UNITED STATES OF AMERICA Before the COMMODITY FUTURES TRADING COMMISSION

)			
C.I.M. INVEST	MENTS, CO., INC.				
Complainant)		CFTC DOCKET NO. 98-R034			
	v.))			
HAMMER TR	ADING, INC., LFG, LCC,	,))			
	ER, INC., MICHAEL S. O STEPHEN G. SCHULER))		TO AN	
	Respondents.))			REC C.F
))		R.M 1	EIVED
	INITIAL DEC	ISION	100 mm m	1 18	

Appearances:

On Behalf of Complainant C.I.M. Investments Co., Inc.:

Walter A. Bajak, Esq.

On Behalf of Respondents Hammer Trading Inc.,
LFG, LCC.,
Michael S. Walker and
Stephen G. Schuler:
Trade Center Inc.

Jane E. Lowdon, Esq.

Before: Painter, ALJ

PRELIMINARY STATEMENT

C.I.M. Investments Co. Inc. ("Complainant") commenced this action against Hammer Trading Inc. ("Hammer Trading"), L.F.G. LLC ("LFG"), Trade Center Inc. ("Trade Center"), Michael S. Walker ("Walker") and Stephen G. Schuler ("Schuler") (collectively "Respondents") in October of 1997, alleging a violation of Section 4b of the Commodity Exchange Act. Complainant claims that Respondents unlawfully transferred Complainant's assets into Respondent Schuler's account and withheld profits owed to Complainant. Respondents have filed an answer, received February 11, 1998, denying any wrongdoing and commencing a counterclaim against Complainant. Respondents' counterclaim is for payment of an alleged debit balance remaining in the Complainant's account.

This proceeding was dismissed without prejudice on April 23, 1998, owing to Complainant's failure either to satisfy the bond requirement for nonresident reparations complainants required under Rule 12.13(b)(4), 17 C.F.R. § 12.13(b)(4), or to show that it was exempt from said rule. Upon appeal by Complainant, the dismissal was vacated and the case was remanded for further proceedings by an Opinion and Order of the Commission dated February 12, 1999.

On November 10, 1999, the parties were notified by a Notice and Order of the possibility of a trading floor violation and the potential imposition of punitive and exemplary damages. In response, the Complainant has claimed it "is entitled to a recovery of \$197,000.00 from Respondent Schuler of which \$155,000 are punitive and exemplary damages and if said Respondent Schuler fails to make such payment, Respondent LFG, LLC is required to satisfy

¹ See C.I.M. Investments, Inc. v. Hammer Trading, Inc., [1998-1999 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,558 (CFTC Feb. 12, 1999).

this reward."2

The trial for this matter took place in Miami, Florida on August 11, 1999. All relevant issues have been tried with the express or implied consent of the parties and, pursuant to Reparations rule 12.307, are, therefore, treated by this Court as if they had been raised in the pleadings. Parties have filed post-hearing briefs and proposed findings of fact and conclusions of law. This matter is now ready for decision.

FINDINGS OF FACT

- 1. Complainant C.I.M. Investments, Inc. is located at 21 S.W. 14 Terrace, #2, Miami, Florida 33130.³ Carlos Menendez ("Menendez") is the director and fifty-percent shareowner of C.I.M. Investments Co. Inc..⁴ Menendez resides in Miami, Florida. The only business of Complainant is investing in commodities and this activity was carried out at all times by Menendez.⁵
- 2. Hammer Trading, Inc., is registered with this Commission as an introducing broker, and guaranteed by futures commission merchant LFG. Hammer Trading maintains an office at 30 South Wacker Drive, Suite 1310, Chicago, Illinois 60606.⁶ Although registered as an introducing broker, Schuler testified that he ran Hammer Trading as a "floor execution and

² Complainant's Response to Notice and Order of Nov. 10, 1999, pg 9.

³ See Affidavit of Carlos Menendez, Nov. 14, 1997.

⁴ See Hearing Transcript, Aug. 11, 1999, 7:7-8. All references to the Hearing Transcript ("Hearing Tr.") refer to the transcript of the August 11, 1999, hearing in Miami, Florida.

⁵ See Complaint, Oct. 1, 1997.

⁶ See National Futures Association Registration.

clearing business Specializing in the S&P 500 contract." It does not appear that Hammer Trading introduced customers to any futures commission merchant.

- 3. LFG, L.L.C. is registered with this Commission as a futures commission merchant, and maintains an office at 233 South Wacker Drive, Suite 2400, Chicago, Illinois 60606. LFG carried the complainant's account.
- 4. Stephen Gregory Schuler is registered with this Commission as a floor broker. Schuler resides at 529 Beloit, Forest Park, Illinois 60301.9
- 5. Trade Center, Inc. is registered with this Commission as an introducing broker, and it is located at 105 Crescent Bay Drive, #B, Laguna Beach, California 92651. Trade Center introduces customers to LFG.
- 6. Michael Steven Walker is registered with this Commission as an associated person of Trade Center, and he resides at 1 Centre Court, Dana Point, California 92629.¹¹
- 7. All of the Respondents were registered with the Commodity Futures Trading Commission during the relevant time period. 12
- 8. Menendez arranged to place his orders directly with Respondents Hammer Trading and Schuler; Schuler was at the time a broker on the floor of the Chicago Mercantile Exchange. 13

⁷ Hearing Tr. 148: 17-18.

