

UNITED STATES OF AMERICA
before the
COMMODITY FUTURES TRADING COMMISSION

Chenli Chu

Complainant,

v.

**James Francis Kelly and
Peregrine Financial Group, Inc.,**

Respondents.

CFTC Docket No. 07-R029

INITIAL DECISION

Appearances:

On behalf of Complainant Chenli Chu

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Opinion of George H. Painter, Administrative Law Judge

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PROCEDURAL HISTORY

On March 21, 2007, Complainant Chenli Chu (“Chu”) filed a reparations complaint seeking to recover damages of \$500,000 from Respondents Peregrine Financial Group (“PFG”) and James Francis Kelly (“Kelly”) alleging various violations of the Commodity Exchange Act. Complainant alleges that PFG and Kelly fraudulently opened and maintained account K0058, executed unauthorized trades, and failed to supervise the account. Complainant further alleges that PFG is liable, under *respondeat superior*, for any fraud committed by Respondent Kelly. Respondents filed timely answers and denied any wrongdoing.

The hearing occurred on June 3-4, 2008 and December 2, 2008, in Los Angeles, California. The parties submitted post-hearing memoranda through March and April of 2009. The matter is now ready for decision.

FINDINGS OF FACT

The findings of fact set forth below are based upon reliable testimony and documentary evidence adduced at trial.

The Parties

1. Chenli Chu, a.k.a. Lisa Chu, (“Complainant” or “Chu”) is a 73-year old retiree, residing at 1249 South Diamond Bar Blvd., #139, Diamond Bar, CA 91765. Chu left Taiwan for the U.S. in 1990, and settled in California. *See* Notice and Order of September 25, 2008. Chu has only a limited ability to communicate in English and required the assistance of a translator to testify at the hearing.

2. Peregrine Financial Group, Inc. (“Respondent” or “PFG”) is a Futures Commission Merchant (“FCM”) located at 190 South LaSalle Street, Seventh Floor, Chicago, Illinois 60603. PFG is registered with the Commodity Futures Trading Commission (“CFTC”)

and the National Futures Association (“NFA”) as a non-clearing FCM and registrant (Answer at 1). During the time in question, PFG was the futures commission merchant behind Wintech Research, Inc. (“Wintech”), the commodity trading advisor that handled Chu’s account. Wintech is a registered Commodity Trading Advisor (“CTA”) located at 670 Monterey Pass, #100, Monterey Park, California 91754.¹ From April through October of 2003 Wintech was registered as a guaranteed introducing broker of PFG (Resp’t Ex. 48; Hr’g Tr. Vol. III, 63:5-8).²

3. James Francis Kelly (“Respondent” or “Kelly”) is and was at all relevant times an Associated Person (“AP”) sponsored by PFG (Answer at 1).

4. Jen Huang (“Huang”) was at all relevant times the president of Wintech (Resp’t Ex. 4).

Chu, Kelly, and PFG’s Initial Relationship

5. Chu’s first account with PFG was opened March 20, 2003 (Resp’t Ex. 4). The account was opened online and assigned account number LE-44295. *Id.* Chu reviewed and executed the requisite customer agreement and risk disclosure statements online. *Id.*

6. On April 15, 2003, a second account was opened under Chu’s name at PFG, account K0018. The account was opened with a generic “new account request form” that was provided by PFG and signed by Chu. The new account request form authorized PFG to use the forms previously executed for LE-44295 as the account forms for the K0018 account (Resp’t Ex. 9).

¹ NFA Online Registration System, available at <http://www.nfa.futures.org/eReg/search>

² Respondents assert that Chu was a referenced “owner” of Wintech Financial Services (“WFS”) (Resp’t Ex. 43, at 003218). WFS, for a very brief period, was a non-guaranteed introducing-broker. The entity operated for less than a year, from October, 2003 until September 2004. *Id.* Chu did not collaborate or affirm Respondents’ claim that she was an owner of WFS. Furthermore, WFS did not handle or control the accounts or transactions at issue. It is clear that Chu did not control Wintech Research, the CTA at controversy in this matter.

The relevant language of this form states:

I am requesting with this letter that you open an additional account for me. I hereby authorize you to use the account forms that I have already executed (for account _____) as the account forms for the new account.

I understand and agree that all promises, representations, and information that I made in my account forms are still true and accurate. I warrant that all statements in those forms shall apply to the new account as if I had executed a complete set of new forms.

I understand and agree that the commissions and fees for this new account are \$_____.

(Resp't Ex. 6, 9, 18, 20).

