# **U.S. COMMODITY FUTURES TRADING COMMISSION**



Three Lafayette Centre

OFFICE OF PROCEEDINGS

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KARL ALBERT CLEMONS, Complainant,

v.

CFTC Docket No. 97-R53

VERNON WESLEY McCABE III, CERES TRADING GROUP, INC., and IOWA GRAIN COMPANY, Respondents.

#### INITIAL DECISION

Karl Albert Clemons alleges: one, that Vernon McCabe fraudulently induced him to open an options account by exaggerating the possibility of making 300% profits; two, that McCabe failed to disclose the higher level of risk associated with buying deep-outof-the-money options; three, that McCabe's recommendation to liquidate a synthetic July soybean spread and then purchase deepout-of-the-money July soybean options was motivated principally to generate commissions; four, that McCabe acted negligently when he advised Clemons to hold, rather than sell, the deep-out-of-themoney July soybean options when they were worth \$6,000 and then when they were worth \$2,000; and five, that a November soybean option spread was unauthorized. Clemons realized a total net loss of \$4,724 over the life of his options account; lost a total of \$18,652 (including \$4,800 in commissions) on the deep-out-of-themoney options; and lost \$9,804 on the allegedly unauthorized

November soybean spread trade. Respondents have denied all of the alleged violations. In addition, respondents have asserted that an exculpatory provision in the customer agreement entitles them to an award of attorneys fees, and that a one-year limitations provision in the customer agreement bars the complaint. $\frac{1}{2}$ 

The findings and conclusions below are based on the parties' documentary submissions and oral testimony, and reflect my assessment of the witnesses' relative credibility. For the reasons set out below, it has been concluded that Clemons has failed to establish any of the alleged violations. It has also been concluded that the provisions in the Iowa Grain customer contract that limit Clemons' statutory rights are unenforceable on the grounds that they are contrary to public policy.

Unless otherwise indicated, dates are in 1996, and amounts are rounded to the nearest dollar.

#### Factual Findings

# The Parties and the Governing Agreements

1. Karl Albert Clemons, has been a teacher in the Dallas public school system since 1992. He has a bachelors degree in sociology and a masters degree in psychology. He had one-and-one-half years of experience investing in stocks and bonds before

<sup>1/</sup> Clemons timely objected when respondents injected the issue of the exculpatory clause into this proceeding. See Clemon's submission filed July 27, 1997 (producing copy of letter from respondents' counsel dated July 27, 1997); Clemons' Objection to respondents' litigation tactics filed December 9, 1997 (producing copy of letter from respondents' counsel dated December 3, 1997); and pages 5-8 of hearing transcript.

opening his account with respondents. [Pages 10-12 of hearing transcript; "New Account Fact Sheet," attached to letter from respondents' counsel to Clemons, dated and filed December 14, 1997; Clemons' reply to respondents' interrogatory 1.]

- 2. Iowa Grain Company is a registered futures commission merchant ("FCM"), with its principal place of business in Chicago, Illinois. Ceres Trading Group is a registered introducing broker guaranteed by Iowa Grain, with its principal place of business in Atlanta, Georgia. Vernon Wesley McCabe III, Clemons' account executive, is a registered associated person with Ceres Trading. During the life of Clemons' account, McCabe initially worked at Ceres Trading's Singer Island, Florida branch office, and then its Annapolis, Maryland branch office. [See pages 101-103, 107-108 of hearing transcript.]
- 3. Pursuant to a guarantee agreement between Iowa Grain and Ceres Trading, Iowa Grain agreed that it would be jointly and severally liable for all obligations of Ceres Trading under the Commodity Exchange Act with respect to the solicitation of, and transactions involving commodity customers of, Ceres Trading. The guarantee agreement also contained the following language that underscores the absolute, unconditional nature of the guarantee:

The futures commission merchant acknowledges that at the time of execution of this guarantee agreement there are not any conditions precedent, concurrent or subsequent affecting, impairing or modifying in any manner the obligations of the futures commission merchant hereunder, or the immediate taking effect of this agreement as the entire agreement of the futures commission merchant with respect to guaranteeing the introducing broker's obligations as set forth to the Commission and to the introducing broker's commodity customers . . . under the

Commodity Exchange Act.