⁸ See id.

⁹ See id.

¹⁰ See id.

¹¹ See Complaint, Oct. 1, 1997.

¹² All registrations were verified with the National Futures Association.

¹³ See Complaint, Oct. 1, 1997 at 1.

The trades were cleared by LFG, a futures commission merchant that guaranteed Hammer Trading at all relevant times. The introducing broker was Trade Center; the associated person employed by Trade Center working on Complainant's account was Michael Walker.¹⁴

- 9. On the morning of Friday, August 15, 1997, Complainant bought five August 1997 S&P put options. Subsequently, Complainant telephoned Respondent Schuler and placed a second order. Schuler then went onto the trading floor and purchased an additional five August 1997 S&P put options for Complainant's account. The telephone conversation initiated by Complainant, placing the disputed order with Schuler, was tape recorded, listened to by Schuler, and later recorded over by Hammer Trading. While this Court finds it unnecessary to make a factual finding as to the contents of the tape, this Court does draw a general negative inference from Respondent Hammer Trading's action of taping over and thereby destroying an accurate record of events.
- 10. At the end of the business day on Friday August 15, 1997, Complainant reported to Walker and Trade Center that it had bought and then sold five August S&P puts. 18
- 11. The ten August S&P put options in Complainant's account expired in the money at the end of trading on August 15, 1997, and were automatically exercised pursuant to Chicago Mercantile Rule 4102. The profitable options thereby became profitable futures contracts.

¹⁴ See id.

¹⁵ See Hearing Tr. 14: 4-6.

¹⁶ See Hearing Tr. 149: 23-24.

¹⁷ See Hearing Tr. 156: 13-25, 157: 1-13.

¹⁸ See Hearing Tr. 121: 25, 122:1.

- 12. On Monday morning August 18, 1997, Walker discovered Complainant's account was not flat, and that five August S&P puts had been added to Complainant's account. Walker then called Hammer Trading to ascertain what had transpired. Walker spoke with Schuler, telling Schuler that Complainant's account should have been flat, but instead had ten open S&P futures contracts.²⁰
- 13. Prior to communicating with Complainant, Schuler transferred Complainant's ten futures contracts from complainant's account with LFG into his own Hammer Trading account.²¹ Such a transfer could only have been achieved with the knowing participation of the futures commission merchant carrying the account, Respondent LFG.
- 14. The transfer of positions from Complainant's account to Respondent Hammer Trading's account did not shift the ownership interest from Complainant to Respondent Hammer Trading.
- 15. There is no indication on the record that the value of the positions increased after they were transferred but before they were liquidated. The positions appear to have been liquidated immediately after the transfer.
- 16. Respondent Schuler liquidated Complainant's ten August S&P futures on August 18, 1997, with the sole intention of appropriating the resulting funds. On the floor of the exchange, Schuler was able to liquidate his customer's positions by misrepresenting them as his own. The net profit of the sale was \$80,750.²² Respondent Schuler failed to inform Complainant of the total profit made on the sale of Complainant's positions.

¹⁹ See Answer at 3.

²⁰ See Hearing Tr. 122: 23-25, 123: 1-13.

²¹ See Hearing Tr. 150: 22-25, 151: 1-20.

²² See Respondents' Post Hearing Brief at 6 n.1.

- 17. Respondent Schuler failed to seek or receive Complainant's authorization prior to the transfer and liquidation of Complainant's positions. Respondent Schuler failed to call his customer after the liquidation and did not speak with Menendez until Menendez called him.²³
- 18. Respondent Schuler testified that he believed Complainant was entitled to \$40,000.²⁴ Respondent Schuler failed to offer Complainant \$40,000 and instead offered Complainant \$27,500.²⁵ Schuler misled Complainant, both by telling Menendez that C.I.M. was not entitled to any profits, and by later promising Complainant that he would "split" the profits.²⁶
- 19. Respondent Schuler made out an initial error report on August 19, 2000.²⁷ The error report was incoherent and could not be used by LFG personnel for the purpose of documenting an error.²⁸ One LFG employee called the error report "the worst error report that they could ever send over."²⁹ By not including the purchase or sale prices on the initial error report,³⁰ Schuler attempted to evade documenting the large profit made on the trades in order to facilitate the misappropriation of his customer's funds.

²³ See Hearing Tr. 24: 17-20.

²⁴ See Hearing Tr. 164: 15-16.

²⁵ See Hearing Tr. 164: 12-13.

²⁶ See Hearing Tr. 24: 21-23.

²⁷ See Hearing Tr. 165: 18-19.

