE Index futures and an 18-contract short put position in NYSE Index options.

On Wednesday, April 29, 1998, Hussain and Thompson had a telephone conversation that Saul Stone recorded. The transcript indicates that when Thompson asked Hussain if he was able to come up with any type of funding to meet his margin call, Hussain said that it was a big problem but that he was "still trying." Respondent's Ex. 5a at 2.

The transcript indicates that Hussain was aware of the trades that Thompson had made the previous day and questioned Thompson's decision to sell an additional futures contract after liquidating six contracts of the 18-contract futures position. Thompson assured Hussain that the trade was not a mistake. Hussain responded that he was trying to listen to Thompson, but in the meantime was "trying to get out of this hole." Thompson replied, "that's exactly what we are trying to do." Respondent's Ex. 5a at 1-2.

That same day, Thompson liquidated one contract of Hussain's short futures position at a loss of $5,275, increasing the account's deficit to $35,095.94. At the close of trading, the account included a 12-contract short position in NYSE Index futures and an 18-contract short put position in NYSE Index options.

On Thursday, April 30, 1998, Hussain and Thompson had another telephone conversation that Saul Stone recorded. During their discussion of Hussain's short futures position, Thompson said that Saul Stone was "looking to keep the account delta neutral,"[1] to which Hussain

[1] "Delta neutral" is defined as the condition in which an investor's portfolio is delta hedged, or hedged in such a way that it is unaffected by small changes in the value of the underlying source of risk. *See* Don M. Chance, *An Introduction to Derivatives*, Glossary of Terms (1998).

responded, "[r]ight." Respondent's Ex. 5a at 3. Later in the conversation, however, Hussain remarked that he didn't "know the delta neutral." *Id*. at 5. Hussain said that Thompson should not "unhedge" the 12-contract put option position with a strike price of 580, and Thompson replied, "that's not what we're going to do at all." *Id*. at 4.

On that same day, Thompson liquidated three contracts of the 12-contract short futures position at a loss of $26,700, increasing the account's deficit to $41,339.21. At the close of trading, the account included a nine-contract short position in NYSE Index futures and an 18-contract short put position in NYSE Index options.

On Friday, May 1, 1998, Thompson liquidated two contracts of the nine-contract short futures positions at a loss of $22,650. Due to changes in the value of open positions, the account's deficit fell to $36,776.39. At the close of trading, the account included a seven-contract short position in NYSE Index futures and an 18-contract short put position in NYSE Index options.

On Monday, May 4, 1998, Thompson liquidated the account's remaining NYSE Index short futures contracts at a loss of $92,500 and paid $6,800 to liquidate four short put option contracts with a strike price of 580. As a result, the account's deficit increased to $44,369.42. At the close of trading, Hussain's account included a six-contract short put position in NYSE Index options with a strike price of 570 and an eight-contract short put position in NYSE Index options with a strike price of 580.

On Tuesday, May 5, 1998, Hussain wrote a letter to Saul Stone. In it, he complained that Thompson was applying "some automatic execution [process] that was never explained to him" and was trading his account without consulting him. He specifically disavowed

responsibility for the debit in the account.

On the same day, Clarence Delbridge ("Delbridge") replied to Hussain for Saul Stone. His letter noted that Hussain's account was in "Liquidation Only" status and that Hussain was not entitled to trade his account until he submitted additional funds. Delbridge's letter also advised that Saul Stone would hold Hussain responsible for any debit that might occur in his account.[2]

Also on that same day, Thompson continued to enter trades without Hussain's prior authorization. Specifically, he established and then liquidated a two-contract position in S&P futures contracts at a gain of $425. In addition, he liquidated the eight-contract put option position with a strike price of 580 at a cost of $22,400. As a result, the account's deficit increased to $50,978.08. At the close of trading, Hussain's account included a six-contract short put position in NYSE Index options with a strike price of 570.[3]

On Thursday, May 7, 1998, Thompson established and liquidated a one-contract position in S&P futures at a gain of $725, sold one June NYSE Index futures contract, and paid $11,300 to liquidate four contracts of the six-contract short put position in NYSE Index options. As a result, the account's deficit rose to $56,726.00.

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[2] Delbridge's May 5, 1998 letter referred to a letter to Hussain dated April 30, 1998. That letter explained that Hussain's account had "an outstanding margin call of $55,171.94," and that as a result of Hussain's failure to meet the call, his account had been placed on "Liquidation Only" status and Saul Stone was "reducing the positions you established and/or the risk associated with those positions." Hussain denies that he ever received the April 30, 1998 letter. Hussain replied to Delbridge in a letter dated May 5, 1998, in which he acknowledged that his account was on "liquidation only" status, but complained that Thompson's trading was not consistent with this status.