The top of the guarantee agreement stated that it was an official "CFTC Form 1-FR-IB (Part B)." [Produced by Iowa Grain and Ceres Trading on December 24, 1997, in response to Order dated December 16, 1997.]

- 4. Iowa Grain and Ceres Trading also executed an introducing broker ("IB") agreement. Under the IB agreement, Iowa Grain and Ceres Trading agreed, among other things: that Ceres Trading would clear and execute all customer trades through Iowa Grain; Ceres Trading would be responsible for opening and establishing that Ceres Trading would immediately notify customer accounts; Iowa Grain of any customer complaint; that Ceres Trading would not institute any legal action in reply to a customer complaint without the prior written consent of Iowa Grain; that Iowa Grain had the exclusive right to respond to, adjust or settle any customer complaint; and that Ceres Trading would indemnify and holdharmless Iowa Grain from and against all losses, liabilities, damages, expenses and costs suffered by Iowa Grain and that result from or relate to any violations by Ceres Trading of the Commodity Exchange Act. [Produced by Iowa Grain and Ceres Trading January 13, 1998, in response to Order dated January 8, 1998.]
- 5. Clemons signed an Iowa Grain customer agreement when he opened the account on February 22, 1996.

The Iowa Grain customer agreement contained an exculpatory clause that provided in pertinent part that:

Customer acknowledges and agrees that Iowa Grain shall not be responsible to Customer for any losses resulting

from conduct or advice on the part of [Ceres Trading]. Customer specifically agrees that Iowa Grain shall have no obligation to supervise the activities of [Ceres Trading] and Customer will indemnify Iowa Grain and hold Iowa Grain harmless from and against all losses, liabilities, and damages (including attorneys fees) incurred by Iowa Grain as a result of actions taken or not taken by [Ceres Trading].

[¶ 19 of Iowa Grain customer agreement, "Third Party Indemnification," attached to letter from respondents' counsel to Clemons, dated and filed December 14, 1997.]

The Iowa Grain customer agreement also included a cost obligation clause that imposed on Ward any costs, including attorneys fees, that Iowa Grain might incur as the result of any dispute:

Customer acknowledges his unconditional obligation to pay to Iowa Grain the amount of any and all costs and damages (including costs and attorneys fees) sustained by Iowa Grain resulting in any way or arising out of customer's account. . . .

[¶ 17 of Iowa Grain customer agreement, "Obligation for Debts and Other Charges."]

During the account-opening process, McCabe never indicated to Clemons that the customer contact was negotiable. McCabe also told Clemons that in the event of a dispute, he could seek redress in reparations or arbitration. [See pages 19-22, 106, and 155 of the hearing transcript.]

By letter dated December 3, 1997, after the parties had concluded discovery, counsel for respondents set out their interpretation of the customer contract:

[Y]our complaint makes only scant reference to [Iowa Grain], does not allege a single violation of the Commodity Exchange Act against [Iowa Grain], and only

includes [Iowa Grain] because they "handled the money involved in the account. . . . " [Paragraph 19 of the Iowa Grain customer agreement states that Iowa Grain's] sole responsibility to you shall be to execute, clear and account for orders transmitted to Iowa Grain for your account [and that] you agreed to "Indemnify and hold [Iowa Grain] harmless from and against all losses, liabilities, and damages (including attorneys fees) incurred by Iowa Grain," as a result of any action taken relating to your account. All of the above appears to bar you from asserting any legitimate claim against [Iowa Grain], and would make the continuance of this action against [Iowa Grain] frivolous and in bad faith. 3/

Clearly, continuing this action against [Iowa Grain], Ceres and Mr. McCabe and forcing them to expend time and money to defend themselves [against a "frivolous and vexatious" complaint will be grounds for an attorneys fees award under CFTC rule 12.210(c)].4/...In view of the foregoing, I urge you in the strongest terms to reevaluate your decision to bring this claim and take the necessary steps immediately to effectuate a dismissal.

[Emphasis added; attached to complainant's Objection to

<sup>2/</sup> It is not clear here whether "any legitimate claim" refers to the merits of Clemons' claim or to an absolute bar.

 $<sup>\</sup>frac{3}{}$  The letter made no reference to the fact that Iowa Grain was the quarantor FCM for Ceres Trading.