²⁸ See Complainant's Exhibit D at 1-2, 9.

²⁹ *Id.* at 9.

³⁰ *Id.* at 10.

- 20. On August 26, 1997, Complainant's account was credited with \$27,500.00 from Hammer Trading.³¹ This transfer of funds was an attempt by Respondents to remit to Complainant a lesser amount than that owed to Complainant. John F. Bellom, company counsel for Respondent LFG, sent Complainant a letter dated September 15, 1997. The purpose of this letter was to provide Complainant an opportunity to accept the \$27,500 transfer as resolution of any dispute concerning the trades at issue. Additionally, the letter from LFG sought Complainant's agreement to pay Michael Walker \$7,500 for "discovering the error" in Complainant's account on the morning of Monday, August 18, 1997.³² Complainant never signed the letter, nor did it ever enter into a settlement of this dispute.
- 21. Complainant continued to trade with Respondents, resulting in a debit balance of \$35,386.19.³³ This debit balance is the result of authorized trades.
- 22. Respondents' use of the Chicago Mercantile Report,³⁴ dated February 2, 1990, as the justification for Schuler's and LFG's actions³⁵ is entirely incredible. This Court finds that Respondents introduced this Proposed Policy document as an afterthought and that Schuler did not base his decisions on his knowledge of this Proposed Policy but was instead motivated by his desire to appropriate his customer's profits.

³¹ See Respondents' Exhibit 2.

³² Complainant's Exhibit G.

³³ See Respondents' Exhibit 3.

³⁴ See Respondents' Exhibit 4.

³⁵ See Hearing Tr. 152: 3-25, 153: 1-12.

DISCUSSION

On the morning of August 15, 1997, Complainant C.I.M. placed an order with its floor broker, Schuler, to buy five August S&P put options.³⁶ Later on that same day Respondent Schuler placed an order to buy 5 additional August S&P put options. Respondents argue that Complainant intended to offset the existing S&P position by ordering Schuler to sell five August S&P put options.³⁷ This Court finds it unnecessary to make a factual determination as to what the Complainant ordered. The behavior of Respondents Schuler, Hammer Trading and LFG, with respect to Complainant's positions, violates the Commodity Exchange Act and therefore requires a determination in favor of Complainant under either factual theory.

On the morning of Monday, August 18, 1997, Complainant's account held ten profitable S&P futures contracts. Respondent Walker, the AP for Complainant C.I.M., diligently reviewed his client's account on that Monday morning and discovered what he believed to be an error in Complainant's account; the account was short the ten S&P futures contracts instead of being flat. At some time later that morning, Respondent Walker telephoned Respondent Schuler in order to ascertain the proper status of the account. Walker spoke with Schuler who said, "[h]e would look into it." Walker then called Complainant and spoke with Menendez, informing him of the discrepancy he had discovered. On the discrepancy he had discovered.

³⁶ See Complaint at 1.

³⁷ See Answer at 2.

³⁸ See Hearing Tr. 122: 9-13.

³⁹ Hearing Tr. 123: 13.

⁴⁰ See Hearing Tr. 124: 6-13.

After speaking with Walker, Respondent Schuler listened to a tape recording of the Friday. August 15th conversation between Menendez and Respondent Schuler during which Complainant placed its order. During the hearing in this matter Schuler stated, "at that point in time there was no talking to Mr. Menendez, I hadn't heard from him, so I on my own, you know, my own authority, I mean, I just went ahead and covered the position." Respondent Schuler transferred the ten positions at issue from C.I.M.'s LFG account into a Hammer Trading account that Schuler described as an error account.

Such a transfer was unnecessary since the positions in question were profitable. The risk of carrying the positions had already been born by Complainant over the weekend. The only purpose for transferring the positions, moments prior to their liquidation, was to capture profits from said positions in an account controlled by Respondents Hammer Trading and Schuler. Such a transfer could only have been accomplished with the knowledge and active participation of the futures commission merchant holding the account, Respondent LFG. After the transfer, Schuler liquidated the positions for a total gross profit of \$80,750.⁴⁴ At no time did Schuler seek authorization from his client, the Complainant, prior to either transferring or liquidating his client's positions.

Approximately one to two hours after their earlier conversation, Respondent Walker called Menendez back to inform him that C.I.M. was not entitled to any of the profit from the

⁴¹ See Hearing Tr. 150: 18-19.

⁴² Hearing Tr. 150: 22-25, 151: 1.

⁴³ See Hearing Tr. 151: 9-14.

⁴⁴ See Respondents' Post Hearing Brief at 6 n.1.

trades. 45 Menendez then called Respondent Schuler, who then told Menendez that he did not "deserve anything" but that he, Schuler, would "split the profits" anyway. 46 During this conversation, Menendez also asked to hear the tape recording of the conversation on Friday when he placed the order in dispute. 47 Complainant was never given a copy of the tape recording, nor was Menendez given a chance to listen to the tape. 48 Hammer Trading subsequently taped over and thereby destroyed the recorded conversation.

