

**UNITED STATES OF AMERICA**  
**Before the**  
**COMMODITY FUTURES TRADING COMMISSION**

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**12:28 pm, Oct 09, 2012**

**In the Matter of:**

**Farr Financial Inc.,**

**Respondent.**

**CFTC Docket No. 13-01**

**ORDER INSTITUTING PROCEEDINGS PURSUANT TO  
SECTIONS 6(c) AND 6(d) OF THE COMMODITY EXCHANGE ACT, AS AMENDED,  
MAKING FINDINGS AND IMPOSING REMEDIAL SANCTIONS**

**I.**

The Commodity Futures Trading Commission (“Commission”) has reason to believe that at various times between February 2005 and December 2010 (the “Relevant Period”), Farr Financial Inc. (“Farr” or “Respondent”) violated Section 4d(a)(2) of the Commodity Exchange Act (“Act”), as amended by the Food, Conservation, and Energy Act of 2008, Pub. L. No. 110-246, Title XIII (the CFTC Reauthorization Act of 2008 (“CRA”), §§ 13101-13204, 122 Stat. 1651 (enacted June 18, 2008), 7 U.S.C. § 6d(a)(2) (2006 & Supp. III 2009), and Commission Regulations (“Regulations”) 1.23, 1.27(a), 1.32, and 166.3, 17 C.F.R. §§ 1.23, 1.27(a), 1.32, 166.3 (2012), and Regulation 1.25(a) – (c), 17 C.F.R. § 1.25(a) – (c) (2011) (amended 2012).<sup>1</sup> Therefore, the Commission deems it appropriate and in the public interest that public administrative proceedings be, and hereby are, instituted to determine whether Respondent engaged in the violations set forth herein and to determine whether any order should be issued imposing remedial sanctions.

**II.**

In anticipation of the institution of an administrative proceeding, Respondent has submitted an Offer of Settlement (“Offer”), which the Commission has determined to accept. Without admitting or denying any of the findings or conclusions herein, Respondent consents to the entry of this Order Instituting Proceedings Pursuant to Sections 6(c) and 6(d) of the

<sup>1</sup> The version of Regulation 1.25 that was codified in 2011 was effective during the Relevant Period.

Commodity Exchange Act, as Amended, Making Findings and Imposing Remedial Sanctions (“Order”) and acknowledges service of this Order.<sup>2</sup>

### III.

The Commission finds the following:

#### A. Summary

During the Relevant Period, Farr was a futures commission merchant (“FCM”) registered with the Commission. FCMs receive money, securities and other property (“funds”) from their customers to margin, guarantee, or secure the customers’ futures and options trades. Under the Act and the Commission’s Regulations promulgated thereunder, 17 C.F.R. §§ 1.1 *et seq.* (2012), FCMs are required to segregate customer funds from funds belonging to the FCM, and can only invest customer funds in investments enumerated in Regulation 1.25, 17 C.F.R. § 1.25 (2012).

During the period from late 2007 through the end of 2010, Farr invested customer funds in at least seven different accounts that failed to comply with the requirements of Regulation 1.25. These investments included (1) an investment in a money market mutual fund from which funds could not be withdrawn by the next business day as required by Regulation 1.25; (2) five savings or money market deposit accounts, which are not permitted investments under Regulation 1.25; and (3) a certificate of deposit whose issuer did not meet the then-existing credit rating requirement of Regulation 1.25.

Farr also failed to prepare and maintain certain records it was required to maintain in connection with its investment of customer funds. Specifically, Farr’s recordkeeping was inadequate both with respect to the records FCMs are required to maintain upon initial investment of customer funds and with respect to daily records containing certain information they must maintain thereafter, in violation of Regulation 1.25(b)(7), 17 C.F.R. § 1.25(b)(7) (2011) (amended 2012, now codified at 17 C.F.R. § 1.25(b)(6) (2012)) and Regulation 1.27(a), 17 C.F.R. § 1.27(a) (2012).

Furthermore, Farr’s calculation of the amount of money that it was required to segregate for its customers was inaccurate for a period of several years. From at least February 2005 through March 2010, Farr understated the amount of customer funds it needed to segregate for its commodity and option customers, and overstated the amount of excess funds in segregation, by amounts that often exceeded \$300,000. By failing to accurately compute its customers’ interest

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<sup>2</sup> Respondent consents to the entry of this Order and to the use of these findings in this proceeding and in any other proceeding brought by the Commission or to which the Commission is a party; provided, however, that Respondent does not consent to the use of the Offer, or the findings or conclusions in this Order consented to in the Offer, as the sole basis for any other proceeding brought by the Commission, other than in a proceeding in bankruptcy or to enforce the terms of this Order. Nor does Respondent consent to the use of the Offer or this Order, or the findings or conclusions in this Order consented to in the Offer, by any other party in any other proceeding.

and its own interest in funds on deposit in segregated accounts, Farr violated Regulations 1.23 and 1.32, 17 C.F.R. §§ 1.23, 1.32 (2012).