<sup>4/</sup> The letter also referred to the ALJ's award of over \$20,000 in attorneys fees in Davis v. Carr, so as "to make certain that you fully understand the implications of continuing this action against any of the three respondents." However, the award in that case was ultimately based on Davis' culpability for the egregiously bad faith conduct of his attorney throughout the course of the proceeding. Davis v. Carr Investments, [1994-1996 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶26,215 (ALJ 1994), reversed in part ¶26,518 (CFTC 1995), vacated Carr Investments v. CFTC, 87 F.3d 9 (1st Cir. 1996), on remand Davis v. Carr Investments, [Current Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶26,916 (CFTC 1996). It should be noted here that the record does not remotely support a finding of bad faith conduct by Clemons during this proceeding, let alone the sort of readily distinguishable egregious conduct in Davis v. Carr.

respondents' litigation tactics, filed December 9, 1997; see also Clemons' submission filed July 27, 1997 (producing letter dated July 27, 1997 from respondents' counsel, threatening Clemons that he will be liable for respondents' attorneys fees if he loses case).]

## The Account Opening

6. In February, 1996, Clemons filled out and returned a postcard advertisement for Ceres that had been enclosed in a packet of advertisements for various companies and products. Clemons recalled little about the ad, except that it included a reference to 300% profits. [See pages 12-19 of hearing transcript; and ¶ 2 of Clemons' submission filed September 2, 1997.] McCabe then contacted Clemons. 5/

Clemons' testimony indicated that he recalls much more about his subjective reactions to McCabe's statements than the actual specific statements. In contrast, McCabe's testimony focussed on the actual statements by Clemons and McCabe. As a result, I have credited McCabe's version about the solicitation as the more credible.

According to Clemons, McCabe "led [Clemons] to believe" that he would not lose all of his money and that he could get a "three-to-one return." [Pages 82-85 of hearing transcript; and Clemons'

<sup>&</sup>lt;sup>5</sup>/ Neither side produced a copy of the advertisement. Respondents in their post-hearing brief backed off from their initial denials that Ceres had paid for such ads, perhaps because they could provide no other plausible explanation for how McCabe had obtained Clemons' phone number.

reply to respondents' interrogatory 12.] Clemons testified that while he understood that "risk was involved," McCabe's solicitation tended downplay the risks in relation to profit potential. According to Clemons, McCabe: "never talked a lot about risk, very seldom mentioning risk [or explaining] what degree of risk was involved in this"; "mentioned the fact that . . . options were pretty safe and that it was a situation where it was a great possibility that you could never lose all of your money because you could always get out of options"; "never discussed the different reports that can manipulate the market"; and emphasized that Clemons "could make a lot of money, . . . as much as 300 percent." [Pages 12-24, 59, 66-67 and 82-85 of hearing transcript; see Clemons' reply to respondents' interrogatory 12; and fourth paragraph of complaint.]

In contrast, McCabe testified that after he had "cover[ed] the risk-reward aspect," Clemons asked if it was possible to make a 100% or 200% return. McCabe replied "absolutely, it could be possible, but you have to remember that there was a chance to lose what you put in the investment." According to McCabe, Clemons then asked if it was possible to make a 300% return as mentioned in the advertisement, and McCabe replied that "it was possible, but we had no idea how high the price of soybeans would go; once again, but that we did have the chance of the possibility of losing the entire investment, worst case scenario." [Pages 109-110 of hearing transcript.]

7. On February 2, 1996, Clemons filled out and signed the

various account-opening documents, including the customer contract and an acknowledgement that he had read, understood and accepted the terms of the futures and options risk disclosure statement. Clemons testified that he understood from the risk disclosure statement that "risk was involved." Clemons also filled out a "New Account Fact Sheet," in which he checked the "yes" box in response to the question "Do you understand the basics of <u>futures</u> trading?" However, Clemons' testimony established that he in fact did <u>not</u> understand the basics of <u>options</u> trading, especially the mechanics of the spreads recommended by McCabe. [Pages 14-19, 24-35 of hearing transcript.]

## The Account Activity

- 8. Clemons would invest a total of \$5,937 (\$3,000 on February 27, \$875 on March 6, \$62 on March 27, and \$2,000 on April 5). On May 20, Iowa Grain would return to Clemons the \$1,213 cash balance. Thus, trading in Clemon's account would realize an over-all net out-of-pocket loss of \$4,724.
- 9. The trading in Clemons account can be broken into three sets of trades.