Complainant was never offered, nor informed of, the full profits from the liquidation.

Respondent Schuler failed not only to offer Complainant the full profits; he failed to offer the amount of profits to which he claimed Complainant was actually entitled. When Counsel for Complainant questioned Respondent Schuler about possible profits to which Complainant was entitled and what Complainant was offered, the following exchange ensued:

- Q. Did you offer him the \$40,000?
- A. No. I offered him 27-5.
- Q. But he was entitled to 40,000?
- A. Under the rules he was entitled to 40,000, but you have the right to ask, the windfall was because I made a mistake and under the rules I have a right to ask him to negotiate how the settlement goes out, and that's what I did. I asked him if I could have some of that profit since it was my mistake, and he was excited as hell to get 27-5, he said fine.
- Q. As opposed to 40,000? Did you tell him . . . that he was entitled to 40,000?
- A. I don't recall exactly how that fell out.⁴⁹

⁴⁵ See Hearing Tr. 24: 11-16.

⁴⁶ Hearing Tr. 24: 21-23.

⁴⁷ See Hearing Tr. 24: 24-25.

⁴⁸ See Hearing Tr. 25: 16-18.

⁴⁹ See Hearing Tr. 164: 12-25, 165: 1-3.

It was clear from the substance of his responses, and by the demeanor of Respondent Schuler during this exchange at the hearing, that he was attempting to hide his failure to offer Complainant the \$40,000 to which Respondent Schuler believed Complainant was entitled. Complainant was never informed by its broker, Schuler, of the \$80,750 profit made on the liquidation of its positions. By telling Menendez he would "split" the profits and then offering \$27,500, Schuler led Menendez to believe that the profits were approximately \$55,000. Respondent Schuler never informed Complainant that \$53,250 profit would remain if \$27,500 were paid to Complainant. Respondent Schuler intended to keep most, if not all, of the remaining profits and thereby misappropriate his customer's assets.

On August 19, 1997, Respondent Schuler generated an error report ostensibly to document the liquidation of his client's positions. However, the original error report failed to include any of the following: the sales price of the positions at issue, the reason for their transfer, the proper months of the position, or a generally coherent accounting of what had transpired. Given Schuler's failure to inform his customer of the profits generated by the sale of the positions, as well as Schuler's clear intention to keep those profits, this Court has determined that the obfuscation of the original error report is further evidence of an attempt to misappropriate customer funds.

Complainant's account was eventually credited with \$27,500 on August 26, 1997. On September 15, 1997, Respondent LFG sent Complainant a letter that was in effect an attempted settlement agreement.⁵² The letter asked that Menendez countersign the bottom evidencing his

⁵⁰ See Hearing Tr. 165: 18-19.

⁵¹ See Complainant's Exhibit D at 1-2, 9.

⁵² See Complainant's Exhibit G.

agreement to accept the \$27,500 in resolution of any dispute and further authorizing payment of \$7,500 to Michael Walker for his discovery of the alleged mistake in Complainant's account. Although the letter incorrectly understated the profit of the sale of the positions as \$75,000, this large amount was the first indication to Menendez that the profits from the liquidation of the positions were significantly greater than he had first been led to believe. Angered by this, Menendez stopped payment on a check intended to cover a growing margin deficit in Complainant C.I.M.'s account, ultimately resulting in a debit balance of \$35,386.19.⁵⁴

The actions of Respondents Hammer Trading, LFG, and Schuler violate Section 4b of the Commodity Exchange Act ("the Act") and Commission Regulation § 166.2. Although the Complainant has only alleged a violation of Section 4b, several of the statutory provisions intended to protect customer property have also been contravened. Section 4d(2) of the Act, 7 U.S.C. § 6d(2), requires that all funds and property received by a futures commission merchant from a customer be treated as belonging to that customer. Commission Regulation § 1.21 entitled *Care of money and equities accruing to customer*, imposes a similar obligation. On the morning of Monday August 18, 1997, Respondent LFG transferred the property of its customer, Complainant C.I.M., into the account of Respondent Hammer at the behest of Respondent Schuler. Respondent LFG treated the property of its customer as if it were the property of Respondents Schuler and Hammer Trading, thereby violating the Act.

⁵³ *Id*.

⁵⁴ See Respondents' Exhibit 3.

Respondents contend that the transfer was appropriate because the positions were the result of an error. St. While this argument will be addressed in greater detail below, the factual record of the Respondents' behavior belies such an innocuous justification. Respondent Schuler never tried to call his customer prior to transferring positions from the customer's account into an account controlled by Hammer Trading. He failed to explain to his customer the justification for such a transfer prior to liquidation of the positions. Schuler never gave his customer a chance to decide what the resolution of the alleged error should be until after the positions had been liquidated. Schuler's transfer of the positions was accomplished with the acquiescence and complicity of the futures clearing merchant LFG, thereby circumventing the required authorization of the owner of the positions. Even if an argument could be made for the transfer of the five additional positions added to Complainant's account by mistake, no justification could be made for transferring the five original positions held by Complainant when the profits from the sale of those positions were not disbursed to Complainant.