During the time period from at least September 2007 through December 2010, Farr failed to diligently supervise its employees and agents in violation of Regulation 166.3, 17 C.F.R. § 166.3. Farr failed to implement any written policies or procedures governing the opening and maintenance of customer segregated accounts, and failed to implement an adequate supervisory structure to insure the proper segregation of customer funds.

By this conduct and further conduct described herein, Farr engaged in acts and practices that violated the Act and Regulations.

**B. Respondent**

Respondent **Farr Financial Inc.** is a California corporation formed in June 1997 located at 1073 S. Winchester Blvd., San Jose, California. During the entirety of the Relevant Period, Farr was a registered FCM. On April 5, 2011, Farr's FCM registration was withdrawn, and Farr was registered as an introducing broker.

**C. Facts**

*1. Investment of Customer Funds*

On several occasions spanning from 2007 through 2010, Farr invested customer funds in investments that were not permitted under Regulation 1.25. Farr invested customer funds in five savings or money market deposit accounts (the "Savings Accounts") from which Farr was not entitled to make immediate demand withdrawals. All of these accounts held in excess of \$1 million at some time, and four of them held in excess of \$7 million of customer funds during some portion of the life of the account.

During portions of the period from March 2008 through December 2008, Farr invested customer funds in the "U.S. Government Money Market Fund" ("US Government Fund") offered by JPMorgan Asset Management. In certain circumstances, the US Government Fund was only obligated to satisfy redemption requests seven days following the request. Farr held a significant amount of customer funds in this account, with the balance at one point exceeding \$25 million.

For over five months in 2010, Farr invested approximately \$1.4 million in customer funds in a certificate of deposit at East West Bank (the "East West CD"). At the time, East West Bank was not rated by a nationally recognized statistical rating organization.

Notwithstanding the above, the Commission's Division of Clearing and Intermediary Oversight ("DCIO")<sup>3</sup> determined that Farr complied with its obligation to segregate customer

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<sup>3</sup> DCIO is no longer one of the divisions of the CFTC organization, and its previous duties relevant to this matter have been assumed by the Commission's Division of Swap Dealer and Intermediary Oversight.

funds from its own proprietary accounts in accordance with applicable statutory and regulatory provisions. As a result, Farr was not required to exclude the market value of the foregoing investments from the total amount of funds on deposit in customer segregated accounts, *see* CFTC Letter No. 07-24 (Dec. 11, 2007), and Farr was not rendered under-segregated by the foregoing investments.

## 2. *Segregated Funds Computation and Recordkeeping*

From at least February 2005, when Farr changed to a new commodity recordkeeping system, through March 2010, Farr mistakenly double-counted debit customer accounts in the course of computing the amount of funds it was required to segregate for its commodity and option customers. As a result, Farr understated its customer segregation requirement, and therefore overstated its excess funds in segregation, by an amount that often exceeded \$300,000. Farr remedied the problem once it was notified of the miscalculation.

Furthermore, at least some of Farr's daily investment records failed to include information such as an adequate description of the type of instruments in which customer funds were invested and the original cost of the instruments. Farr also failed to maintain an adequate record of its investment of customer funds showing information such as the name of the person through whom the investment was made and a description of the instruments in which such investments were made.

## 3. *Supervision*

Farr failed to diligently supervise the activities of its personnel with respect to permitted investments of customer segregated funds, and with respect to its recordkeeping obligations related to those investments. Farr did not implement any policies or procedures to assist its staff in selecting permitted investments and maintaining adequate records regarding those investments.