7. Three months after opening her first account with Respondents, Chu began to have problems with her accounts. In May of 2003, Chu and Kelly exchanged emails under the subject line "Notification of Problem" (Resp't Ex. 24). In an email dated May 30, 2003, Chu complained of orders being placed without her knowledge, stating "Jim, I need you attention for someone placing order without my knowledge or agreement [sic]." *Id.*

8. On June 14, 2004, Chu executed a Limited Power of Attorney agreement granting Huang discretionary trade authority. The agreement contained no reliable information as to what accounts this discretionary trade authority was applicable (Resp't Ex. 15, 16).³

9. On August 4, 2004, a third account, K0088, was opened in Chu's name. And again PFG's new account request form was used, authorizing the use of the forms executed for K0018 to open the new K0088 account (Resp't Ex. 15).⁴

10. Four months later, a fourth account was opened in Chu's name. On November 17, 2004, account K0098 was opened using a new account request form, this time authorizing the use of the forms executed for account K0088 (Resp't Ex. 20).

³ Respondents' submitted the same document titled "Discretionary Account Documents" for account K0088 and account K0098, with the account numbers written on the front sheet (*Resp't Ex. 15, 16*). However, neither of these accounts were open prior to the execution the Limited Power of Attorney form. *Id.*

⁴ The integrity of this document is questionable because Huang references account K0088 in an e-mail sent on September 22, 2003, almost a year before the account documents showed the account was opened (Resp't Ex. 13).

11. On December 21, 2004, a fifth account, F-3888, was opened in Chu's name. The new account request form for account F-3888 authorized the use of the forms executed for accounts K0098, K0088, and K0018 (Resp't Ex. 21).

A Prelude to Account K0058

12. In February of 2005, approximately a month before account K0058 was opened, Respondent Kelly and Chu exchanged emails regarding a busted trade (Resp't Ex. 24). In the email Chu complained about Huang's availability, claiming that her accounts were suffering due to Huang's placing priority on bringing large overseas accounts back to PFG (Resp't Ex. 24, at 1). Chu claimed, "She [Huang] is putting the oversea trips as priority over our accounts claiming that she need bring back large accounts to satisfy her moral obligation for PFG. I wish she never act as fund raiser because she is such a good trader [sic]." *Id.*

13. In early March of 2005, another series of emails took place between Chu and Kelly (Resp't Ex. 26). Chu initiated the correspondence, complaining about PFG's failure to notify her or Huang after a "busted trade" caused a loss in one of her accounts. She accused PFG of lying to her about attempting to contact Huang. *Id.* at 4. Kelly responded by assuring Chu that she was not lied to, and stated, "1. We do not lie to clients. 2. You enjoy an outstanding clearing rate. 3. You receive outstanding service from Jen as well as PFG because of Jen's relationship with PFG. 4. I have personally credited your account from my own pocket to keep your business as a goodwill gesture. 5. PFG assumes responsibility for all of its actions and goes above and beyond what a lot of other firms would do." *Id.* at 3.

14. In the same series of emails Chu referenced the \$500,000 that had been recently deposited into account F3888 (Resp't Ex. 26). In the email, Chu complained that she was not receiving any statements, nor could she access the trading platform for account F3888. *Id.*

15. Also, in that same series of March emails, Kelly requested that Chu submit a signed Power-of-Attorney letter stating which accounts that Huang could trade. *Id.* On March 3, 2005, Chu sent a fax at the request of Kelly's aforementioned email. The pertinent part stated:

"I am here granting a blanket trading authority for Jen Huang to trade/placing order to all my accounts with PFG which is including K0018, K0088, K0098, F3888 as well as any futures accounts that I might open. Thanks [sic]."

(Resp't Ex. 25).

Account K0058

16. Shortly before Chu opened K0058 account, Chu and Kelly had a discussion in which she expressed her desire to open an account that would generate interest (Hr'g Tr. Vol. III, 90-91, December 2, 2008). Kelly informed her that in order to generate interest she would have to move the money from her Forex account (F3888) into an existing non-Forex account, or open a new one. *Id.*

17. Chu also discussed this new account with Huang, and expressed that this new account was to be used for the purchase of a T-Bill in order to generate interest, and not for trading (Hr'g Tr. Vol. I, 25, June 3, 2008).

18. Following Kelly's advice, on March 18, 2005, Chu opened account K0058, transferring the \$500,000 from F3888 into the new account (Resp't Ex. 27). Account K0058 was the sixth and final account opened with PFG's new account request form, adopting the forms previously executed for account K0088. As with the earlier accounts, account K0058 was opened without the execution of a new PFG Risk Disclosure Statement or any type of discretionary account documents specific to account K0058. This new account was to be used to generate interest and meet the margin requirements of Chu's other accounts. *Id.* Neither Wintech

nor Huang had discretionary authority over account K0058 beyond the trades associated with the requested T-Bill (Hr’g Tr. Vol. I, 6, 25-26, 73,76 June 3, 2008).