The mere transfer, and change in account numbers of the positions in question, does not change Complainant's ownership interest in the positions.⁵⁷ Since Respondent Schuler was not the true owner of the positions in question, he was forced to utilize deceit in order to liquidate his

⁵⁵ See Answer.

⁵⁶ See Hearing Tr. 150: 22-25, 151: 1.

⁵⁷ See Hunter v. Madda Trading Co., [1980-1982 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,242 at 25,204 (Sept. 2, 1981). In the following excerpt the Commission made clear the continuing ownership interest of customer properties held by a futures commission merchant. Section 4d(2) recognizes that the ownership of customer funds on deposit with a futures commission merchant continues with the customer and mandates the integrity of segregated customer funds must be maintained. The language of the statute and its legislative history indicate that Section 4d was designed for the broad purpose of protecting customers from having their money, securities or property appropriated by a

customer's positions and misappropriate the proceeds from said liquidation. Respondent Schuler went onto the floor of the Chicago Mercantile Exchange and liquidated his client's positions by representing them as his own. Respondent Schuler thereby committed fraud on the floor of an exchange. Such fraud is strictly prohibited and is a violation of the Act. Section 4b(a)(iii) makes it unlawful for any member of a contract market "willfully to 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 such order or contract, or in regard to any act of agency performed with respect to such order or contract for such person". Respondent Schuler further compounded his violation by failing to disclose the total profits from the liquidation of the customer positions and by leading his customer to believe that the liquidation was less profitable than in actuality it was.

After realizing a net profit of \$80,750 on the trade,⁵⁹ Respondent Schuler told Menendez that he did not "deserve anything," but that he, Schuler, would "split" the profits anyway.⁶⁰ Although Respondent Schuler admitted during his testimony that he believed Complainant was entitled to \$40,000, he only offered Complainant \$27,500.⁶¹ Section 4b of the Act (7 U.S.C. § 6b) makes it unlawful "to cheat or defraud or attempt to cheat or defraud such other person" or "willfully to make or cause to be made to such other person any false report or statement thereof, or willfully to enter or cause to be entered for such other person any false record thereof [.]"

futures commission merchant, or some other depository, without adequate legal basis . . . (footnotes omitted).

⁵⁸ 7 U.S.C. § 6b(a)(iii) (1994) (emphasis added).

⁵⁹ See Respondents' Post Hearing Brief at 6 n.1.

⁶⁰ Hearing Tr. 24: 21-23.

⁶¹ See Hearing Tr. 164: 12-13.

Respondents Schuler, Hammer Trading and LFG cheated their customer by not remitting to it the full profits from the liquidation of its positions. In addition, Respondent Schuler willfully made false statements to Complainant by telling his customer it was not entitled to any profits, and by hiding the true profitability of the liquidation. The failure to disclose the profitability of the sale is a further violation of Section 4b as it advanced the scheme of defrauding the customer.

Respondents have argued that their behavior was appropriate because the positions at issue were the result of an error. They allege that Respondent Schuler accidentally doubled his customer's positions instead of liquidating the positions as ordered. Respondents argued at trial that they followed the rules of the Chicago Mercantile Exchange in properly resolving this error. ⁶² In support of this position they introduced a Chicago Mercantile Exchange Special Executive Report ("Executive Report") dated, February 2, 1990, entitled *CME OUT-TRADE AND ERROR RESOLUTION POLICY*. ⁶³ Reliance on this document as justification for Respondents' behavior is misplaced.

As a preliminary matter, the Executive Report focuses on resolving errors that are the result of out-trades. The definition of an out-trade follows below.

Out Trade: A trade which cannot be cleared by a clearinghouse because the trade data submitted by the two clearing members involved in the trade differs in some respect (e.g., price and/or quantity). In such cases, the two clearing members or brokers involved must reconcile the discrepancy, if possible, and resubmit the trade for clearing. If an agreement cannot be reached by the two clearing members or brokers involved, the dispute would be settled by an appropriate exchange committee. ⁶⁴

⁶² See Hearing Tr. 152: 19-25, 153: 1-12.

⁶³ See Respondents' Exhibit 4.

⁶⁴ See Commodity Futures Trading Commission Glossary at 30.

The possible error in the case at bar could not be defined as an out-trade because the trade was executed properly on the floor of the exchange. Although the Executive Report does address instances when "a floor broker errs in the filling of a customer order and has bought instead of sold or vice versa," such an occurrence is also not present. In the matter at bar, there is no trading floor related error in the *filling* of the customer order. If there was an error in this matter, it was an error in the *recording* of the customer order during the telephone conversation with the customer. The fact that the individual taking the order, Respondent Schuler, happens to be a floor broker is incidental to the proper understanding of the possible mistake. The potential error at issue would most accurately be characterized as a unilateral error, by a broker, while recording a customer order.