# IV.

## LEGAL DISCUSSION

### A. **Improper Investment of Customer Funds**

Section 4d(a)(2) of the Act provides that customer segregated funds “may be invested in obligations of the United States, in general obligations of any State or of any political subdivision thereof, and in obligations fully guaranteed as to principal and interest by the United States, such investments to be made in accordance with such rules and regulations and subject to such conditions as the Commission may prescribe.” Regulation 1.25(a), 17 C.F.R. § 1.25(a) (2011) (amended 2012) contains a list of “permitted investments” in which FCMs may lawfully

invest customer funds. Savings accounts and money market deposit accounts are not included in the list of permitted investments.<sup>4</sup>

Public Commission guidance regarding permitted investments has further explained the prohibition on investment of customer funds in savings and money market deposit accounts bearing restrictions on the ability of the FCM to withdraw funds immediately on demand. *See, e.g.,* CFTC Div. of Trading and Markets Fin. and Segregation Interp. No. 9 (Nov. 23, 1983) (“it has always been the Division’s position that customer funds deposited in a bank cannot be restricted in any way,” so “the Division has not allowed customer funds to be deposited in savings accounts,” and money market deposit accounts are impermissible “unless it is demonstrated to the Commission that there is a lawful mechanism by which the account holder can obtain such funds immediately upon demand”); Form 1-FR-FCM Instructions (Mar. 2010), at 10-8 (“Except as otherwise set forth in Commission Regulation 1.25, cash in savings accounts or any other type of deposit account in which funds may not be immediately withdrawn upon demand may not be included as part of segregated funds.”). As a result, Farr’s investment of customer funds in the Savings Accounts violated Section 4d(a)(2) of the Act and Regulation 1.25(a).

Regulation 1.25(a)(viii), 17 C.F.R. § 1.25(a)(viii) (2011) (amended 2012), provides that FCMs may invest customer funds in “[i]nterests in money market mutual funds,” but permitted money market mutual fund investments are subject to certain limitations found in Regulation 1.25(c), including that “[a] fund shall be legally obligated to redeem an interest and to make payment in satisfaction thereof by the business day following a redemption request, and the futures commission merchant or derivatives clearing organization shall retain documentation demonstrating compliance with this requirement.” Regulation 1.25(c)(5)(i), 17 C.F.R. § 1.25(c)(5)(i) (2011) (amended 2012). Farr failed to retain this documentation in connection with its investment in the US Government Fund, and it could not have obtained such documentation had it tried, as the prospectus for the fund dated July 1, 2008 provided that “redemption proceeds will be paid within seven days . . . after the Fund receives the redemption order.” As a result, Farr’s investment of customer funds in the US Government Fund violated Regulation 1.25(c).

Regulation 1.25(b) establishes “[g]eneral terms and conditions” applicable to investment of customer funds, and provided during the Relevant Period<sup>5</sup> that “[w]ith respect to certificates of deposit, the commercial paper or long-term debt instrument of the issuer of a certificate of deposit or, if the issuer is part of a holding company system, its holding company’s commercial paper or long-term debt instrument, must have the highest short-term rating of a[] [nationally recognized statistical rating organization (“NRSRO”)] or one of the two highest long-term ratings of an NRSRO.” Regulation 1.25(b)(2)(E), 17 C.F.R. § 1.25(b)(2)(E) (2011) (amended 2012). Because East West Bank was not rated by an NRSRO at the time of Farr’s investment of customer funds in the East West CD, that investment violated Regulation 1.25(b)(2)(E).

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<sup>4</sup> Regulation 1.25(a)(1)(i) explains parenthetically that the Act’s reference to “obligations fully guaranteed as to principal and interest by the United States” is a reference to “U.S. government securities.”

<sup>5</sup> Consistent with Section 939A of the Dodd-Frank Wall Street and Consumer Protection Act, PL 111-203, July 21, 2010, 124 Stat. 1376, Regulation 1.25 no longer references ratings requirements.

## **B. Recordkeeping and Computation Violations**

Regulation 1.25(b)(7), 17 C.F.R. § 1.25(b)(7) (2011) (amended 2012, now codified at 17 C.F.R. § 1.25(b)(6) (2012)) required FCMs to “prepare and maintain a record that will show for each business day with respect to each type of investment made pursuant to this section” information including “[t]he type of instruments in which customer funds have been invested” and “[t]he original cost of the instruments.” Certain of Farr’s records maintained pursuant to this Regulation failed to include original cost information and failed to include information on the nature of the investments as well, instead listing only the name of the institution where funds were held. Furthermore, Regulation 1.27(a), 17 C.F.R. § 1.27(a) (2011) (amended 2012) requires that FCMs maintain a record containing a variety information on investments and divestments of customer funds. Farr failed to maintain this record.