The first, and only profitable, set of trades involved two synthetic spreads, which were both liquidated on April 25. This set of trades realized an aggregate net profit (aggregate net premiums collected, less commissions) of about \$21,425, which represented a return of over 300% on Clemons' investment. Set out below is a summary of these trades, all of which involved July '96 call options:

In	Out	Description	Net premium	Commissions and fees
2-26	4-25	buy 4 \$8.50 soybeans	\$ 5,650	\$(663)
3-04	4-25	buy 2 \$8.25 soybeans	3,825	(331)
4-12	4-25	sell 6 \$9.00 soybeans		(994)
3-25	4-25	buy 2 48¢ wheats	14,450	(311)
4-03	4-25	buy 3 52¢ wheats	16,350	(497)
4-12	4-25	sell 5 58¢ wheats	(14,625)	(828)

The \$18,900 in premiums collected when the options were sold for the short legs generated equity for the cost of the additional — and ultimately profitable — purchases on March 4 and 25 and April  $3,\frac{6}{}$  and also generated equity for the cost of the November soybean spread that was initiated on April 15. The two synthetic spreads realized an aggregate net profit of about \$21,425. [See pages 25-42, and 47 of hearing transcript.]

The second set of trades was a November '96 soybean call spread:

In	Out	Description	Net premium	Commissions and fees
4-15	10-21	buy 4 800 soybeans	\$(9,400)	\$(631)
4-15	7-16	sell 4 875 soybeans	800	(662)

The November spread realized a net loss of about \$9,893.

The third set of trades involved the purchase on April 26 of 32 deep-out-of-the-money July soybean options, which expired worthless on June 22. Clemons essentially reinvested his April 25 profits in this trade, paying \$13,600 in premiums and \$5,052 in commissions and fees.

10. Before each option purchase, the Ceres Trading compliance

 $<sup>\</sup>frac{6}{}$  For these two synthetic spreads, Clemons paid about \$3,644 in commissions.

department reviewed the order and obtained Clemons' authorization. 7/ See 27, pages and 103-106 of hearing transcript. The compliance review for each trade was identical or substantially similar, with the Ceres Trading compliance employee first confirming the order, for example, "to buy July 4.80 wheat calls, at 11 or better." The staffer then read off, at a measured pace but without pause, several straight figures for the break-even price; the amount of market movement necessary to break even; the expiration date; the premium for each option; the commission-to-equity percent; the total cost per option; and the total cost. Unfortunately, the effectiveness of this portion of the review was undermined by the fact that so much information was covered without any meaningful opportunity to confirm that Clemons fully understood each piece of information. effectiveness of the compliance review was further undercut by the fact that neither McCabe nor the Ceres Trading compliance employees ever explained the significance of the term "commission-to-equity percent," which typically is used to quantify the detrimental

<sup>7/</sup> Respondents produced a tape-cassette recording of the trade authorizations for the trades on the following dates, in the following order: March 25, April 26, March 4, April 12, April 15, and April 4. The recording did not include the authorizations for the trades on the following dates: February 26, April 25, and July 12. [Respondents' production filed October 27, 1997, and January 21, 1998; see Clemons' objections filed November 20, 1997, and January 30, 1998; CT "Option Compliance" scripts, produced October 27, 1997; and respondents' reply to Clemons' document request number 4.]

effect of commissions on profit potential. $\frac{8}{}$  [See pages 35-39, and 77-78 of hearing transcript.]

11. Clemons' testimony indicates that while he understood that he had authorized the purchase of the various buys and sells that corresponded to the long and short legs of the profitable July synthetic spreads and to the unprofitable November spread, he never adequately understood the mechanics of spreads. [See pages 25-26, and 129-130 of hearing transcript.]

Clemons' confusion persisted, despite the fact that the November Soybean spread, initiated on April 15, was clearly described as a spread both by the Ceres Trading compliance employee and on the Iowa Grain account statements. As a result, when McCabe reminded Clemons in a subsequent conversation that he had placed a spread trade for the account, Clemons protested that he had not specifically authorized a spread. However, Clemons then decided to keep the trade. [Pages 42-47, and 85-87 of hearing transcript.] On July 16, Clemons would instruct McCabe to liquidate the short leg for a small profit; and in October, the long leg would expire worthless. [See pages 57-58 of hearing transcript.]