[3] In a letter to Delbridge dated May 6, 1990, Hussain complained that a better liquidation strategy would have been to close six contracts of the 18-contract short futures position at 570 and the remainder at 580. He demanded that Saul Stone restore his 18-contract short put position in NYSE Index options.

Saul Stone liquidated the remaining positions in Hussain's account on Friday, May 8, 1998. The losses on these trades increased the account's deficit to $56,882.29.

II.

On May 28, 1998, Hussain filed a reparations complaint against Saul Stone alleging unauthorized trading. In support of his claim, he submitted his account statements for the period April 27, 1998 through May 8, 1998, and the letters he sent to Saul Stone on May 5 and 6, 1998.

In early June, the Commission's Office of Proceedings ("Proceedings") sent Hussain a letter seeking additional information about his claim. On June 8, 1998, Proceedings received Hussain's response noting that he was seeking damages of $31,653.[4] He also asserted a claim of misrepresentation against Saul Stone. In this regard, he alleged that Saul Stone had falsely assured him that his open positions "would be carried [until] expiration despite [the account's] debit," and that the account would be on liquidation only status while Saul Stone worked with him to liquidate. June 8, 1998 Letter at 2. According to Hussain's letter, within a few days of offering these assurances, Saul Stone began trading his account without consulting him and putting "losing trades in my account that did not belong in my account." *Id*.

Saul Stone's answer included a general denial of any wrongdoing and a counterclaim for $56,822.29 plus costs and attorney fees. The answer focused on Hussain's failure to pay the April 28, 1998 margin call and emphasized the clause in Saul Stone's customer agreement permitting it to close out positions "in its sole and absolute discretion" when a customer fails to maintain required margin. According to the answer, Saul Stone began liquidating positions in

[4] Following another exchange of correspondence with Proceedings, Hussain subsequently limited his damage claim to $30,000.

Hussain's account on April 28, 1998 and "the volatility of the markets" prevented it from completing the liquidation prior to May 8. Answer at 9.

As for Hussain's misrepresentation claim, Saul Stone denied that it had agreed to maintain the undermargined positions until the expiration of the options. In support, Saul Stone attached the April 30, 1998 letter from Delbridge notifying Hussain that his account had been placed on "Liquidation Only" status.

Hussain's August 1998 response to Saul Stone's counterclaim focused on facts related to his misrepresentation claim. Hussain alleged that he discussed the margin call with Thompson on April 28, 1998 and that they reached an agreement to place his account on "liquidation only status," and "to carry the open option positions [until] . . . expiration time of May 15, 1998." Complainant's August 1998 Response at 1. According to Hussain, if they had not reached this agreement, he would have "met [his] margin calls." *Id*. Hussain also challenged Saul Stone's claim that "market volatility" explained its delay in liquidating the account until May 8, 1998. According to Hussain, all of his positions were "totally liquid" and could have been liquidated in "5 minutes." *Id*.

III.

Proceedings forwarded this case for a formal decisional proceeding in August 1998 and assigned the matter to an ALJ. In December 1998, the ALJ conducted a one-day hearing in Washington, D.C., at which Hussain testified in his own behalf. Saul Stone offered the testimony of Thompson and Jeffrey Soman ("Soman"), its chief operating officer.

In response to a series of questions posed by the ALJ, which focused for the most part on Hussain's claim that Saul Stone agreed to maintain his option positions until expiration, Hussain explained that when the margin call was issued, his account included a put option position that

was hedged with a futures position. He said that when he discussed the margin call with Thompson on the morning of Tuesday, April 28, 1998, Thompson agreed to maintain the option position until expiration on May 15, 1998, as long as it remained protected by the futures hedge. He said that they also agreed that trading would be for liquidation only.

As discussed earlier, on the day of that conversation, Thompson liquidated six contracts of an 18-contract short NYSE Index futures position and then increased the hedge position from 12 contracts to 13 contracts by selling an additional futures contract. Hussain testified that he believed this was contrary to the liquidation only status of the account, and that he questioned Thompson about the trade. Hussain stated that when Thompson assured him that the trade was correct, he replied, "this one contract is probably okay." (Tr. at 12.)

The ALJ then questioned Hussain about his knowledge of the margin status of the account. Hussain acknowledged that he knew his account was subject to a margin call and told Saul Stone that his financial situation was not good at that time. He emphasized, however, that Saul Stone did not inform him that it would liquidate his account if he did not submit the funds. (Tr. at 16.)

On cross-examination, Hussain acknowledged that during the previous 20 years he had worked in both the securities and commodities industries. In response to questions about the termination of his employment by a securities firm due to his failure to disclose a prior disciplinary action, Hussain admitted that a customer complained to the New York Stock Exchange ("NYSE") about his conduct and due to his failure to participate in the proceeding, the NYSE barred him from associating with its members for 15 months. Hussain testified that he did not disclose the proceeding to his employer because "he thought the problem was resolved." (Tr. at 38.)

