



U.S. COMMODITY FUTURES TRADING COMMISSION

Three Lafayette Centre
1155 21st Street, NW, Washington, DC 20581

**OFFICE OF
PROCEEDINGS**

OFFICE OF PROCEEDINGS
PROCEEDINGS CLERK

1999 JUL 23 A 10:20

RECEIVED
C.F.T.C.

DONALD EUGENE BAKER,
Complainant,

v.

GARY LOUIS YARUSSO,
Respondent.

*
*
*
*
*
*
*
*
*
*

CFTC Docket No. 98-R160

INITIAL DECISION

Donald Baker alleges that Gary Yarusso defrauded him during the solicitation and trading of his options account with American Futures Group, and seeks to recover \$24,634.39 in out-of-pocket losses. Yarusso denies any violations.

The findings and conclusions below are based on the parties' documentary submissions and oral testimony, and reflect the determination that Yarusso's testimony— especially concerning the rationale for his trade recommendations — was less convincing and less plausible than was Baker's. As discussed below, Baker has established violations by Yarusso causing damages in the amount sought.

Factual Findings

1. Donald Baker, a resident of Grand Rivers, Kentucky and an unmarried father with two dependent children, was 44 years old when he opened his account with American Futures Group. Baker was also in debt and unemployed, having been disabled by carbon monoxide poisoning. The symptoms of the resulting brain damage included severe headaches, nausea, and impairment of his ability to comprehend and remember information. Baker's testimony indicates that while he could not recall the technical details of Yarusso's trading recommendations, he did remember with sufficient accuracy what he told Yarusso about simple and basic facts such as his disability and financial status, as well as what Yarusso told him about simple and basic facts such as profit projections.

Before his retirement, Baker had been employed as a steel worker and as the owner of a small construction firm. Baker has a GED high school diploma.

Baker's income was limited to social security payments. At the time that he opened his account, Baker was negotiating a settlement of a lawsuit seeking damages, including lost income and lost earnings potential, in connection with the carbon monoxide poisoning. Baker eventually settled for \$190,000, of which he received about \$40,000, with the balance of the settlement funds going to his children. At the time that he opened his account, Baker was purchasing a new house.

Baker had no investment experience before he opened his account with American Futures Group.

2. Gary Yarusso was a registered associated person with American Futures Group from June 1996 to April 1997. He subsequently became a registered associated person with American Financial Services, Incorporated. Yarusso was principally compensated by a one-third share of the commissions charged to his customers. Thus, Yarusso received about \$2,800 out of the \$8,550 in commissions charged to Baker's account.

3. American Financial Group, Incorporated ("AFG") was registered at the relevant time as a futures commission merchant. AFG failed to file an answer to the complaint, and was found in default and ordered to pay reparations, on August 26, 1998. That default order has become final.

4. In September of 1996, Baker saw a television commercial touting quick and large profits that could be made trading options on soybean futures. In response to the commercial, Baker called a toll-free number and spoke to Yarusso. They spoke about four times, before Yarusso convinced Baker to open an account with AFG.

Baker credibly testified that he told Yarusso that he had no investment experience; that he had no savings; that he was currently unemployed with two children and about to buy a new house; that he had no income beyond social security and the expected settlement from a lawsuit arising from carbon monoxide poisoning; that he was interested in investing no more than \$6,500 of the settlement funds; that he was looking for a quick return in the soybean market as discussed in the commercial; and that he hoped to use the expected profits to help pay the closing costs on the house he was planning to buy.

Baker also credibly testified that Yarusso acknowledged that trading options involved a general risk of loss, but that Yarusso negated these warnings by assuring him that supply and demand conditions in the soybean market virtually assured profits. Yarusso told Baker that the soybean market was jumping and that if he had invested earlier as had Yarusso's other clients, he already would have realized tremendous profits. Yarusso further assured Baker not to worry about picking trades or losing money, because Yarusso would provide all of the necessary advice. Finally, Yarusso told Baker that AFG charged a \$150 commission, which Baker understood to be per-transaction, rather than per-contract.

5. On or about September 5, 1996, Baker filled out, signed and express-delivered the account application. Baker told Yarusso that he still had not received any funds from the settlement. Yarusso told Baker that he had to follow Yarusso's instructions if the account application was to be "accepted." Following Yarusso's instructions, Baker indicated that he had \$20,000 in risk capital and an annual income between \$25,000 and \$50,000. None of this information was remotely accurate. Yarusso also urged Baker to send in a post-dated check for \$15,000, in hopes that Baker would be able to cover it before AFG cashed it.

6. On September 10, AFG received Baker's check for \$15,000. This check would bounce on September 19.

On or about September 11, Yarusso urged Baker to initiate a soybean spread and a crude oil spread. Baker credibly testified that he informed Yarusso that he did not understand Yarusso's explanation for these recommendations, and that in

response Yarusso assured him that his advice would reap Baker a \$40,000 profit within a week or two.