19. At the bottom of the new account request letter used to open K0058, Chu wrote: “*Please move \$500k T-Bill to K0058 also link margin for k0018/88/98. Chen Chu [sic].” *Id.*

20. During the time in question neither Respondent Kelly nor PFG’s Compliance Department ever reviewed the K0058 new account request form. (Hr’g Tr. Vol. III, 91, December 2, 2008). The letter went directly to the new accounts department at PFG. *Id.*

21. Beginning in early March and continuing through May of 2005, Huang or one of her employees at Wintech began moving a substantial amount of Euro Currency contracts in and out of Chu’s accounts, including K0058(Resp’t Ex. 35; Resp’t Ex. 50-59).⁵ Several of these trades either originated from or ended up in accounts K0027 and K0059 (Resp’t Ex. 35). No evidence indicates that accounts K0027 or K0059 were Chu’s accounts or that Chu authorized these moves.

22. Within a week of account K0058’s opening Huang, or an agent of hers, placed forty (40) long June 2005 IMM Euro FX contracts ranging in price into the new account (Resp’t Ex. 35,53). However, the requested T-Bill was never executed. During the time in question PFG charged account K0058 a commission of only one dollar (\$1.00) per round turn trade (Hr’g Tr. vol. III, 76, December 2, 2008).

⁵ The questionable transactions that occurred over these three months are as follows: On March 7, Huang moved a “pair of currency” placed in account K0027 by “mistake,” into Chu’s K0098 account (Resp’t Ex. 35). On March 22, 2005, Huang called PFG requesting that twenty (20) Euro contracts from Chu’s K0088 account be moved to account K0058 (Complainant’s Ex. 2; Hr’g Tr. vol. III, 71-72, December 3, 2008). On April 8, Huang moved trades from K0059 into Chu’s K0058 account (Resp’t Ex. 35, 53). On April 25, Huang moved twenty buy orders from account K0098 into K0059, and moved sell orders into Chu’s K0088 account. On May 5, Huang again moved trades from Chu K0098 account into K0059. On May 19, Huang moved several trades from K0059 into Chu’s K0088 account. On May 23, Huang again moved several trades from K0059 into K0088. *Id.*

23. Between April 8, 2005 and April 20, 2005, several trades in account K0058 were executed and then inexplicably reversed and reinstated (Resp't Ex. 53).

24. Also during the life of K0058, there were several cash transfers in and out of K0058, presumably done by Huang. On April 25, 2005, \$30,000 was wired into K0058 (Resp't Ex. 53). On May 16, 2005, \$5,000 was wired from K0058 to K0018. *Id.* On May 31, 2005, \$30,000 was transferred from account K0088 to K0058, and \$100,000 was transferred from account K0098 to K0058. *Id.* On June 1, 2005, \$12.30 was transferred to K0018 from account K0058, and \$50,000 was transferred to K0058 from account K0098. *Id.* On June 2, 2005, effectively the last day of K0058, \$107,801.30 was transferred from account K0058 into K0088. *Id.*

25. On June 1, 2005, the amount of June 2005 IMM Euro FX contracts in account K0058 was increased from the original forty (40) to sixty (60) and then offset. *Id.* The liquidation of these trades resulted in a net futures loss of \$537,027.60 to account K0058. *Id.* In the span of only three months, Chu's account was totally depleted of her initial \$500,000 investment.

26. On June 2, 2005, the very day after K0058 was effectively ruined, Huang sent a suspicious email to Kelly requesting that account K0058 be closed, allegedly at Chu's instruction (Resp't Ex. 28). Her email further stated, "It is confirmed that Chen Chu is the only person who has trading power and has been trading on this account." *Id.* Huang's denial of placing any trades in the K0058 account is contradicted by the record and Respondent Kelly's testimony that identifies Huang as having placed trades in the account. (Hr'g Tr. vol. III, 71-72, December 2, 2008).

DISCUSSION

Complainant Chu alleges four actionable claims: (1) Respondents placed unauthorized transactions in account K0058; (2) Respondent PFG failed to diligently supervise account K0058; (3) Respondents defrauded her in the creation and subsequent trading of account K0058, which also encompasses Complainant's breach of agreement claim; and (4) Respondent PFG is liable, under *respondeat superior*, for fraud committed by Respondent James Kelly (Complainant's Post-Hr'g Br. 3, March 17, 2009). The court will address these claims below.

Unauthorized Trades

The evidence on record shows Respondents violated Regulation 166.2 by executing unauthorized trades in account K0058. 17 C.F.R. § 166.2 (2006); *Peltz v. SHB Commodities, Inc.*, 115 F.3d 1082 (2d Cir. 1997); *Sansom Refining Company v. Drexel Burnham Lambert, et al.* [1987-1990 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,796 (CFTC July, 20 1987). Regulation 166.2 prohibits transactions in a customer's commodity account unless (a) the customer has specifically authorized the transactions in advance, or (b) the customer has executed a written authorization (e.g., a "power of attorney") permitting a third party to trade in that account without specific authorization for each transaction. 17 C.F.R. § 166.2 (2006); *In re Mock*, [2000-2002 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 28,662 at 52,600 (CFTC Oct. 10, 2001).