Counsel also questioned Hussain about his conversations with Thompson on April 28, 29, and 30, 1998. Hussain stated that he told Thompson that:

> [W]e have a hedge position, it has 18 contracts of New York June futures, and we have 18 put options to offset that and control each other. It is a hedge position. There is $55,000 time premium for this option, which expires in three weeks, and if we just keep this hedge position my account will be covered out of this and we will be out of the debit and the problem will be solved.

(Tr. at 48.) According to Hussain, Thompson said that the strategy made sense and that "we will do it." *Id.* Hussain said that he did not think that Thompson mentioned keeping the account "delta neutral." He indicated that when Thompson did use that term, Hussain indicated that he did not understand "delta neutral." (Tr. at 53.)

Thompson's testimony directly challenged Hussain's version of the events at issue. He specifically denied telling Hussain that Saul Stone would maintain his option position until the May 15, 1998 expiration date. According to Thompson, on April 28, 1998, he advised Hussain that Saul Stone had determined that in order to "limit the risk and to stop the margin call from growing" it would be necessary to create a "delta neutral position in the account." Under questioning by the ALJ, Thompson said that Saul Stone decided to keep the account delta neutral "in hopes that Mr. Hussain would send funds to [Saul Stone]." (Tr. at 84.)

Thompson explained that during their April 28, 1998 conversation, Hussain agreed to the liquidation of six contracts of his futures position as part of the delta neutral strategy. Thompson testified that he informed Hussain that:

> [W]e were going to work and look at the account, keeping it delta neutral until funds were submitted to cover up the debit or the margin call.

(Tr. at 73-74.)

Soman's testimony was limited to describing his conversations with Thompson concerning the status of the account following Hussain's failure to pay the outstanding margin

call. Soman explained that he chose to employ a delta neutral strategy because the "market had been extremely volatile" and Hussain had indicated that he was trying to get funds together to pay the margin call. (Tr. at 88-89.) He indicated that Saul Stone began liquidating Hussain's positions on May 4, 1998 due to the futures position's large accrued loss. In response to a question from counsel, Soman stated that if Saul Stone had exercised its right to liquidate Hussain's positions on April 28, 1998, Hussain's losses "would have been much greater." (Tr. at 98.)

On cross-examination, Soman indicated that once Saul Stone decided to implement its delta neutral strategy, "[i]t was immaterial . . . what Hussain wanted to do," because he did not have "any money in the account to effect control of the account." (Tr. at 102.)

IV.

The ALJ issued his Initial Decision ("I.D.") in May 1999. *Hussain v. Saul Stone and Company, LLC,* [1998-1999 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,645 (May 20, 1999). While the ALJ did not expressly assess witness credibility, he based his findings concerning Hussain's April 28, 1998 conversation with Thompson on Thompson's testimony. I.D. at 48,079.[5]

The ALJ found that on the morning of April 28, 1998, Hussain received a margin call and advised Saul Stone that he was unable to meet it. *Id*. According to the ALJ, Thompson offered to permit the account to remain open while Hussain obtained the funds to pay the margin call if Hussain agreed that Saul Stone could trade the account in order to keep it delta neutral. The ALJ found that Hussain agreed to this offer and that Saul Stone's subsequent trades in the account were consistent with a delta neutral strategy. *Id*.

[5] The ALJ also referred to Hussain's letters to Saul Stone as "self-serving." I.D. at 48,079.

In light of these findings, the ALJ concluded that Hussain had failed to establish either misrepresentation or unauthorized trading. He emphasized that Hussain had agreed to implement a delta neutral strategy in order to keep his account open. The ALJ reasoned that this amounted to a grant of discretion to Saul Stone to maintain his account in delta neutral. Finally, he noted that Hussain could have ordered his account liquidated at any time, but failed to take this step. I.D. at 48,079.

On this basis, the ALJ dismissed Hussain's claims and granted Saul Stone's counterclaim for the debit balance in Hussain's account. The ALJ denied Saul Stone's counterclaim for attorney fees because there was no evidence that Hussain had acted in bad faith.

V.