12. On April 25, Clemons accepted McCabe's recommendation to

<sup>8/</sup> The commission-to-equity percent (i.e., the ratio of commissions-paid-to-premiums-paid) for the trades in Clemons' account ranged from 22% to 30% for the spreads, and was about 33% for the deep-out-of-the-money options. Ceres' commission-to-equity calculation did not include the costs of the various fees.

 $<sup>\</sup>frac{9}{}$  The synthetic spreads were not described as spreads by the Ceres Trading compliance department or the Iowa Grain account statements.

liquidate the two synthetic spreads for a net profit of about \$21,425, based on McCabe's expectation of a "sharp correction" rally. $\frac{10}{}$ recent [Pages after a 118-119 of hearing transcript.] On April 26, Clemons reinvested these profits by accepting McCabe's recommendation to buy 32 deep-out-of-the-money July soybean calls with a 1000-point strike price. [See  $\P$  30, respondents final verified statements.] According to Clemons, McCabe "just explained to me that I would be getting a lot of leverage; he did not explain that it was going to be a high amount of risk to anything." [Page 47 of hearing transcript, see pages 47-53, and 66-67 of hearing transcript.] In contrast, McCabe asserts that:

I told [Clemons] that I would re-enter the soybean market on the long side. And at that point, I pulled up my option page. It gives me all the strike prices in the July contracts and exactly what the prices are with those particular option contracts. For comparison reasons, I'd let him know where his \$8.25 and \$8.50s were, that he'd just sold the day before. And they were lower, dramatically lower, than where he'd sold them the day before.

I then gave him the prices all the way up to the \$10 call. His comment at that point was that the \$10 call -- I think it was "Wow. The \$10 calls are trading at about the same price that I picked up those other options." And I said, "Yes, that's true."

<sup>10/</sup> The correction in fact did occur the next day (Friday, April 26) in the soybean market, with the July \$8.25 and \$8.50 calls losing about 8 cents, and the \$9.00 calls losing about six cents. [Page C15, April 29, 1996 Wall Street Journal.] In addition, the July \$8.25, \$8.50, and \$9.00 calls would expire worthless. Thus, if Clemons had held this spread until expiration, he would have realized a modest gross trading profit of \$700 (based on the difference between the \$3,525 premium collected on the short leg and the \$2,825 in premiums paid for the long legs), which would have been negated by the \$1,987 in commissions.

He then asked me the leverage aspect. "How many of those option contracts could I purchase?" . . . I said you could afford with your equity to buy 32 of those option contracts. . . . I then let him know the . . . the fact that the [\$10 calls were further out of the money than the \$8.50 calls] and the fact that we definitely needed a more significant move to see returns on those options. 11

[Pages 138-139 of hearing transcript.] McCabe also testified that he explained that these options had "less of a chance" to capture a profit than options with closer strike prices. [Page 122 of hearing transcript; see pages 119-123 and 135-139 of hearing transcript.]

Unfortunately, the \$10 options began a quick drop almost as soon as Clemons had purchased them, and lost more than half their value by April 30. At least three times, Clemons asked McCabe if he should sell the options: when they were worth about \$6,000 mid-May; when they were worth about \$2,000 in late May; and just before expiration when they were worth only a few hundred dollars. Each time, McCabe told Clemons that he could sell, but recommended that he hold, and each time, Clemons accepted McCabe's advice. [Page 51 of hearing transcript.]

13. By late May, Clemons called Iowa Grain to open a direct account with Iowa Grain with a lower commission structure. At some point, the account executive for Clemons new Iowa Grain account, Steve Sheetz, criticized the purchase of the deep-out-of-the-money options as the equivalent of "buying a lottery ticket," with minimal chance of making money, and suggested that McCabe had

<sup>11/</sup> Clemons has not alleged that McCabe distorted the likelihood of a "significant move" that would produce profits.

recommended this trade principally to generate commissions for Ceres and McCabe. [Clemons' reply to respondents' interrogatories 16 and 17.] On this record, it cannot be determined when Clemons received this advice from Sheetz.  $\frac{12}{}$ 