If a third party has actual authority, that authority is clearly expressed in writing and Respondents would not be required to make an inquiry into the extent of a third party's authority. *Peltz v. SHB Commodities, Inc.*, 115 F.3d 1082, 1088 (2d Cir. 1997). However, if it's ambiguous as to whether written authorization applies to a particular account, it becomes necessary to determine whether the third party possessed, at minimum, apparent authority for that account.

Apparent authority is created when a customer's actions provide a reasonable basis for the Respondent to believe the third party had such authority. *Wheeler v. Investment Managers Commodity Corp.*, [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,770 at 31,220 (CFTC Oct. 30, 1984); *see also Sansom Refining Company*, (CCH) ¶ 23,796 (CFTC July, 20 1987). In cases of apparent authority, Respondents must make a reasonable inquiry into the nature and extent of a third party's authority before accepting trades from the third party. *Peltz v. SHB Commodities, Inc.*, 115 F.3d 1082, 1088 (2d Cir. 1997). In such a situation, a reasonable inquiry is the only defense against liability for accepting unauthorized trades; thus, regardless of the perception of actual or apparent authority, it is beneficial to make a reasonable inquiry. *Id.* at 1089. "[C]ourts need [to] determine if there was a reasonable inquiry only when the question is whether the designee had apparent, rather than actual authority." *Id.*

In addressing the matter at hand, it's clear that Huang had neither actual authority nor apparent authority to trade in account K0058.⁶ Respondents' assertion that Huang had trade authority relies on two documents: (a) the Power of Attorney forms executed ten months prior for an unspecified account, and (b) the four-line fax sent at the request of the Respondents granting Huang "blanket trading authority" over all her current and future accounts.⁷ However, several facts indicate that these documents did not apply to account K0058. First, neither document expressly references K0058. Second, both documents were executed prior to K0058's creation.⁸ Third, Chu had other accounts she used to trade. K0058 was opened for the specific purpose of generating interest, not for trading. Chu even testified, "The purpose that I set up the [K0058] account wasn't to make trades."⁹

⁶ Resp't Ex. 27; Hr'g Tr. Vol. I, 25, June 3, 2008; Hr'g Tr. Vol. III, 90-91, December 2, 2008

⁷ Resp't Ex. 15, 16, & 25

⁸ Resp't Ex. 27; Hr'g Tr. Vol. I, 25, June 3, 2008; Hr'g Tr. Vol. III, 90-91, December 2, 2008

⁹ Hr'g Tr. Vol. I, 73, December 2, 2008

Fourth, the account form used to open K0058 itself implies a limitation and different purpose for the account because of the written request found on it.¹⁰ Finally, Huang herself disclaimed having authority to trade, both in her testimony and in an email sent once the account was effectively ruined.¹¹ Though the court finds Huang's denial of trading in K0058 to be disingenuous, the facts support her assertion that she lacked discretionary authority over K058.¹² These facts, along with the ambiguity of the written authorization documents, indicate that Huang did not possess actual authority to place trades in K0058. *Peltz v. SHB Commodities, Inc.*, 115 F.3d 1082, at 1088 (2d Cir. 1997); *Sansom Refining Company v. Drexel Burnham Lambert, et al.* [1987-1990 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,796 (CFTC July, 20 1987); *In re Mock*, [2000-2002 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 28,662 at 52,600 (CFTC Oct. 10, 2001).

Nor do the facts demonstrate that Huang had apparent authority over K0058, because Respondents failed to conduct the "reasonable inquiry" required. *Peltz v. SHB Commodities, Inc.*, 115 F.3d 1082, at 1088 (2d Cir. 1997); *Sansom Refining Company v. Drexel Burnham Lambert, et al.* [1987-1990 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,796 (CFTC July, 20 1987). The circumstances surrounding K0058 required Respondents to make a "reasonable inquiry" into Huang's trade authority before allowing her to trade in that account. Allowing Huang to trade in K0058 was inconsistent with Chu's decision to open the account because she had other accounts set up exclusively to trade. *Id.* The trades were also inconsistent with Chu's expressed "conservative" investment objective to earn interest.¹³ Respondents were aware of both of these facts, since it was Kelly who recommended that Chu open K0058. Moreover,

¹⁰ Resp't Ex. 27

¹¹ Hr'g Tr. Vol. I, 25-26, June 3, 2008

¹² Huang's credibility was further eroded when it was brought to the attention of this court that Huang had attempted to "sell" allegedly damaging information about Chu to Respondents.