On appeal, Hussain argues that the record does not support a finding that he agreed to implement a delta neutral strategy. He also reiterates his claims that Saul Stone traded the account without consulting him and breached its agreement to maintain his option positions until expiration. In response, Saul Stone emphasizes that Hussain breached its customer agreement when he failed to meet his account's margin requirements and that the customer agreement gave Saul Stone the right to liquidate his positions in such circumstances. Saul Stone argues that its decision to trade the account in a manner that created and maintained a delta neutral position was reasonable in light of its belief that Hussain might submit additional margin funds. Finally, Saul Stone contends that market volatility made it reasonable to liquidate Hussain's account in stages between May 4 through 8, 1998.[6]

[6] Saul Stone did not appeal from the ALJ's denial of its claim for attorney's fees. We therefore treat it as waived. *Weissman v. Bull Market Commodities, Inc.*, [1987-1990 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,064 at 34,653 (CFTC Dec. 18, 1987).

DISCUSSION

I.

As described above, Hussain asserted an unauthorized trading claim based upon Saul Stone's failure to secure his approval prior to conducting the trading activity in his account that took place after he failed to meet the margin call on April 28, 1998. Commission Rule 166.2 provides that a futures commission merchant ("FCM"), such as Saul Stone, may not effect futures or options transactions in a customer's account unless, prior to the transaction, either the customer or the person designated by the customer to control the account: (1) specifically authorizes the transaction; or (2) executes a written authorization for the FCM to effect transactions without the customer's specific authorization. *See also Slone v. Dean Witter Reynolds, Inc.,* [1994-1996 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,283 at 42,433 (CFTC Dec. 16, 1994) (allegation that FCM liquidated open positions without specific authorization states a cause of action under Commission Rule 166.2, as well as Sections 4b(a) and 4d of the Act). Commission precedent recognizes, however, that an FCM may take protective steps when a customer fails to meet a demand for additional margin deemed necessary by an FCM in the exercise of its good faith business judgment. *See Baker v. Edward D. Jones & Co.*, [1980-1982 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,167 at 24,771 (CFTC Jan. 27, 1981). In such circumstances, we have held that the FCM is free to "liquidate [the] account without hesitation." *Id.* at 24,772. More recently, we explained that when a customer receives but fails to pay a margin call:

> an FCM's duty to protect the financial position of its other customers and its right to protect its own financial position supersedes any duties it owes to the defaulting customer. In these circumstances, the Commission permits FCMs to make good faith judgments about the steps necessary to protect [their] financial interests. These steps may include liquidation of the defaulting customer's open positions.

Lee v. Lind-Waldock & Co., [1999-2000 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 28,173 at 50,159 (CFTC June 29, 2000).

Neither *Baker* nor *Lee* addressed the apparent conflict between the protective steps they discussed and the requirements of Commission Rule 166.2.[7] In *Slone*, however, we held that a customer's failure to pay a margin call was "a narrow circumstance warranting an exception" to the general rule that an FCM "has a duty to follow a customer's instructions regarding his money and property[,]" and stated that "payment of all margin calls is the only effective short-term method [by which a customer may] preserve his right under the Act to control the disposition of a position in the futures market.[8] *Slone,* ¶ 26,283at 42,433. We then explained that complainant Slone:

> acknowledge[d] that he received written notice of a margin call on October 21 and simply refused to meet it. In these circumstances, respondents were not required to seek his specific authorization to liquidate his account, and his unauthorized trading claim must fail.

Id. at 42,433-34. Clearly, this language suggests, and we now hold, that when a customer receives and fails to pay a legitimate margin call, the prior authorization requirement of Rule 166.2 does not apply to trading decisions affecting the undermargined positions.

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[7] *Baker* discussed an FCM's rights and responsibilities in the context of Section 4b of the Act, *Baker*, ¶ 21,167 at 24,770, while *Lee* relied on both Sections 4b and 4d of the Act. *Lee*, ¶ 28,173 at 50,159 (explaining that "[i]n practice, [one of the duties imposed by Section 4d] requires an FCM to follow customers' instructions regarding their money and property").

[8] We noted in *Slone* that, "[i]f the customer refuses to pay a disputed call, he may later be able to collect damages by proving that the margin call the FCM issued was not legitimate. In the meantime, however, the FCM is free to liquidate the customer's position in an effort to control its financial exposure." *Slone*, ¶ 26,283 at 42,433 n.4.

In the present case, there is no question regarding the propriety of Saul Stone's margin call or the fact that Hussain failed to meet it. Accordingly, his unauthorized trading claim is without merit.[9]

Hussain also claims, however, that if Saul Stone had pursued an immediate liquidation strategy on April 28, 1998, the losses in the account would have been limited to approximately $31,700.[10] Saul Stone countered at the hearing in this matter that "the market [was] extremely volatile" and that "it would [have been] extremely detrimental to [Hussain's] position to liquidate it immediately."[11] (Tr. at 88).

