UNITED STATES OF AMERICA
Before the
COMMODITY FUTURES TRADING COMMISSION

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ALEXANDER TIMOTHY J. DARRAH, Complainant, v. FIRST AMERICAN INVESTMENT SERVICES, INC., GREG PETER ALLOTTA, STEVE DAVID KNOWLES, PAUL F. PLUNKETT, ROSEMARY SALVEGGI, Respondents	*	CFTC Docket No. 05-R042

Appearances:

On behalf of Complainant Alexander Timothy J. Darrah:
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On behalf of Respondents First American Investment Services, Inc., Greg Peter Allotta, Steve David Knowles, Paul F. Plunkett, and Rosemary Salveggi:
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Opinion of Painter, Administrative Law Judge

INITIAL DECISION

Complainant Alexander Timothy J. Darrah, an airline pilot with Cathay Pacific Airways, alleges that First American Investment Services, Inc., two of its Associated Persons, Rosemary Salveggi and Greg Peter Allotta, Principal Steven David Knowles and Principal/Director Paul F. Plunkett defrauded him of his entire pension, saved over seventeen years, and additional reserves and loans all totaling approximately $1,513,354.48. Darrah asserts that First American and the individual Respondents deceived and defrauded him by making false statements concerning their expertise, the existence of numerous institutional customers, and First American's poor customer trading performance. Darrah alleges that First American also committed fraud by virtue of the inappropriate orders placed on his behalf, by omitting material information required by Darrah to make reasonable investment decisions, by excessive trading of his account, without regard to Complainant Darrah's trading objectives, for the sole purpose of converting his funds to commissions, and by unauthorized trading through improper trade allocations, all in violation of Section 4b(a) of the Commodities Exchange Act ("CEA"), 7 U.S.C. § 6b(a), Section 4c(b) of the CEA, 7 U.S.C. § 6c(b), and Section 33.10(a) and (c) of the Commission's Regulations, 17 C.F.R. § 33.10 (a) and (c).

Specifically, among other things, Respondents placed Darrah's funds in a series of deep-out-of the money crude oil option "strangles"[1] that garnered them massive commissions without having any foreseeable chance of implementing Darrah's trade goals. In addition, Respondents

[1] As defined by Complainant's financial expert Joel Finard, a "strangle" is a version of a straddle. Specifically, a "long strangle" is a tactic in which the investor will purchase call options above the commodity spot price and put options below the commodity market price. Expert Finard demonstrated that to be successful in using the strategy, an investor must purchase a particular quantity of "Delta neutral" call and put contracts for the same target month. According to Finard, there was no effort to implement the requirements of a potentially successful strategy in the instant case. (Tr. 104-5; 108-9) (Finard Report).

removed successful trades from Darrah's account, replacing them with losing trades. After his review of the trading history, Darrah's financial expert Jon L. Lyman concluded that he would have been equally served by investing his pension and additional funds, including loans from friends, in a lottery ticket. (Lyman Report).

Respondents assert that Darrah received the standardized warnings accorded clients; that he was a sophisticated investor who authorized the trading in his account; and that, through his account statements, Darrah received notice of disappointing trading results that should have terminated his investments. However, in response to discovery requests, a subpoena issued by this Court, and in disregard of the specific document preservation requirement contained in a June 10, 2004 Statutory Restraining Order imposed on Respondents by the U.S. District Court for the Southern District of Florida,[2] Respondents were not able to produce any of the trade documents they allege would support their arguments or provide any credible evidentiary basis for their defense.[3]

The findings and conclusions below are based on the parties' reliable documentary submissions and testimony,[4] and reflect the determination that Darrah's version of events,

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[2] *See generally Commodity Futures Trading Commission v. First American Investment Services, Inc., Michael Savitsky, Adam Mills, Greg Allotta and James Eulo,* Case No.: 04-60744 CIV, United States District Court for the Southern District of Florida, West Palm Beach Division (May 22, 2005*). See also* [2003-2004 Binder] Comm. Fut. L. Rep. (CCH) ¶ 29,775 (Statutory Restraining Order).

[3] On May 22, 2005, the United States District Court for the Southern District of Florida issued a "Final Consent Order of Permanent Injunction and Other Equitable Relief Against First American Investment Services, Inc., Steve Knowles, and Greg Allotta," along with other First American personnel, based upon stipulated facts, including First American's practices of misrepresenting the risks and advantages involved in options trading, and the firm's extensive history of severe loss by customers trading options. *Commodity Futures Trading Commission v. First American Investment Services, supra.*

[4] The principal documents and items in the evidentiary record include, but are not limited to, Darrah's Complaint, Respondents' Answers, Transcript of the February 27, 2006 Hearing before this Court, the Expert Report and Affidavit of Joel Finard, the Expert Report and Affidavit of John L. Lyman, Darrah's Motion for Summary Disposition, Respondents' Response to Darrah's Motion for Summary Disposition, Darrah's Proposed Findings of Facts and Conclusions of Law, Darrah's Post-Hearing Brief, Respondents' Post-Hearing Reply Brief, Darrah's Response to Selective Items in Respondents' Post-Hearing Reply Brief, Parties Conference Report, all other filed briefs, motions and other legal pleadings, Account Opening and Compliance Documents, including the First American Compliance Manual related to the Darrah Account and First American's conduct of its business, Universal account statements and confirmation sheets, and NFA BASIC Details for Respondents.