This Court finds Respondents' purported reliance on the Executive Report to be disingenuous. Respondents failed to even mention their reliance on this CME "rule" in Respondents' Answer in this matter. Introduction of the Executive Report at trial as an exhibit, instead of making reference to it in an earlier pleading, suggests that Respondents discovered this rather obscure document only after they drafted their answer. One can look to Respondents' actions prior to the initiation of this proceeding to discern their true state of mind and understanding. After Respondents were in physical control of the funds at issue, they sought Complainant's authorization for a payment of \$7500 to Walker. Respondents now claim to have had a good faith belief in their ownership interest. It is impossible for Respondents to argue that they believed they had the proper authority to keep the profits from Complainant, but could not disburse those funds without Complainant's authority.

⁶⁵ Respondents' Exhibit 4 at 4.

⁶⁶ See Complainant's Exhibit G.

Had Respondents Schuler, Hammer Trading or LFG tried to call their client prior to transferring or liquidating Complainant's positions, this Court would be less skeptical of Respondents' after-the-fact justifications. Had the tape recording of the original order being placed not been destroyed, or if Schuler had generated a usable original error report, Respondents would be in a much better position to argue their innocence. Given Respondents' general pattern of behavior in relation to this matter, the introduction of the Executive Report is most likely an afterthought intended to justify the wrongful conduct.

This Court would be more receptive to Respondents' justifications if they were based on the published Rules of the pertinent exchange or of the Commodity Futures Trading Commission. Although the Rules of the Chicago Mercantile Exchange ("CME") give guidance in the resolution of a dispute related to an out-trade, ⁶⁷ the CME Rules are silent on the type of error which is alleged to be present in the instant matter. Further guidelines for the resolution of trading floor errors can be found in the Commodity Futures Trading Commission interpretative statement on Trading Errors, Unmatched Trades, and Outtrades dated September 6, 1989.⁶⁸ The following is an excerpt from said statement:

When a broker or clearing firm makes an error in connection with a customer's order, the position reflecting the error may be placed in an error account. Any loss as a result of the error generally must be made up to the customer through a cash payment from the broker or clearing firm. In addition, a broker or clearing firm must provide certain profits made from the corrected trade to the customer, unless the customer agrees to other arrangements. ⁶⁹

⁶⁷ See Chicago Mercantile Rulebook (2000) (Chapter 5 floor privileges – Trading Qualifications and Practices, § 527 entitled *OUT-TRADE RESOLUTION POLICY*).

⁶⁸ 54 Fed. Reg. 37,004. (1989).

⁶⁹ *Id.* at 3.

Neither precise nor exhaustive, the above passage gives little guidance either to Respondents or this Court. The relevant portions of the statement allow for the transfer of positions into an error account and for the payment of "certain profits" to the customer in the event of a profitable trading floor error. The rules are silent as to an error in recording the order of a customer. One can be certain however, that the Commission does not sanction the taking of profits from a customer without the customer's knowledge and agreement.

Respondents have proposed that they are entitled to the majority of the profits derived from this error because Complainant agreed to the payment of \$27,500 and, as a matter of equity, they would have been obligated to cover any resulting losses. Respondents have argued that case precedent supports allowing a floor broker to keep profits which are the result of error as it is the equitable counterpart to forcing brokers to cover losses resulting from errors. Respondents cite Rogillio v. Merrill Lynch, [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) \$22,249 (Court of Appeals of Louisiana, 4th Cir., March 14, 1984), and Gaw v. First Commercial Financial Group, Inc., et. al., [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) \$25,324 (CFTC June 26, 1992), as supporting a broker's equitable right to retain profits in the instance of an error. As Rogillio was largely decided under Louisiana's Civil Code, this Court does not find it to be a dispositive authority. Furthermore, there are pertinent factual distinctions between Rogillio and the case at hand.

In <u>Rogillio</u> the customer wanted to liquidate his position but the customer and broker "both erroneously used the word 'sell' (rather than 'buy') when they referred to the

⁷⁰ See Respondents' Answer and Post Hearing Brief.

⁷¹ Respondents' Post Hearing Brief at 14.

⁷² *Id*.

transaction."⁷³ Such an error is a *mutual customer and broker* mistake, resulting in the doubling of a customer position, not a *unilateral* mistake by the broker, as would be the case at hand. Nonetheless, the court in <u>Rogillio</u> found that the Commodity Exchange Act was not violated, and the correction of the error was not unauthorized trading, because the profits from the original customer positions were "immediately placed in [the customer's] account."⁷⁴ If the analysis of <u>Rogillio</u> were to be embraced by this Court, Respondent Schuler's failure to immediately credit Complainant's account with half of the profits from the liquidation would be sufficient grounds to find a violation of the Commodity Exchange Act. Furthermore, Respondents Schuler and Hammer Trading's claim to ownership interest in the positions at issue is far more tenuous than that of the broker in Rogillio because any error in the case at hand was Schuler's error alone.