¹³ Resp't Ex. 27; Hr'g Tr. Vol. I, 25-26, June 3, 2008

Kelly's correspondences with Chu indicate that it would have taken minimal effort for Respondents to inquire about the scope of Huang's authority. *Sansom Refining Company v. Drexel Burnham Lambert, et al.* [1987-1990 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,796 (CFTC July, 20 1987)(finding an Associated Person unreasonably permitted trades knowing the trades ran counter to the account's goal, and that other accounts existed for trading); *Smith v. Murlas Commodities, Inc.*, [1987-1990 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,439 at 35,927 (CFTC Apr. 24, 1989) (Even in a discretionary account a customer can limit the scope of the broker's discretion to accommodate the customer's investment objectives).

Finally, the court will briefly address Respondents' absurd contention that Chu was a co-owner of Wintech, and thus Huang had shared control over all of Chu's accounts. There is some documentation indicating Chu's involvement with an entity called Wintech Financial Services (WFS)¹⁴. However, several facts demonstrate that Respondents' claim that Chu was a co-owner of Wintech Research is meritless. First, Wintech Research and WFS were separately registered entities.¹⁵ Moreover, WFS was registered for less than a year, and was no longer in operation when K0058 was opened.¹⁶ The accounts at issue were solely under Wintech Research, and its principal Huang, not WFS. Huang denied that Chu had any control over Wintech Research.¹⁷ There is no documentation indicating Chu as an owner of Wintech Research. There is also the parties' conduct contradicting this assertion, including Kelly's request that Chu submit a Power of Attorney for Huang, and Chu's complaints regarding Huang's service. Based on these facts it is clear that Chu was not a co-owner of Wintech Research, and thus Huang could not have had shared control over these accounts.

¹⁴ Resp't Ex. 40, 46, 47

¹⁵ Resp't Ex. 40-45

¹⁶ Resp't Ex. 45

¹⁷ Hr'g Tr. Vol. I, 48, June 3, 2008

Therefore, based upon findings set forth above, Respondents violated Regulation 166.2 by executing unauthorized trades in Account K0058. Huang possessed neither actual authority nor apparent authority since Respondents failed to conduct the reasonable inquiry required.

PFG's Failure to Supervise

The evidence on record demonstrates that PFG violated Regulation 166.3 by failing to diligently supervise Chu's account. 17 C.F.R. § 166.3 (2006).¹⁸ Under Regulation 166.3, a FCM has an affirmative duty to supervise their employees by establishing, implementing, and executing an adequate supervision structure and compliance programs. *In re MF Global Inc.*, [2007-2009 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 30,730 (Dec. 26, 2007). This duty does not apply to Respondent Kelly, because under Regulation 166.3 an associated person has "no supervisory duties." 17 C.F.R. § 166.3 (2006). In order to prove a violation of Regulation 166.3, the Complainant must demonstrate that either: (1) the registrant's supervisory system was generally inadequate; or (2) the registrant failed to perform its supervisory duties diligently. *In re Walsh Trading Inc.*, Comm. Fut. L. Rep. (CCH) ¶ 31,325 (CFTC March 11, 2009); *In re Murlas Commodities*, [1994-1996 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,485 at 43,161 (CFTC Sept. 1 1995); *In re Paragon Futures Assoc.*, [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 25,266 at 38,850 (CFTC Apr. 1, 1992).

PFG's violation of Regulation 166.3 is demonstrated by several facts, beginning with the convoluted set of "adopted" documents used to open and maintain account K0058. The daisy-chain of new account request forms used to open K0058 went back three years, involved six

¹⁸ Rule 166.3 states: "Each Commission registrant, except an associated person who has no supervisory duties, must diligently supervise the handling by its partners, officers, employees and agents of all commodity interest accounts carried, operated, advised or introduced by the registrant and all other activities of its partners, officers, employees and agents relating to its business as a Commission registrant." 17 C.F.R. § 166.3 (2006).

accounts, and was far from clear.¹⁹ The initial Power-of-Attorney form granting Huang discretionary authority failed to specify as to which accounts this authority applied. The only other documentation allegedly imputing Huang with Power of Attorney was the fax sent at the request of Respondent Kelly, and this was only four lines long.²⁰ PFG also did not adequately review the forms once they were filled out. This is demonstrated by their failure to inquire about the T-Bill request found on the K0058 new account form, as well as the testimony of PFG's own Director of Compliance.²¹ *See generally* Proposed Standards of Conduct for Commodity Trading Professionals for the Protection of Customers, 42 Fed. Reg. 44,742, reprinted in [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,474, at 21,941 (proposed Sept. 6, 1977) (proposed guidelines suggesting review of customer account-opening documents to find any restrictions on the account). Respondents also failed to produce any documentation reflecting the limitations and trading objectives Chu had expressed for K0058 in her discussions with Respondent Kelly, another fact highlighting the inadequacies of their supervisory system.²²