Following Yarusso's recommendation, Baker authorized 15 soybean option spreads and 10 crude oil spreads, which resulted in a total debit of about \$25,025, based on a debit of \$29,250 for total premiums paid for the long legs of the spreads; a debit of \$7,500 for total commissions paid; and a credit of \$11,500 for total premiums collected for the short legs of the spreads. Without the \$11,500 credit infusion from the short legs of the spreads, a \$15,000 investment would have paid for the purchase of 10 of the same soybean options in the long leg of the spread, which would have generated only \$1,500 in total commissions and a mere \$500 share for Yarusso: significantly less than the \$7,500 actually paid and the \$2,500 actually received by Yarusso.

The \$7,500 in commissions resulted in a commission-to-investment ratio of 50%,¹ a commission-to-premiums-collected ratio of 65%,² and a commission-to-net-premiums-paid ratio of about 42%.³

Yarusso testified that he recommended the spreads because they lowered the cost of buying in-the-money options for the long legs, and provided stability

¹ The commission-to-investment ratio relates to the adverse effect of commissions on potential profitability: the higher the ratio, the lower the potential profitability.

² The commission-to-premiums-collected ratio is based on the total premiums collected for the short legs of the spreads. This ratio relates to the adverse effect on commissions on the hedging capacity of the short leg: the higher the ratio, the lower the hedging capacity.

³ The commission-to-net-premiums-paid ratio relates to the adverse effect of commissions on profitability and indicates how much the spreads must appreciate before expiration to break even: the higher the ratio, the lower the likelihood of breaking even or making a profit. The adverse effect of a relatively high commission-to-net-premiums-paid ratio is exacerbated when coupled with a high commission-to-premiums-collected ratio, which is the case here.

against short-term volatility. However, Yarusso's explanation was unconvincing in light of the overall circumstances: one, Yarusso was compensated by a percentage of the commissions charged and collected a \$2,500 share of commissions from the 25 spreads, rather than a mere \$500 share had Baker just bought 10 of the in-the-money options; two, as found below, Yarusso and AFG failed to disclose fairly and accurately the amount of the commissions; three, Yarusso advised Baker to buy too many spreads, and when the three excess spreads had to be liquidated, Yarusso and AFG failed to assume the cost or the commissions on these excess spreads; four, the high commission ratios discussed above patently crippled the profit potential of the spreads, and the high commission-to-premiums- collected ratio shows that the high commissions substantially negated the capacity of the short legs of the spreads to cushion volatility; and five, after Yarusso advised Baker to liquidate the unleaded gasoline spread, he advised Baker to buy several far-out-of-the-money options less than a month before expiration.

7. In support of Yarusso's assertion that he and AFG adequately disclosed the commissions, Yarusso produced copies of compliance scripts relating to the authorization to initiate the spreads on September 11.⁴ However, Yarusso failed to establish that the scripts reliably reflected the actual conversations with Baker. The reliability of the scripts was further undermined by the fact neither Yarusso nor the

⁴ Yarusso also produced the script relating to the purchase of soybean options on September 23, but did not produce scripts relating to the liquidations on September 17 and 23, and October 3.

Baker that the account was "doing well" and that he was in a "hundred percent no-lose situation." Yarusso also guaranteed Baker that he would be doubling or tripling his money in a week. Baker then sent in two checks totaling \$25,000 which cleared.

9. On September 23, Yarusso advised Baker to buy seven more November soybean calls, and to fund this purchase by liquidating the remaining seven crude oil spreads. This liquidation of the seven crude oil spreads realized a net loss of \$3,710 on the liquidation, but infused \$3,950 back into the account. Baker credibly testified that Yarusso again did not disclose the loss on the trade.

Baker paid another \$2,625 in premiums, plus \$1,050 in commissions, for the purchase of the seven soybean calls, which had an October 19 expiration date. For this trade, the commission-to-premium-paid ratio was 40%.

10. Overall, Baker paid a total of \$8,550 in commissions, of which Yarusso received a share of about \$2,850. The \$8,550 in total commissions resulted in a 34% commission-to-investment ratio.

11. On October 3, after Baker had reviewed the September monthly account statement and determined that the actual account value did not match Yarusso's oral assurances, Baker instructed AFG to close the account. AFG then returned the account balance of \$365.61.

Discussion and Conclusions

The preponderance of the evidence supports Baker's claim that Yarusso fraudulently induced him open an options account in violation of Section 4c(b) of

scripts identified the AFG compliance employee who conducted the review, and the fact that the scripts did not state the date or time of the interview.

More significantly, even if the inherent unreliability of the scripts were overlooked, the scripts on their face tend to support Baker's assertion that neither AFG nor Yarusso fairly or accurately disclosed the commissions. The script indicates that Baker was told at most that he would be charged "\$150 per option" and "\$300 per spread," and that Baker was not clearly told the total commissions paid for the spreads. The script also indicates that Baker was not told how to calculate the breakeven point, and not told how the commissions adversely affected the likelihood of breaking even or making a profit.