#### Conclusions

#### Clemon's claim

generalized and subjective impressions, while relevant, are insufficient by themselves to establish that the Ceres advertisement was deceptive, that McCabe took advantage of any misconceptions created by the ad, or that McCabe otherwise deceptively undermined the various written risk disclosures, downplayed the risks or exaggerated the likelihood of profits during the account opening or in connection with the purchase of the deep-out-of-the-money options. CFTC rule 33.7(b)(6) requires that the written options risk disclosure statement include a warning that "A person contemplating purchasing a deep-out-of-themoney option . . . should be aware that the chance of such an option becoming profitable is ordinarily remote." Although this rule does not require this explicit warning before recommendation. it strongly indicates that the advice that accompanies a recommendation to buy deep-out-of-the-money options must accurately reflect this fact. Here, McCabe credibly testified that, once Clemons expressed an interest in the deep-out-of-themoney options, McCabe adequately explained that they were

 $<sup>\</sup>frac{12}{}$  Neither side called Sheetz as a witness.

significantly less likely to realize a profit than options that were not as far out of the money.

Clemons' allegation that McCabe churned the account when he recommended the liquidation of the synthetic soybean spread and the subsequent purchase of deep-out-of-the-money soybean options was undermined by the fact that he would have lost money if he had held onto the spread, and by his failure to establish any disclosure violations by McCabe in connection with the deep-out-of-the-money options. Clemons' allegation that the initiation of the November soybean spread on April 15 was unauthorized was completely contradicted by the recording of Clemons giving the authorization for this trade. Finally, Clemons has failed to show that McCabe's advice to hold, rather than to sell, the declining options lacked a reasonable basis, or was otherwise actionable.

# Enforceability of the Exculpatory and Limitations Clauses in the Iowa Grain Customer Contract

The express terms of the guarantee agreement, and the regulations upon which the agreement is based, clearly establish that Iowa Grain's statutory obligation as Ceres Trading's guarantor is absolute and unconditioned. The exculpatory clause in Iowa Grain's customer contract — especially when read together with the attorneys fees clause — constitutes an audacious attempt to dodge its voluntarily undertaken statutory obligation, to shield its guaranteed introducing broker from any liability for violations of the Act, and to chill legitimate customer claims. Thus, as explained below, it is concluded that the exculpatory and attorneys

fees clauses in Iowa Grain's customer contract are, at best, flatly inconsistent with the purpose of CFTC rule 1.10, and are thus unenforceable.

Commission rule 1.10(j) sets forth the requirements for a guarantee agreement that may be used to satisfy the minimum financial requirements of an introducing broker ("IB") in CFTC rule 1.17(a)(2)(ii). 17 C.F.R. §§ 1.10(j), and 1.17(a)(2)(ii) (1997). When the Commission adopted rules permitting the use of a guarantee agreement as an alternative minimum capital mechanism for certain IBs to protect the customers of the IB, it stated that the "alternative adjusted net capital requirement embodied in the guarantee agreement is consistent with two of the factors upon which an adjusted net capital requirement for IBs should be based: (1) insuring that IBs are not judgment proof; and (2) providing coverage for potential liabilities of IBs arising from business operations and customer relations." Emphasis added; 48 Fed.Reg. 35248, 35264 (August 3, 1983).  $\frac{13}{}$  The Commission emphatically and unambiguously reaffirmed this policy in Paragon Futures by stating that where an FCM enters into a guarantee agreement with an

<sup>13/</sup> Similarly, the National Futures Association recently amended its arbitration rules and its handbook for arbitrators, <u>Legal and Procedural Issues in NFA Arbitration</u>, to clarify the obligations of guarantor FCMs. The NFA revised its handbook to state that "[w]hen determining FCM liability for the actions of the FCM's guaranteed IBs, the arbitrators must resolve only two issues: (1) whether the alleged conduct of the guaranteed IB involved an obligation of the IB under the [Commodity Exchange] Act or any CFTC regulation; and (2) whether the conduct occurred while the agent was in effect." The NFA also amended its arbitration rules to provide that a guarantor FCM may be suspended if its guaranteed IB fails to pay an arbitration award or honor a settlement agreement. Section 10(g) of the NFA Code of Arbitration.