PFG's violation of 166.3 is further demonstrated by their failure to investigate the numerous questionable activities associated with K0058, and permitting unauthorized trades. *In re MF Global Inc.*, [2007-2009 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 30,730 (Dec. 26, 2007); *citing In re Thomas W. Collins*, ¶ 27,194 (if a supervisory system is in place, then the registrant must diligently administer it); *In re GNP*, [1990-1992] Comm. Fut. L. Rep. (CCH) ¶ 25,360 at 39,219 (Aug. 11, 1992), *aff'd sub nom., Monieson v. CFTC*, 996 F.2d 852 (7th Cir. 1993). Several incidents occurred that should have raised red flags for PFG. For example, Respondent Kelly was aware of a history of unauthorized transactions and "busted trades"

¹⁹ Resp't Ex. 2-4, 8-10, 15, 16, 18-27

²⁰ Resp't Ex. 24

²¹ Resp't Ex. 27; Hr'g Tr. Vol. III, 118-119

²² Hr'g Tr. Vol. III, 90-91, December 2, 2008, Hr'g Tr. Vol. I, 25, June 3, 2008

occurring in Chu's account.²³ Chu had also complained about not receiving statements and not having access to the trading platform.²⁴ PFG and Kelly were aware of the problems Chu was having with Huang, such as her unavailability and lack of responsiveness.²⁵ Then there are the trades that were inexplicably offset and reinstated back into K0058, over a month before the account's final liquidation.²⁶

The record also indicates Respondents allocated trades from other accounts not controlled by Chu, specifically accounts K0027 and K0059, to and from Chu's accounts.²⁷ These trade allocations clearly constituted questionable activity that should have been detected. This is also evidence of other possible violations by the Respondents. *In re Walsh Trading Inc.*, Comm. Fut. L. Rep. (CCH) ¶ 31,325 (CFTC March 11, 2009) (The lack of an adequate supervisory system can be established by showing that the registrant failed to develop proper procedures for the detection of wrong doing); *citing CFTC v. Trinity Fin. Group Inc.*, [1996-1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,179 at 45,635 *aff'd in relevant part, vacated in part and remanded sub nom. Sidoti v. CFTC*, 178 F.3d 1132 (11th Cir. 1999). Then there is the dubious email Huang sent to Kelly after the effective demise of Account K0058. In the email Huang disavows having any trade authority over account K0058, and asserts that Chu was the only one placing trades in the account.²⁸ Huang even testified as to not having trade authority over K0058.²⁹ However, according to Respondent Kelly it was Huang who placed the trades that

²³ Resp't Ex. 24

²⁴ Resp't Ex. 26

²⁵ *Id.*

²⁶ Resp't Ex. 53, 54

²⁷ Resp't Ex. 34

²⁸ Resp't Ex. 28;

²⁹ Hr'g Tr. Vol. I, 25-26, June 3, 2008

decimated account K0058.³⁰ *Id.* Despite this apparent and clear contradiction, no inquiry was ever made by the PFG.

Generally, violations that are isolated or inherently difficult to detect do not “give rise to any inference of supervisory failure.” *In re Paragon Futures Assoc.*, at 38,850. However, the violations and questionable activities associated with K0058 were neither isolated nor difficult to detect. Despite these numerous complaints and questionable acts, including the three months of unauthorized trading discussed above, PFG failed to institute any sort inquiry, review, or investigation into the handling of K0058 during its operation.³¹ *See In re MF Global Inc.*, [2007-2009 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 30,730 (Dec. 26, 2007); *In re Thomas W. Collins*, ¶ 27,194; *In re GNP*, [1990-1992] Comm. Fut. L. Rep. (CCH) ¶ 25,360 at 39,219 (Aug. 11, 1992). Furthermore, the Respondents’ previously discussed unauthorized trade violation constitutes independent proof of Respondents failure to supervise. *In re GNP*, at 38,850 (the existence of undetected violations is independent proof of a failure to supervise if the violations should have been detected).

Therefore, based on reasoning stated above, this court finds that PFG violated 166.3 by failing to diligently supervise Chu’s account.

Fraud

Finally, the evidence on record demonstrates Respondents defrauded Chu in the opening and maintaining of account K0058, violating Section 4b of the Commodity Exchange Act (“CEA”).³² 7 U.S.C. § 6b(a) (2006). Chu’s breach of agreement claim is also encompassed

³⁰ Resp’t Ex. 28; Tr. III, p. 71-72

³¹ Hr’g Tr. Vol. III, 106-121, Dec. 5, 2008

³² The relevant part of Section 4b states that it shall be unlawful for any person connected to the sale of a commodity contract to “willfully deceive or attempt to deceive such other person by any means whatsoever in regard to any such order or contract or the disposition or execution of any, or in regard to any act of agency performed with respect to such order or contract for such person.” CEA, 7 U.S.C. § 6b(a) (2006).

under this Section 4b violation. *See Tysdal v. Jack Carl/312 Futures, Inc.* [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 25,242 (CFTC Feb. 27, 2002).