In support of his contention that an immediate liquidation on April 28, 1998 would have limited his losses to approximately $31,700, Hussain apparently relies solely on the account statement for that date, which shows a liquidation value for the account of approximately that amount. This evidence is not compelling. The valuation reflected on the account statement was based on settlement prices. Such prices do not reflect information regarding liquidity, which

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[9]In view of our analysis, we need not resolve Saul Stone's defense based upon its customer agreement with Hussain, which contained a clause authorizing it to liquidate the account "in its sole and absolute discretion," in the event that he failed to maintain adequate margin.

[10] In the context of Saul Stone's counterclaim, we view this argument as raising the defense that Saul Stone failed to mitigate its damages. Under Commission precedent, the party raising the mitigation defense has a duty to show that the opposing party failed to act reasonably to limit its damages. *Sansom Refining Co. v. Drexel Burnham Lambert, Inc.*, [1987-1990 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,596 (CFTC Feb. 16, 1990).

[11] Soman testified that, aside from market conditions prohibiting immediate liquidation, he agreed to the longer-term delta neutral strategy because Hussain was trying to raise funds to pay the margin call. As we have observed, an FCM is under no obligation to undertake the risk inherent in granting a customer additional time to obtain margin funds and may liquidate an undermargined position without hesitation. Consequently, we would not view trading for this purpose alone as directed at protecting either the FCM's own financial interests or those of its other customers.

We also observe that, generally, prudence would dictate that an undermargined position be liquidated as quickly as possible. Clearly though, there are circumstances in which a more complex or longer-term liquidation strategy would best serve the interests of the FCM and its customers, including the defaulting customer. For example, a simple immediate liquidation of the affected position would not be an option if the price of the contract at issue had reached a trading limit and participants on the opposite side of the market were unwilling to trade. Similarly, when the size of the affected position is substantial in relation to the immediately available liquidity, a simple immediate

may result in actual liquidation prices that are substantially different from settlement prices.[12] We conclude, therefore, that Hussain failed to carry his burden of proof on this score.

II.

Hussain's misrepresentation claim is based on his contention that, despite his failure to meet the margin call on April 28, 1998, Thompson assured him that morning that Saul Stone would carry his open option positions until their expiration on May 15, 1998. Thompson specifically denied that he did so. Although the ALJ did not directly address this conflict in the evidence, he implicitly found that Hussain's testimony on this score was not credible.

While the undisputed evidence demonstrates that Saul Stone agreed to maintain Hussain's option positions for some indefinite period of time beyond April 28, 1998 while he attempted to raise funds to pay the margin call, there is no evidence, other than Hussain's own testimony, to support his claim that this agreement extended to carrying the option positions to expiration. Recognizing that presiding officers are able to assess demeanor-based factors in determining credibility, the Commission generally defers to their credibility determinations in the absence of clear error. *See Ricci v. Commonwealth Financial Group, Inc.*, [1996-1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26, 917 at 44,444 (CFTC Dec. 20, 1996). Because Hussain has not established that the ALJ's negative assessment of his credibility was the result of clear error, we have no basis for disturbing it. Moreover, even if we were to credit Hussain's version of the facts, he has not demonstrated how he relied on the alleged

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liquidation may expose both the FCM and its customers to unnecessarily high losses. In such circumstances, FCMs must be afforded the flexibility to make the type of sound business judgments we discussed in *Baker* and *Lee*.

[12] Hussain produced no evidence in support of his allegations that his positions were "totally liquid" and could have been completely liquidated "in five minutes." Complainant's August 1998 Response at 1.

misrepresentation to his detriment.[13] Accordingly, Hussain's misrepresentation claim also must fail.

III.

We take this opportunity to clarify the burden of proof in cases such as this in which a complainant alleges both unauthorized trading and that losses could have been mitigated by pursuing a different liquidation strategy. As we stated in *Slone*, liquidation for failure to pay a margin call is a defense to an unauthorized trading claim, thus, the burden of proof is on the FCM to show that a margin call was made and that the customer failed to meet it. *Slone*, ¶ 26,283 at 42,433. If the customer contends, as here, that despite an unpaid margin call, the FCM promised but failed to keep positions open, the burden of proof is on the customer, as it is with any other claim of misrepresentation.[14] Likewise, a customer who contends that an FCM could have mitigated the losses in his account by employing a different liquidation strategy must carry the burden of proof.

CONCLUSION

For the foregoing reasons, we conclude that Hussain's complaint should be dismissed for

[13]Hussain alleged that, if Saul Stone had not agreed on April 28, 1998, to carry his option positions to expiration, he would have met the margin call. Hussain failed to produce any evidence, however, that he was ready or able to do so.

[14] To the extent that *Ahlstedt v. Capitol Commodity Services, Inc.*, [1996-1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,131 at 45,290 (CFTC Aug. 12, 1997), may be interpreted otherwise, it is overruled.

a failure of proof and that judgment should be entered on Saul Stone's debit balance counterclaim.