Respondents' use of the <u>Gaw</u> decision, in support of an equitable argument for a broker to keep the profits in the event of a mistake in recording a customer order, is misplaced because <u>Gaw</u> neither raised nor addressed such an argument. In <u>Gaw</u> the broker mistakenly informed his customer that the customer account had a position in a commodity. In response, the customer purchased positions to offset the fictional positions in his account. The error was discovered by the broker, who then called the customer to inform him that the positions had been transferred out of the customer's account, and into the broker's error account where they were offset at a loss. This Court found that the customer later attempted to position himself into a "no lose"

⁷³ Rogillio v. Merrill Lynch, [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,249, 29,290 (Court of Appeals of Louisiana, 4th Cir., March 14, 1984).

⁷⁴ *Id.* at 29,291.

⁷⁵ See Gaw v. First Commercial Financial Group, Inc., [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 25,324 (CFTC June 26, 1992).

situation by disowning the positions when they were unprofitable and attempting to reclaim the positions when they became profitable.

The most detailed commentary by the Commodity Futures Trading Commission on a situation analogous to the one at bar can be found in Shashaani v. Merrill Lynch, Pierce, Fenner & Smith, Inc., [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH), ¶ 22,629 (CFTC June 19, 1985). In Shashaani, Respondents were found to have made unauthorized trades in Complainant's account. When considering the allocation of profits from said unauthorized trades the Commission stated the following:

Allowing complainant to retain profits resulting from the wrongful use of her funds is not only consistent with legal precedent, but also reflects sound policy. To attribute the profit directly or indirectly to the futures commission merchant would be to reward it for wrongful conduct, and encourage such conduct by holding the futures commission merchant blameless as long as the net result of its unauthorized conduct is profitable. Second, if the futures commission merchant wishes to receive profits from trades that are alleged to be unauthorized, it may remove the positions from complainant's account when it is first notified that the position is unauthorized. Once a futures commission merchant takes a position—and with it the attendant risk of loss—it may rightfully claim any profit that accrues from its unauthorized acts. ⁷⁶

Although the above passage was written to address the allocation of damage awards, the Commission in Shashaani makes clear that a futures commission merchant may only retain the profits from unauthorized positions accruing after the positions have been moved into an error account. Respondents in the case at hand would only be entitled to those profits accruing after the positions in question were moved on Monday August 18, 1997. Respondents have failed to assert that the positions appreciated in value after the transfer. Furthermore, there is no indication on the record that the value of the positions increased after they were transferred as they were immediately liquidated.

⁷⁶ Shashaani v. Merrill Lynch, Pierce, Fenner & Smith, Inc., [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH), ¶ 22,629, 30,687 (CFTC June 19, 1985).

Respondents' general contention that equitable principles support Respondents' actions fails when analyzed in the context of the role of brokers and other registered individuals. The broker is compensated through commissions to perform the duty of properly recording and then placing his customer's orders. The failure to properly record a customer's orders is a failure by the broker (unlike floor related errors such as out-trades which may not be the result of a broker's error). Despite such a failure the broker charges commissions and, as in the matter at bar, is still compensated. No equitable redress is necessary because the broker is always compensated regardless of the outcome of the trade. Failure to properly record a customer order may result in an error that the broker must cover. This is, to borrow a colloquialism, the price of doing business. This Court will weigh any equitable entitlement of a broker against what the Seventh Circuit of the United States Court of Appeals characterizes as, "the need to insure the highest fiduciary standards for persons registered under the [Commodity Exchange] Act." Respondents have failed to live up to the expected standards and are certainly not entitled to equitable redress.

Respondents have also raised the affirmative defense of accord and satisfaction.⁷⁸

Accord and satisfaction is a contractual settlement of a dispute where both parties agree to a definite offer of settlement and acceptance of the offer according to agreed upon terms.⁷⁹ Accord and satisfaction requires the following: a mutually recognized dispute, the existence of a contract constituting the accord, acceptance of the terms of the contract by Complainant, and performance

⁷⁷ Silverman v. CFTC., [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH), ¶ 20,487, 21,980 (7th Cir. Sept. 19, 1977).

⁷⁸ See Answer at 8.

⁷⁹ See generally 1 Am. Jur. 2d, Accord and Satisfaction § 5 (1999).

as satisfaction of that accord. As a contract, accord and satisfaction is defeated by the presence of fraud, duress or mutual mistake.