Commission Regulations require all FCMs to compute, as of the close of each business day, on a currency-by-currency basis (1) the total amount of customer funds on deposit in segregated accounts on behalf of commodity and option customers; (2) the amount of such customer funds required by the Act and these regulations to be on deposit in segregated accounts on behalf of such commodity and option customers; and (3) the amount of the futures commission merchant’s residual interest in such customer funds. Regulation 1.32, 17 C.F.R. § 1.32 (2012). Regulation 1.32 inherently requires that FCMs accurately compute these amounts. Regulation 1.23, 17 C.F.R. § 1.23 (2012) further requires that “[t]he books and records of a futures commission merchant shall at all times accurately reflect its interest in [customer] segregated funds.” Farr violated Regulations 1.23 and 1.32 when it understated the amount of customer funds it needed to segregate for commodity and option customers, and overstated the amount of excess funds in segregation, during the period from February 2005 through March 2010.

## **C. Supervision Violation**

Regulation 166.3, 17 C.F.R. § 166.3 (2012), imposes on each registrant (except an AP who has no supervisory duties) an affirmative duty to “diligently supervise the handling by its ... employees and agents ... of all commodity interest accounts carried, operated, advised or introduced by the registrant and all other activities of its ... employees and agents ... relating to its business as a Commission registrant.” For a registrant to fulfill its duties under Regulation 166.3, it must both design an adequate program of supervision and ensure that the program is followed. *In re GNP Commodities, Inc.*, [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 25,360 at 39,219 (CFTC Aug. 11, 1992), *aff’d in part and rev’d in part sub nom. Monieson v. CFTC*, 996 F. 2d 852 (7th Cir. 1993); *CFTC v. Carnegie Trading Group, Ltd.*, 450 F. Supp. 2d 788, 805 (N.D. Ohio 2006). “A showing that the registrant lacks an adequate supervisory system can be sufficient” to establish a breach of duty under Regulation 166.3. *In re Collins*, [1996-1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,194 at 45,744 (CFTC Dec. 10, 1997).

Farr failed to implement any policies or procedures to assist its staff in selecting permitted investments and maintaining adequate records regarding those investments. Farr violated its supervisory obligations as a result.

**V.**

**FINDINGS OF VIOLATION**

Based on the foregoing, the Commission finds that, during the Relevant Period, Farr Financial Inc. violated Section 4d(a)(2) of the Act as amended, 7 U.S.C. § 6d(a)(2) (2006 & Supp. III 2009), Regulations 1.23, 1.27(a), 1.32, and 166.3, 17 C.F.R. §§ 1.23, 1.27(a), 1.32, 166.3 (2012), and Regulation 1.25(a) – (c), 17 C.F.R. § 1.25(a) – (c) (2011) (amended 2012).

**VI.**

**OFFER OF SETTLEMENT**

Respondent has submitted the Offer in which it, without admitting or denying the findings and conclusions herein:

- A. Acknowledges receipt of service of this Order;
- B. Admits the jurisdiction of the Commission with respect to all matters set forth in this Order and for any action or proceeding brought or authorized by the Commission based on violation of or enforcement of this Order;
- C. Waives:
  - 1. the filing and service of a complaint and notice of hearing;
  - 2. a hearing;
  - 3. all post-hearing procedures;
  - 4. judicial review by any court;
  - 5. any and all objections to the participation by any member of the Commission's staff in the Commission's consideration of the Offer;
  - 6. any and all claims that it may possess under the Equal Access to Justice Act, 5 U.S.C. § 504 (2006) and 28 U.S.C. § 2412 (2006), and/or the rules promulgated by the Commission in conformity therewith, Part 148 of the Commission's Regulations, 17 C.F.R. §§ 148.1-30 (2011), relating to, or arising from, this proceeding;
  - 7. any and all claims that it may possess under the Small Business Regulatory Enforcement Fairness Act of 1996, Pub. L. No. 104-121, §§ 201-253, 110 Stat. 847, 857-868 (1996), as amended by Pub. L. No. 110-28, § 8302, 121 Stat. 112, 204-205 (2007), relating to, or arising from, this proceeding; and