IT IS SO ORDERED.[15]

By the Commission (Chairman NEWSOME and Commissioners HOLUM, LUKKEN and BROWN-HRUSKA).

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Jean A. Webb
Secretary to the Commission
Commodity Futures Trading Commission

Dated: April 22, 2003

Concurring Opinion of Commissioner Sharon Brown-Hruska

Although I agree with the decision to dismiss Hussain's claim, I write separately to express my views regarding the Commission's standard for evaluating the propriety of an FCM's liquidation of a customer's account when margin is not met.

[15] Under Sections 6(c) and 14(e) of the Commodity Exchange Act (7 U.S.C. §§ 9 and 18(e)) (1994), a party may appeal a reparation order of the Commission to the United States Court of Appeals for only the circuit in which a hearing was held; if no hearing is held, the appeal may be filed in any circuit in which the appellee is located. The statute also states that such an appeal must be filed within 15 days after notice of the order, and that any appeal is not effective unless, within 30 days of the date of the Commission order, the appealing party files with the clerk of the court a bond equal to double the amount of the reparation award.

Prior to 1994, the Commission unambiguously deferred to an FCM's assessment of how much risk that it was willing to accept from a customer's financial inability to carry a position, and permitted it to set and enforce its margin policy based upon its own "business judgment."[1] This policy was considered integral to "the *necessarily flexible process* by which futures commission merchants control financial risk to themselves."[2]
Under this policy, an FCM was free to demand additional funds from a customer in accordance with its margin policy and to liquidate the account if that demand was not met.[3] Moreover, an FCM's exercise of such business judgment was not to be "curtailed by fear of subsequent claims of constructive fraud which have no basis."[4]

The Commission's policy during this period was consistent with both state and federal precedent on this issue, which treated a customer's failure to meet a margin call as a "material breach" of his contractual obligation to maintain sufficient margin, thus dissolving the broker's obligation to follow the customer's instructions any further.[5]

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[1] *See Baker v. Edward D. Jones & Co.*, [1980-1982 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,167 (CFTC Jan. 27, 1981), and *Roberts v. Ray E. Friedman & Co.,* [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,063 (CFTC May 15, 1986). The FCM's latitude to deal with this problem derives from the fact that margin policy is governed by a combination of exchange rules and contractual arrangements between the FCMs and their customers. While the Commodity Exchange Act leaves the determination of the appropriate level of margin to the exchanges, most exchanges, in turn, leave the authority to demand additional margin deposits to the FCM, as it deems necessary. Moreover, most FCM customer agreements empower the FCM to exercise its business judgment in demanding further margin deposits and in dealing with noncompliance by its customers. *See Baker,* ¶ 21,167 at 24,770-771.

[2] *Baker,* ¶ 21,167 at 24,770 (emphasis added).

[3] *See also* Commission Rule 1.55(b)(1) (Risk Disclosure Statement for Futures and Options) (warning prospective customers that failure to comply with margin call may result in account liquidation at customer's loss).

[4] *Baker*, ¶ 21,167 at 24,772. In *Baker*, the Commission specifically declined to hold that an FCM's liquidation of an under-margined account constituted unauthorized trading in the absence of evidence that the firm defrauded its customer. The Commission framed the issue as follows:

> We are asked to consider whether in the absence of any evidence that the firm computed its margin demand in bad faith or that the customer was misled or otherwise defrauded in connection with the firm's margin policy when entering into or maintaining a contractual relationship with [the FCM], a customer may decline to meet a margin call with which he disagrees and, should his open positions be liquidated as a result, whether that liquidation may properly be held to constitute unauthorized trading in violation of Section 4b of the Act.

Id. at 24,770. In rendering its decision, the Commission made clear that such liquidation would not be regarded as unauthorized trading.
[5] *Agra, Gill & Duffus, Inc.*, 970 F.2d 1173, 1177 (4th Cir. 1990) (broker under no duty to continue to comply with customer's orders following customer's failure to meet margin call).

Futhermore, FCMs were neither obligated to give notice nor obtain the consent of a customer prior to liquidating positions on an under-margined account.[6] As with the Commission, courts reasoned that such a hands-off policy was vital to the financial integrity of both FCMs and the marketplace.[7]

During the mid-1990s, however, the Commission abandoned this sound policy in favor of one that increasingly treated the exercise of such judgment as a form of unauthorized trading. In *Slone v. Dean Witter Reynolds, Inc.,* for example, the Commission ruled that a customer's failure to satisfy a margin call merely constituted "a *narrow* circumstance warranting an exception to the general rule" requiring a customer's specific authorization to liquidate his account.[8] Furthermore, that decision also shifted the burden of proof to the FCM to establish that the liquidation was proper.[9] Then in *Faro v. Interlink Trading, Inc.,* the Commission declared that an FCM's failure to obtain such authorization in connection with the liquidation of a customer's position would constitute a *prima facie* violation of Section 6b.[10] In *Lee v. Lind-Waldock & Co.*, the Commission explicitly imposed notice and demand obligations upon FCMs in such circumstances, and held that any delay in notifying customers of material changes in the status of