supported by the testimony of other First American clients and Darrah's financial experts, is far more plausible and compelling than Respondents' unsupported version. As explained more fully below, Respondents intentionally divested Darrah of funds by misleading him about options trading, about the effect of trading in deep-out-of–the money "strangles," and about the history and effectiveness of First American and its brokers.

Factual Findings

The parties

1. Alexander Timothy J. Darrah ("Darrah"), an airline pilot with Cathay Pacific Airways, residing in France, had a net worth of between five and ten million dollars, and had made some successful and unsuccessful investments of varying kinds based upon the advice of friends and, in some instances, a financial advisor. (Tr. 87-88). While Darrah previously invested in businesses and stocks upon the advice of friends and advisors, Darrah had no experience in trading futures or options (Complaint page 3, ¶ 1; Tr. 114).

2. First American Investment Services, Inc. ("First American") was registered with the National Futures Association ("NFA") as an IB from February 4, 2002 through September 25, 2003, with NFA ID 0313974. While its business address was reported to the NFA as 771 Siesta Key Tr. #1014, Deerfield Beach Florida,[5] its literature cited its business address as 6245 North Federal Highway, Suite 401, Fort Lauderdale 33308. First American introduced all of its business to the futures commission merchant ("FCM") Universal Commodity Holdings Corp. ("Universal"). First American's principals included Paul F. Plunkett and Steven David Knowles.

First American's business practices attracted the Commodity Future Trading Commission's ("Commission") scrutiny. On June 7, 2004, the Commission filed a Complaint in

[5] This address is the residence of Respondent and First American principal Steven David Knowles.

the United States District Court for the Southern District of Florida seeking an injunction and other equitable relief against First American and individuals including Respondent Knowles and Allotta. The Complaint alleged, among other things, that First American was responsible for fraudulent sales solicitations that omitted discussions of the actual risks of trading options, misrepresentations exaggerating the likelihood of profits based upon events in the Middle East (including a probable war in Iraq), along with misrepresentations and omissions concerning the risk of loss,[6] and failure to disclose First American's actual bleak performance record between December 2002 and August 2003.

The District Court issued the requested Statutory Restraining Order against First American and individual defendants, including Knowles and Allotta, on June 10, 2004, prohibiting defendants from destroying records, while requiring them to maintain all existent records and make them available upon Commission request. The District Court issued a Final Consent Order of Permanent Injunction and Other Equitable Relief against First American and individual defendants on May 22, 2005, in which Respondents specifically stipulated to numerous specific violations of the CEA based upon First American's fraudulent solicitations and the mismanagement of customer accounts. The stipulated violations include fraudulent solicitation based upon presentation of a false customer success rate and substantial firm expertise, promises of great profits, mischaracterizations of the operation and effect of seasonality and forthcoming events on heating and crude oil futures and options, and the omission of required disclosures of risk. First American's false promises of great profit were not balanced by the disclosure of its unfavorable customer trading history.

3. Rosemary Salveggi ("Salveggi") during all relevant time periods was an AP of the Introducing Broker First American. Her NFA ID is 0312970. Just prior to working at First

[6] As in the instant case, First American personnel offered virtual guarantees of profit.

American, Salveggi was employed at First Liberty Investment Services, Inc.[7] ("First Liberty"), where her supervisor was Respondent Steven David Knowles. Prior to her employment at First Liberty, Respondent Salveggi had no financial training or experience with futures and options, but instead had been a skin care specialist. (Tr. 187-9). Subsequent to her employment at First American, Salveggi briefly became an AP at a number of IB firms, including Prescott Trading Group (June through July 2003), at Future Tech Venture Capital Group in Delray Florida. (Tr. 358), Futuretech Trading Group, Inc.[8] and simultaneously First Choice Investment Services.

4. Greg Peter Allotta ("Allotta"), NFA ID # 0248553, was an AP of First American during the relevant time period. Allotta has been associated with a lengthy series of futures and options shops, including several that have been the focus of regulatory concern. His resume includes Commonwealth Financial Group, Inc. (1993-1994), FSG International, Inc. (1994-1997), Barkley Financial Group (1997-2002), First Liberty (June through September 2002), First American (September 2002 through August 2003), Millennium Investment Services (December 2002 through February 2003), United Investors Group ("UIG")(August 2003 through November 2004); Majestic Financial (June through December 2004) and Commodity Trading Group (between October 2004 and March 2005).