8. AFG issued margin calls on September 11 and 17. On September 17, Yarusso told Baker that he had to liquidate three of the crude oil spreads to meet the margin call. Baker credibly testified that Yarusso neither advised him before the liquidation that he would lose money nor reported after the liquidation that he had lost \$1,170. Yarusso testified merely that he had "miscalculated" how many spreads Baker could purchase. However, Yarusso never acknowledged this error to Baker, and never offered to credit the account the \$1,170 amount of the loss or the \$900 in commissions for the three spreads. By this date, Baker still had not received any funds from the settlement of the law suit, and thus had not covered his \$15,000 check.

On September 19, Baker's check for \$15,000 bounced. Yarusso told Baker he had to get \$25,000 into the account as quickly as possible. Although the first trade had lost money and the open spreads were losing money, Yarusso assured

the Commodity Exchange Act and CFTC rule 33.10. Baker was convinced to contact American Futures Group by a commercial that touted short-term profits being made in a bullish soybean market. Soon after Baker responded to the commercial, he received a call from Yarusso, who discussed the commercial and then essentially guaranteed virtually risk-free profits following the strategy mentioned in the commercial by excitedly claiming that the market was jumping, that other clients were making big profits, and that Baker could double or triple his money in a week or two. Yarusso perpetuated this fraud by advising Baker to exaggerate his income and financial worth in the account application, by inducing Baker to invest four times more money than he had initially intended, by steering Baker away from a simple long strategy and recommending option spreads that generated substantially larger commissions for himself and AFG, by failing to disclose fairly and accurately the amount of the commissions, by failing to disclose the adverse effect of the large commissions on profitability, and by inducing Baker to continue trading by misrepresenting the status of the account. The deliberate nature of Yarusso's fraud is underscored by Yarusso's blatant disregard of Baker's desire to limit his investment, by Yarusso's recommendation that Baker begin trading before he had any money, by Yarusso's recommendation that Baker buy too many options, and by Yarusso's knowledge of Baker's patent lack of sophistication, inability to understand the basic matters such as the mechanics of trading options, and dire financial condition.

Baker's decision to invest what was for him a significant sum of money was consistent with his testimony that he relied on what he had learned from Yarusso:

that is, that he was likely to make quick and large profits with minimal accompanying risk. The fact that Baker acknowledged receipt of the written risk warning does not alter the conclusion that he relied on Yarusso's representations, where the overall effect of his oral representations outweighed and vitiated the written risk warnings. See, e.g., *Scheufler v. Stuart*, [1996-1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶27,171, at 45,577 (CFTC September 30, 1997); *Hannay v. FCCB*, [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,936 (CFTC 1987); *Dunn v. Murlas* [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,357 (CFTC 1986); and *O'Hey v. Drexel Burnham Lambert, Inc.*, [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,754 (CFTC 1985).

More importantly, Yarusso's minimalist disclosure of commission costs and of risk did not free him to make his unrestrained claims of profits made by other customers or his assurances that Baker was sure to double or triple his investment in a few days:

Because the size of a firm's commissions and fees affects the profit potential of an investment, it affects the kinds of representations that can be made about profitability. . . . All else being equal, customers of a firm with a high commission or fee structure will have a more difficult time making a profit than those who employ a less expensive firm. As a result, the firm charging higher commissions and fees is more limited in what it can claim regarding profit potential.

Johnson v. Fleck, [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶24,957, at 37,502 (CFTC 1990) (Gramm concurrence). Here, where the high commissions not only severely limited profit potential, but substantially undermined the viability of the spreads, Baker was not only constrained from making the sort of profit projections that he made, but also obligated to disclose that the high commissions

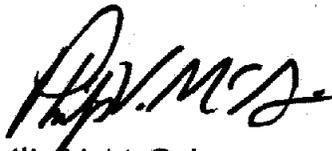
assured a low likelihood of profits. Yarusso made no such disclosure, which further aggravated his deceptive profit projections.

Similarly, AFG's scripted compliance review cannot be used as "advance exoneration" of respondents' fraud, especially where Yarusso failed to explain the material terms mentioned during the review and where neither Yarusso nor the AFG compliance representative fairly and accurately disclosed the total amount of the commissions or the adverse effect of the commissions on profitability. *JCC, Incorporated v. CFTC*, [1994-1996 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,492 (11th Cir. September 15, 1995).

ORDER

Baker has established that Gary Yarusso violated Section 4c(b) of the Commodity Exchange Act and CFTC rule 33.10, and that these violations proximately caused \$24,634.39 in damages. Accordingly, Gary Yarusso is ORDERED to pay to Donald Baker reparations of \$24,634.39, plus interest on that amount at 4.966% compounded annually from September 19, 1996, to the date of payment, plus \$125 in costs for the filing fee.

Dated July 23, 1999.


Philip V. McGuire,
Judgment Officer