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[6] *See Geldermann & Co., Inc. v. Lane Processing, Inc.,* 527 F.2d 571, 577 (8th Cir. 1975) (upholding summary liquidation procedures on the grounds that they "promoted the interest and protection of the commission merchants, their customers and the investing public as a whole"). *Accord Moss v. J.C. Bradford & Co.,* 337 N.C. 315, 328 (N.C. 1994) (interpreting the CEA as not requiring an FCM to issue a margin call or notice prior to liquidating a customer's commodity account).

[7] For example, in *Moss v. J.C. Bradford & Co.,* the Supreme Court of North Carolina concluded "that the pervasive federal regulatory paradigm in the areas of futures trading . . . is designed to afford maximum protection to the commodities merchants and the commodities exchanges themselves and therefore permits the liquidation of a customer's under-margined account *without prior demand or notice*." 337 N.C. at 328 (emphasis in original). Similarly, the Court in *Geldermann* explained:

> Investors or speculators who have failed to deposit sufficient maintenance margins may have insufficient financial resources to withstand substantial losses on the market and, if so, continued trading on that account is a financial risk for the commission merchant, and ultimately for the commodities exchange if the loss suffered by the commission merchant exceeds its capital account. Imposing requirements of demand and notification, particularly where it may be extremely difficult or time-consuming to contact an investor, would violate the manifest purpose of the liquidation provision.

527 F.2d at 577.

[8] *Slone v. Dean Witter Reynolds, Inc.,* [1994-1996 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,283 at 42,433 (CFTC Dec. 16, 1994) (emphasis added).

[9] *Id.* The Commission in *Slone* thus took the extraordinary step of shifting the normal burden of proof with respect to the issue of fraud from the complainant to the FCM respondent.

[10] *Faro v. Interlink Trading, Inc.,* [1994-1996 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,537 at 43,374 (CFTC Nov. 16, 1995).

their accounts would be regarded as "reckless" and a breach of the FCM's duty under Section 4b to make such disclosures.[11] Finally, in *Ahlstedt v. Capitol Commodity Services, Inc.*, the Commission reaffirmed the FCM's burden to establish the propriety of its liquidation when challenged by a customer.[12]

The Commission's unacknowledged departure from its earlier well-established precedent, however, created a number of conceptual and practical problems. First, it undermined the principle that "nothing" in either the CEA or our regulations "dictates that an FCM must retain an account when the customer is unable to continue to maintain the position."[13] In addition, it disregarded the existence of exchange rules and contractual arrangements authorizing FCMs to liquidate without notice or customer authorization in such circumstances.[14] It also placed the FCM in legal and financial peril whenever it sought to exercise its contractual rights following a customer default on his margin obligations. Finally, the presumption of illegality placed upon an FCM encouraged customers to claim that their accounts were unlawfully liquidated. Not surprisingly, the case before us represents an attempt by a customer to transform an FCM's liquidation of his plainly under-margined account into an unauthorized trading case.

In the matter before us, however, the customer has little reason to complain about the treatment he received from his FCM. As a former stockbroker with fifteen years of experience trading futures and options who was accorded special privileges by his FCM, Saul Stone and Company, including direct access to the trading floor and daily facsimiled updates of his positions, Hussain was a sophisticated investor, who, in the words of Administrative Law Judge Painter, was "well aware" of his vulnerable position. Moreover, while Stone indulged Hussain's request to keep his positions open for nearly two weeks following his default, Hussain made no effort to reduce or eliminate his account deficit. In light of Hussain's plea for more time and the possible adverse effect that immediate liquidation of his positions might have entailed, Stone's liquidation strategy, in my opinion, cannot be viewed as anything other than a good faith and commercially reasonable effort by an FCM to accommodate the interests of a purportedly good customer.[15]

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[11] *Lee v. Lind-Waldock & Co.*, [1999-2000 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 28,173 at 50,160 (CFTC Jun. 29, 2000). In effect, *Lee* overrode contractual provisions authorizing FCMs to liquidate without notice in under-margined accounts.

[12] *Ahlstedt v. Capitol Commodity Services, Inc.*, [1996-1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,131 at 45,290 (CFTC Aug. 12, 1997).

[13] *Roberts,* ¶ 23,063 at 32,132.