Respondents have failed to show an accord agreed to by Complainant. The only evidence of such an agreement is the letter dated September 15, 1997, which was intended by Respondents as an opportunity for Complainant to agree to the payment of \$27.500.80 Complainant never signed this letter and has never agreed to its terms. Respondents contend that the \$27,500 payment to Complainant fulfilled the purported agreement with Complainant, and that Complainant's acceptance and use of these monies constitutes acceptance of Respondents' performance in satisfaction of the purported accord. 81 As there is no evidence of an accord, this Court does not construe the use of the \$27,500 payment as acceptance of Respondents' performance. Any accord would have been the result of duress, as Menendez was pressured by Respondents Walker and Schuler, respectively, when they told Menendez he would "get nothing from the trades" and that he did not "deserve anything". 82 Furthermore, by failing to inform Complainant of the extent of the profits from the sale of the positions, Respondents would have fraudulently induced any ensuing agreement. Respondents have failed to meet the burden requisite for proving the affirmative defense of accord and satisfaction. If Respondents had succeeded in showing the existence of an accord and its satisfaction, the contract would be nullified by the presence of both fraud and duress.

⁸⁰ See Complainant's Exhibit G. It should be noted that the letter understates the profits as "approximately \$75,000." The material misstatement of the profits by approximately \$5,750 would be sufficient to nullify this agreement even if Complainant had entered into it.

⁸¹ See Answer at 8-9.

⁸² Hearing Tr. 24: 15-22.

Respondents have filed a counterclaim based on a debit balance left in Complainant's account. The presence of an ongoing dispute, discussed above, does not mitigate the Complainant's obligation to cover the margins and losses on trades it properly authorized. The debit balance remaining is the result of authorized trades. Accordingly, Complainant owes Respondents the remaining debit balance of \$35,386.19.

CONCLUSIONS OF LAW

In contravention of Section 4b of the Commodity Exchange Act, 7 U.S.C. § 6b, Respondent Schuler fraudulently withheld profits owed to his customer, Complainant C.I.M.. Respondent Schuler violated Section 4b by failing to inform his customer of the true extent of profits from the liquidation of that customer's positions and by telling the customer that he was not entitled to any profits. Section 14(a)(1)(B) of the Commodity Exchange Act allows for the award of punitive and exemplary damages of no more than twice the amount of actual damages, "in the case of any action arising from a willful and intentional violation in the execution of an order on the floor of a contract market [.]" Respondent Schuler willfully and intentionally misrepresented his customer's positions as the positions of Hammer Trading while executing orders on the floor of an exchange.

Respondent LFG, the futures commission merchant for whom Schuler performed floor execution trades, willfully aided and abetted in Schuler's misrepresentations, both on the floor of the exchange and to Complainant, by transferring funds rightfully belonging to a customer into an account controlled by Schuler and Hammer Trading. Pursuant to Section 13(a) of the Act, LFG is responsible as a principal for the above mentioned violations. Respondent LFG also violated Section 4b by failing to inform their customer of the profits owed to it. Finally,

^{83 7} U.S.C. § 18(a)(1)(B) (1994).

Respondent LFG committed fraud in violation of Section 4b by withholding profits owed to its customer Complainant.

Respondent Hammer Trading violated Section 4b of the Act, 7 U.S.C. § 6b, both by fraudulently withholding profits owed to their customer, Complainant, and by failing to inform its customer of the full extent of profits made on the sale of his positions. Acting through its agent, Respondent Schuler, Hammer Trading willfully and intentionally misrepresented its customer's positions as its own, while executing orders on the floor of an exchange.

Respondents Schuler, LFG and Hammer Trading share equally in all of the above mentioned violations, including a willful and intentional violation on the floor of an exchange.

Accordingly, punitive and exemplary damages will be assessed as to all.

Complainant has failed to prove by a preponderance of the evidence that it sustained monetary damages by the acts of Respondents Walker and Trade Center.

As there is no indication that the positions in question appreciated in value after the transfer to an alleged error account, Complainant has a right to the full \$80,500 profit resulting from their sale.

Respondent LFG is owed the remaining debit balance of \$35,386.19.

DAMAGES

Complainant is entitled to the full profits from the sale of his positions, \$80,750, less \$27,500 that has already been remitted to Complainant, resulting in \$53,000 in actual damages. The application of punitive and exemplary damages under Section 14(a)(1)(B) establishes that the final award be "no more than two times the amount of such actual damages." The \$53,000 in actual damages is therefore doubled to \$106,000. Finally, the remaining debit balance of

\$35,386.19 owed to Respondent LFG shall be deducted from this award. The final damage award is \$70,613.81.

ORDER

Complainant has failed to establish by the weight of the evidence that Trade Center and Walker violated the Act. Accordingly, the complaint against Trade Center and Walker is dismissed.

Complainant has established by the weight of the evidence that it sustained monetary damages by reason of Respondents' violations of the Commodity Exchange Act. In accordance with the rules and regulations of the Act, Respondents Schuler, Hammer Trading, and LFG are hereby ordered to pay to the Complainant C.I.M. \$70,613.81 in reparations. Additionally, Respondents must pay interest on this sum, compounded annually at the rate of 6.375% from August 18, 1997, until the date of payment to the Complainant. Respondents Schuler, Hammer Trading, and LFG are jointly and severally liable for the payment of this judgment.

14th day of June, 2000

Administrative Law Judge

Michael J. Alamo, Law Clerk