To establish a Section 4b fraud violation of the CEA, a complainant must prove by a preponderance of the evidence: (1) a material misrepresentation or omission by the Respondent; (2) scienter; (3) reliance on the misrepresentation or omission by the complainant; and (4) damages that are proximately caused by the party's reliance on respondent's misrepresentation. *Hammond v. Smith Barney Harris Upham & Co.*, [1987-1990 Transfer Binder] Comm. Fut. L. Rep. (CCH) 24,617 (CFTC Mar. 1, 1990).³³ Whether these four elements have been met will be discussed below.

The record demonstrates Respondents failed to disclose material facts to Chu. A fact is material if "there is a substantial likelihood that a reasonable investor would consider the information important in making a decision to invest." *R & W Technical Services Ltd., v CFTC*, 205 F3d 165, at 169 (5th Cir. 2005); *citing TSC Indus. v. Northway, Inc.*, 426 U.S. 438, at 449 (1976); *CFTC v. Weinberg*, 287 F. Supp. 2d 1100, at 1105 (C.D. Cal. 2003). Respondents failed to inform Chu that the \$500,000 T-Bill she requested was not purchased. The request for the T-Bill was written on the new account request form Chu used to open account K0058, and was consistent with Chu's discussions with Respondents and Huang.³⁴ Respondents had a minimum obligation to inquire about the \$500,000 T-Bill request found on the new account Request form. However, Respondents failed to inquire about the request, and they failed to inform Chu that the requested T-Bill was not purchased. The Commission has stated that "when a customer makes known that he or she intends to rely on an commodity professional to perform special

³³ *See also Horn v. Ray E. Friedman and Company*, 776 F.2d 777 (CA8 Ark. 1985); *In re Slusser* [1998-1999 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,701 at 27,417 (CFTC July 19, 1999); *Omega Cotton Company v. Brown* [2005-2007 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 30,217 (CFTC April 7, 2006)

³⁴ Resp't Ex. 27; Hr'g Tr. Vol. III, 90-91, December 2, 2008; Hr'g Tr. Vol. I, 25-26, June 3, 2008

instructions, the professional must undertake the duty unless he or she disavow[s] that duty... in unequivocal language.” *Do v. Lind-Waldock & Company* [1994-1996 Transfer Binder] Comm. Fut. L. Rep. CCH ¶ 25,516, FN. 5 (CFTC Sept. 27, 1995), *citing* *Avis v. Shearson, Hayden Stone, Inc.*, [1980-1982 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,379 (CFTC Apr. 13, 1982). Clearly, a reasonable investor would want to know whether or not a requested order was executed, a material fact not disclosed by the Respondents. Respondents’ failure to purchase the requested T-Bill was a material fact, and one that they had a duty to disclose in “unequivocal language.” *Id.*

Respondents also failed to inform Chu that they were permitting Huang to place trades in account K0058.³⁵ Respondents engaged in fraudulent unauthorized trading because they executed trades in K0058 contrary to Chu’s instructions. *In re Mock*, [2000-2002 Transfer Binder] Com. Fut. L. Rep. (CCH) ¶ 28,662 at 52,599 (CFTC Oct. 10, 2001) (finding that an AP engaged in fraudulent unauthorized trading in violation of 4b when he willfully executed trades contrary to customers’ instructions); *citing In re Interstate Securities Corp.*, [1990-1992 Transfer Binder] Com. Fut. L. Rep. (CCH) ¶ 25,295 at 38,955 (CFTC June 1, 1992).

The next element, scienter, is established by showing that the Respondents’ acts were “committed intentionally or with reckless disregard for their duties under the Act.” *In the Matter of Slusser* [1998 1999 Transfer Binder] Comm. Fut. L. Rep. CCH ¶27,701 (CFTC July 19, 1999).³⁶ A respondent’s conduct is “reckless” when their actions depart “so far from the standards of ordinary care that it’s very difficult to believe that the [actor] was not aware of what he was doing.” *Do v. Lind-Waldock & Company* [1994-1996 Transfer Binder] Comm. Fut. L. Rep. CCH ¶ 25,516 (CFTC Sept. 27, 1995). Respondents’ failure to inquire about Chu’s T-Bill

³⁵ Resp’t Ex. 53; Hr’g Tr. Vol. I, 25-26, June 3, 2008; Hr’g Tr. Vol. III, 71-72, 90-91, December 2, 2008