[14] *Geldermann,* 527 F.2d at 574-578 (upholding exchange rule allowing customer only one hour to meet margin requirements and provision in customer contract providing for summary liquidation "without notice or demand" as "eminently reasonable"); *Olmos v. Golding,* 736 F.Supp. 1472 (N.D. Ill. 1989) (upholding FCM's liquidation of account following customer's failure to meet margin call demand by end of day as consistent with parties' obligations under brokerage agreement and applicable exchange rules).

[15] The delta neutral strategy employed by Stone appears to have been consistent with an effort to manage the financial risks associated with immediate liquidation and to minimize further losses in the customer's

While the standard adopted today rectifies some of the problems associated with the *Slone-Ahlstedt* approach, I am concerned that the Commission still regards margin call liquidation as a form of unauthorized trading. This is best illustrated by the reference to the "apparent conflict" between an FCM's protective steps and the requirements of Commission Rule 166.2, and by the characterization of such steps as a "narrow exception" to those requirements.[16] In my view, such references are relics of a prior misguided approach that placed the interest of a defaulting customer over the financial integrity of the FCM and the investing public.

The Commission's opinion gives no consideration to the contractual rights of the parties here. In opening his account, Hussain gave the FCM full authority "in its sole and absolute discretion, without notice or demand" to close out his open positions "*in whole or in part, or take any other action it deems necessary*" to satisfy its margin requirements (emphasis added). Notwithstanding this unambiguous language, which grants Stone broad powers to deal with this problem, the Commission avoids taking it into account. Yet the legality of the broker's actions, in my view, is governed by this very provision.[17] Indeed, the outcome here is "mandated by the existence of a valid and enforceable contractual term authorizing the broker to close out an undermargined account with or without notice to the customer." *Olmos v. Golding,* 736 F.Supp. at 1476. At the same time, the existence of such a contractual provision is fully consistent with the plain language of Commission Rule 166.2 (b), since the FCM's actions are made pursuant to a *written* contractual agreement explicitly *authorizing* it to take such protective steps "without the customer's *specific* authorization." 17 C.F.R. § 166.2(b) (emphasis added).[18]

By focusing on the terms of the customer agreement, as Judge Painter did here, we avoid getting bogged down in the hollow exercise of trying to determine whether an FCM's action

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account. From April 28 to May 1, 1998, Stone attempted to minimize changes in the value of Hussain's account by maintaining a delta neutral hedge between the option and futures positions in the account. Such a strategy, which is effective only for short-run time horizons and correspondingly small changes in price, was consistent with allowing Hussain time to acquire funds to meet his margin call. By May 4, when it became apparent that such funds would not be forthcoming, Stone began the process of liquidation by eliminating the entire futures positions and beginning to offset the option contracts in the account. Since the account was no longer in a delta neutral position, Stone initiated two small short futures positions on May 5th, and again on May 7th, apparently to hedge the short-term risk on the exposed option positions. Such a protective strategy was in the interest of both the client and the FCM.

[16] Or more specifically, to the Commission's insistence that a customer's failure to satisfy a margin call is "a narrow circumstance warranting an exception" to the general rule that an FCM "has a duty to follow a customer's instructions regarding his money and property."

[17] *See First American Discount Corp.,* 324 Ill. App. 997 (App. Ct. Ill. 2001) (broker had right *under parties' agreement* to liquidate clients' account without notice); *Geldermann,* 527 F.2d at 577 (upholding "manifest purpose" of "liquidation provision").

[18] Therefore, the Commission's holding here that the prior authorization requirement of Rule 166.2 does not apply "when a customer receives and fails to pay a legitimate margin call," is plainly wrong.

constitutes "a narrow circumstance warranting an exception" to the prohibition against unauthorized trading. That does not mean that the FCM has unlimited authority over the defaulting customer's account, but it does mean that in order to prevail, the complaining customer must show that the FCM acted in a manner that was inconsistent with either the agreement's express terms or applicable exchange rules.[19] Absent evidence of fraud or breach of the contractual agreement by the FCM, the principles of unauthorized trading are irrelevant to our analysis. *Cf. Agra, Gill & Duffus, Inc.*, 970 F.2d at 1177.

In conclusion, as Hussain's account was liquidated within the authority of the customer agreement, I would have summarily affirmed Judge Painter's straightforward handling of the issues here, which was based on the proper application of sound contractual principles.

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Commissioner Sharon Brown-Hruska Date: April 9, 2003

[19] No such showing was made here. Stone's liquidation strategy, as Judge Painter found, was consistent with both (1) the "full authority" it had under the customer agreement to close out an under margined account, and (2) the discretion that Hussain granted it to maintain the account in delta neutral. Moreover, as Judge Painter further found, there was no showing that Stone abused that discretion.