IB, it shall be, at a minimum, jointly and severally liable for all violations by the IB of the Commodity Exchange Act or CFTC rules.

In re Paragon Futures Association, [1990-92 Transfer Binder] Comm.

Fut. L. Rep. (CCH) ¶25,266, at 38,851 (CFTC 1992). 14/

The Commission has not specifically addressed contractual waivers of significant statutory rights and remedies in the context of guarantee agreements. See, e.g., Kline v. Atlantic Mercantile Group, Inc., Order Denying Review, slip opinion at p. 4 (CFTC 92-R119 August 20, 1993) (declining docket no. interlocutory review on the issue of such a waiver, but agreeing with ALJ that the "interplay between contractual and statutory rights is often 'subtle and difficult to assess.'") However, the Commission in dicta has signalled that it most likely disapproves See Sansom Refining Co. v. Drexel Burnham of such waivers. Lambert, Inc., [1987-90 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶24,596 (CFTC 1990) (noting that no weight will be accorded contractual provisions that are contrary to the Commodity Exchange Act or CFTC rule); and Wolken v. Refco, Inc., [1987-90 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶24,509, at 36,188 n.2 (CFTC 1989) (citing with approval Judge Easterbrook's concurrence in Cange v. Stotler and Co., Inc. 826 F.2d 581, 596 (7th Cir. 1987) ("[p]rivate bargains are subject to attack if enforcement would do too much

<sup>14/</sup> Similarly, NFA Compliance Rule 2-9 imposes a direct duty on guarantor FCMs to supervise the activities of their guaranteed IBs. See NFA Interpretive Notices 9008 (November 7, 1988), and 9019 (October 6, 1992); see also NFA Compliance Rule 2-23 (imposing strict liability on guarantor FCMs for violations of NFA rules and requirements by their guaranteed IBs).

damage to the statutory system"). 15/ Here, the exculpatory provisions of Iowa Grain's customer contact obviously would nullify the result in Paragon Futures by bargaining away a significant statutory remedy -- that is, by barring customers from asserting legitimate claims against Ceres or its guarantor Iowa Grain -- and are flatly inconsistent with the purpose of CFTC rule 1.10, and are thus unenforceable. 16/ This conclusion is further mandated by the fact that the exculpatory provisions, combined with the threat of an attorneys fees award, have a patent chilling effect on any customer seeking legitimate statutory relief.

Respondents' affirmative statute of limitations defense based on a provision in the customer contract that provided for a one-year limitations period,  $\frac{17}{}$  raised for the first time in their post-hearing brief, must be denied on the grounds that it is

<sup>15/</sup> The two cases cited by respondents in the counterclaim and the post-hearing brief are inapposite. The Commission's Order of Remand in Violette v. First Options of Chicago, Inc., [Current Transfer Binder] COMM. FUT. L. REP. (CCH) ¶26,951, at 44,624 (CFTC 1997) involved the narrow issue of whether an IB's guaranteed status by itself was sufficient to establish that it was an "agent" covered by the terms of an ambiguous settlement agreement. And, in AAA & Brothers International Financial Corp. v. Pioneer Futures, Inc., [Current Transfer Binder] COMM. FUT. L. REP. (CCH) ¶27,014 (CFTC 1997), the award on the counterclaim for attorneys fees and costs was entered as a sanction for the complainant's failure to respond to a discovery order and failure to participate in the proceeding. See CFTC rules 12.35, and 12.304(c) and (i).

<sup>16/</sup> Recent federal court decisions have voided exculpatory clauses in guarantor FCM customer contracts on the grounds that they are contrary to strong public policy. Skipper v. Index Futures Group, Inc., 1995 WL 493435 (N.D. Ill. Aug. 15, 1995); and First Commercial Financial Group, Inc. v. Baghdoian, 812 F. Supp. 837 (N.D. Ill. 1993).

 $<sup>\</sup>frac{17}{125}$  of Iowa Grain customer contract.

untimely, as well as on the grounds that it is contrary to strong public policy. 18/

## ORDER

No violations having been established, the complaint is DISMISSED.

Dated March 31, 1998.

Judgment Officer

 $<sup>\</sup>frac{18}{}$  See Madero v. Refco, Inc., 934 F. Supp. (N.D. Ill. 1996) (voiding one-year limitation provision strong public policy).