³⁶ See also *Hammond v. Smith Barney, Harris Upham & Co. Inc.* [1990-1992 Transfer Binder] Comm. Fut. L. Rep. CCH ¶24,617 (CFTC Mar. 1, 1990); *CFTC v. Weiberg*, 287 F. Supp. 2d 1100, at 1105 (C.D. Cal. 2003)

request constitutes a reckless disregard for their duties under the CEA, especially considering the conversations between Chu and Kelly prior to the opening of K0058. While PFG was not required to execute the order, they were required to take reasonable steps to find out about Chu's request. *Do v. Lind-Waldock & Co.; Drexel Burnham Lamber v. CFTC*, 850 F.2d 842, 848 (D.C. Cir. 1988), citing *First Commodity Corp. of Boston v. CFTC*, 676 F.2d 1, 7 (1st Cir. 1982); *Mazoya v. Heinold Commodities, Inc.*, 871 F.2d 672, at 679 (7th Cir. 1989); *Hammond* at 36,659 n.21 (collecting cases interpreting "recklessness"). Furthermore, Respondents acted recklessly in failing to ascertain Huang's trade authority before permitting her to place trades that ran contrary to Chu's instructions. See *In re Interstate Securities Corp.*, [1990-1992 Transfer Binder] Com. Fut. L. Rep. (CCH) ¶ 25,295 at 38,955 (CFTC June 1, 1992); *In re Mock*, [2000-2002 Transfer Binder] Com. Fut. L. Rep. (CCH) ¶ 28,662 at 52,600 (CFTC Oct. 10, 2001).

Moving on to the third element, reliance, it's clear that Chu reasonably relied on the T-Bill request found on the new account request letter, as well as her conversations with Kelly and Huang, in believing that her T-Bill request would be executed and her account would be adequately maintained. Prior to opening account K0058, Chu had discussed with both Respondents Kelly and Huang that the purpose of the new account was not to trade, but to generate interest through the purchase of the requested T-Bill.³⁷ These discussions led to Chu's T-Bill request found on the new account request form.³⁸

Regarding the final element, damages, it is apparent that by June 2005, Chu's K0058 account had suffered a loss of well over \$500,000.³⁹ If Respondents had inquired about the requested T-Bill, or questioned the trade authority of Huang, Chu's account would not have suffered these losses. The court recognizes that account K0058 was linked to other accounts for

³⁷ Hr'g Tr. Vol. I, 25-26, June 3, 2009; Hr'g Tr. Vol. III, 90-91, December 2, 2008

³⁸ Resp't Ex. 27

³⁹ Am. Compl. Ex. H-4, June 25, 2007; Resp't Ex. 52, 53

margin purposes and that the Customer Agreement provided PFG the right to use any funds under their control to meet margin requirements.⁴⁰ However, the trades that ultimately ended up in K0058 went far beyond the expressed limited purposes of account K0058, and the T-Bill requested was never purchased. Therefore, Respondents' actions were the proximate cause of the damages Chu suffered.

Based upon the facts and reasoning stated above, it is evident that Respondents violated Section 4b of the Commodity Exchange Act in their handling of account K0058. Respondents recklessly failed to disclose the material fact that Chu's T-Bill request was never executed, and that they were permitting Huang to place trades that ran counter to Chu's expressed instructions for account K0058. These actions were resulted in the loss of Chu's \$500,000.

PFG's Liability for James Kelly

During the time in question, Kelly was employed as an associated person for PFG. Therefore, PFG is liable for the fraudulent conduct of Kelly, as an associated person and agent, pursuant to 7 U.S.C. § 2(a)(1)(B).

Conclusions of Law

Based upon the findings of fact set forth above, Complainant Chu has established by the preponderance of evidence that: (1) Respondents PFG and James Kelly violated Regulation 166.2 by executing unauthorized trades, 17 C.F.R. § 166.2 (2006); (2) Respondent PFG violated Regulation 166.3 by failing to diligently supervise account K0058, 17 C.F.R. § 166.3 (2006); and (3) Respondents PFG and James Kelly violated Section 4b of the CEA by recklessly failing to follow the express instructions regarding account K0058 and failing to disclose material facts from Complainant. 7 U.S.C. § 6b(a) (2006). These violations were the proximate cause of the damages suffered by Complainant, and resulted in an out-of-pocket loss of \$500,000.00.

⁴⁰ Resp't Ex. 27; Resp't Ex 4, at 8

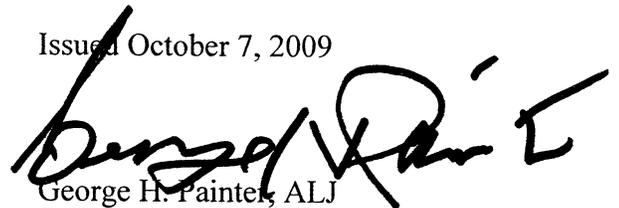
Furthermore, PFG is liable for the violations committed by its agent, Respondent James Kelly, committed in connection with his employment as an associated person for PFG, pursuant to 7 U.S.C. § 2(a)(1)(B) (2006).

ORDER

Respondents PFG and James Francis Kelly are hereby **ORDERED** to pay Complainant Chenli Chu her out-of-pocket losses totaling \$500,000.00 plus interest from the date of this judgment at a rate of 0.14% per annum. Respondents shall have 30 days to satisfy this award once the judgment becomes final. Respondents shall be jointly and severally liable for the payment of this judgment.

So ordered.

Issued October 7, 2009



George H. Painter, ALJ