8. any claims of Double Jeopardy based on the institution of this proceeding or the entry in this proceeding of any order imposing a civil monetary penalty or any other relief;
- D. Stipulates that the record basis on which this Order is entered shall consist solely of the findings contained in this Order to which Respondent has consented in the Offer;
- E. Consents, solely on the basis of the Offer, to the Commission's entry of this Order that:
1. makes findings by the Commission that Respondent violated Section 4d(a)(2) of the Act as amended, 7 U.S.C. § 6d(a)(2) (2006 & Supp. III 2009), Regulations 1.23, 1.27(a), 1.32, and 166.3, 17 C.F.R. §§ 1.23, 1.27(a), 1.32, 166.3 (2012), and Regulation 1.25(a) – (c), 17 C.F.R. § 1.25(a) – (c) (2011) (amended 2012);
  2. orders Respondent to cease and desist from violating Section 4d(a)(2) of the Act as amended, 7 U.S.C. § 6d(a)(2) (2006 & Supp. III 2009), Regulations 1.23, 1.27(a), 1.32, and 166.3, 17 C.F.R. §§ 1.23, 1.27(a), 1.32, 166.3 (2012), and Regulation 1.25(a) – (c), 17 C.F.R. § 1.25(a) – (c) (2011) (amended 2012);
  3. orders Respondent to pay a civil monetary penalty in the amount of two hundred and eighty thousand dollars (\$280,000), plus post-judgment interest; and
  4. orders Respondent and its successors and assigns to comply with the conditions and undertakings consented to in the Offer and as set forth in Part VII of this Order.

Upon consideration, the Commission has determined to accept the Offer.

## VII.

### ORDER

#### Accordingly, IT IS HEREBY ORDERED THAT:

- A. Respondent and its successors and assigns shall cease and desist from violating Section 4d(a)(2) of the Act as amended, 7 U.S.C. § 6d(a)(2) (2006 & Supp. III 2009), Regulations 1.23, 1.27(a), 1.32, and 166.3, 17 C.F.R. §§ 1.23, 1.27(a), 1.32, 166.3 (2012), and Regulation 1.25(a) – (c), 17 C.F.R. § 1.25(a) – (c) (2011) (amended 2012).
- B. Respondent shall pay a civil monetary penalty in the amount of two hundred and eighty thousand dollars (\$280,000) within ten (10) days of the date of entry of this Order (the "CMP Obligation"). If the CMP Obligation is not paid in full within ten (10) days of the date of entry of this Order, then post-judgment interest shall accrue on the CMP beginning on the date of entry of this Order and shall be determined by using the Treasury Bill rate prevailing on the date of entry of this Order pursuant to 28 U.S.C. § 1961 (2006). Respondent shall pay the CMP Obligation by electronic funds transfer, U.S. postal money order, certified check, bank cashier's check, or bank money order. If payment is to be made other than by electronic funds transfer, then the payment shall be

made payable to the Commodity Futures Trading Commission and sent to the address below:

Commodity Futures Trading Commission  
Division of Enforcement  
ATTN: Accounts Receivables --- AMZ 340  
E-mail Box: 9-AMC-AMZ-AR-CFTC  
DOT/FAA/MMAC  
6500 S. MacArthur Blvd.  
Oklahoma City, OK 73169  
Telephone: (405) 954-5644

If payment is to be made by electronic funds transfer, Respondent shall contact Linda Zurhorst or her successor at the above address to receive payment instructions and shall fully comply with those instructions. Respondent shall accompany payment of the CMP Obligation with a cover letter that identifies the paying Respondent and the name and docket number of this proceeding. The paying Respondent shall simultaneously transmit copies of the cover letter and the form of payment to (1) Chief Financial Officer, Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street, NW, Washington, D.C. 20581; and (2) Regional Counsel, Commodity Futures Trading Commission, 525 West Monroe Street, Suite 1100, Chicago, IL 60661.

- C. Respondent and its successors and assigns shall comply with the following conditions and undertakings set forth in the Offer:
1. **Public Statements**: Respondent agrees that neither it, its successors and assigns, nor any of their agents or employees under their authority or control shall take any action or make any public statement denying, directly or indirectly, any findings or conclusions in this Order or creating, or tending to create, the impression that this Order is without a factual basis; provided, however, that nothing in this provision shall affect Respondent's: (i) testimonial obligations; or (ii) right to take legal positions in other proceedings to which the Commission is not a party. Respondent and its successors and assigns shall undertake all steps necessary to ensure that all of their agents and/or employees under their authority or control understand and comply with this agreement.
  2. **Partial Satisfaction**: Respondent understands and agrees that any acceptance by the Commission of partial payment of Respondent's CMP Obligation shall not be deemed a waiver of its obligation to make further payments pursuant to this Order, or a waiver of the Commission's right to seek to compel payment of any remaining balance.
  3. **Change of Address/Phone**: Until such time as Respondent satisfies in full its CMP Obligation as set forth in this Consent Order, Respondent shall provide written notice to the Commission by certified mail of any change to his telephone number and mailing address within ten (10) calendar days of the change.

**The provisions of this Order shall be effective as of this date.**

By the Commission.

  
Sauntia S. Warfield  
Assistant Secretary of the Commission  
Commodity Futures Trading Commission

Dated: October 9, 2012