Allotta himself has been the subject of several regulatory actions in addition to the Commission's First American action, which permanently enjoined his trading and required his payment of $1,137,000.00 in restitution and $373,000.00 in civil monetary penalties.[9] While Allotta was an AP at Barkley Financial, the NFA found him to have committed fraud in his sales

[7] In July 2003, the NFA brought an action against First Liberty based upon its high pressure solicitations and fraudulent sales tactics. Salveggi's First American supervisor, Respondent Knowles, was held responsible for his failure to supervise and his failure to cooperate with the NFA as a First Liberty Principal.

[8] In July 2005, the NFA found that Futuretech Trading Group also was involved in deceptive sales and trading practices.

[9] Along with the other defendants, Allotta was specifically required to retain all First American trading records and books pursuant to the U.S. District Court's June 10, 2004 Statutory Restraining Order.

solicitations and in his handling of customer accounts.[10] In addition, Allotta was a named defendant in a Commission action against UIG. On June 9, 2005, the U.S. District Court for the Southern District of Florida issued a permanent injunction against UIG and individual defendants, including Allotta, based upon its findings of fraudulent sales practices. *Commodity Futures Trading Commission v. United Investors Group, Inc.; Greg P. Allotta; Jay M. Levy; Paul F. Plunkett; Andrew D. Ross; Michael Savitsky,* 2005 W.L. 34747596 (S.D. Fla. 2005); [Current Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 30,099 at 57,399.

5. Steven David Knowles ("Knowles"), NFA ID # 0299126, was an approved Principal and AP with First American during the relevant period. He held at least a ten percent interest in First American from September 11, 2003 through August 11, 2003. His home address was provided to the NFA as First American's business address. Prior to his involvement with First American, Knowles was Principal and AP of Group One Financial Services, Inc. (December 1999 through June 2001), and a Principal and AP with First Liberty (June 2001 through October 2002). Subsequent to his ownership of and association with First American, Knowles has been a principal of US Capital Management, Inc., and Principal and AP of Safeguard Financial Holdings, L.L.C. ("Safeguard"). Pursuant to the May 22, 2005 Consent Order of Permanent Injunction in *First American*, Knowles is permanently enjoined from engaging in any commodity-related activity, and has agreed to make restitution in the amount of $1,600,000.00 and to pay civil monetary penalties of $400,000.00.[11]

In addition to the Commission's *First American* action, Knowles has been deemed responsible for failure to supervise and fraudulent solicitation in the Commission's 2005 action

[10] Based upon his improper sales practices, the NFA required Allotta to pay a $12,000 fine.

[11] As a named defendant in the Commission's First American action, Knowles explicitly was made subject to the U.S. District Court's June 10, 2004 Statutory Restraining Order requiring retention and production of all relevant books and records.

against foreign exchange boiler rooms in South Florida, including Safeguard. *Commodity Futures Trading Commission v. World Market Advisors, Inc., et al,* 2005 W.L. 3804693 (S.D. Fla. 2005); [Current Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 30,100 at 57,401. The NFA records also indicate that the NFA previously was forced to take an adverse action based upon Knowles' failure to supervise the fraudulent actions of First Liberty brokers and failure to cooperate with the NFA. The NFA fined Knowles $20,000.00 and placed him in an enhanced surveillance program for a period of 18 months.

6. Paul F. Plunkett ("Plunkett"), NFA ID # 0313975, was AP, Director, and Principal of First American during the relevant time period. Like Allotta, Plunkett was a named defendant in the Commission's fraud action against UIG. Subsequent to his tenure as owner and AP with First American, Plunkett has been a registered AP and Principal at UIG (September 2003 through February 2005); AP and Principal with US Capital Management, Inc. (January through March 2004); Principal and AP with Light House Capital Management, L.L.C. (March through June 2004); Principal and AP of G7 Advisory Services, L.L.C. (March through June 2004); and Principal and AP of Commodity Trading Group (March through August 2004).

Solicitation and Account Opening

7. Darrah, an airline pilot, consistently testified that he had no experience at futures and options trading. (Complaint, page 3, ¶ 1; Tr. 114). While he previously made financial investments, he relied on the advice of friends and advisors. (Tr. 87-88). Darrah's demeanor and self-report were entirely credible. He simply had a history of investing based on reliance -- merited and unmerited -- upon the advice or expertise of others.

8. Darrah first came in contact with First American as the result of a telephone call from a friend, who conveyed false information from First American. In January 2003, Darrah's friend Dr. Ronald Hay ("Hay") called him to inform him of Hay's successful investment in heating oil with First American Investment Services, Inc. ("First American") (Tr. 84-86; 92). Hay said he was "making great money" and suggested that Darrah establish a similar interest. (Tr. 92). Hay based his claims of great profit upon false information about his account provided to him by First American Associated Person ("AP") Salveggi. Hay also reported, in accordance with false information provided to him by Salveggi, that First American was a large company that handled investments for financial institutions, including banks and insurance companies, and other large clients. (Tr. 92). In late January 2003, based upon Hay's statements, Darrah called Salveggi.

9. In response to Darrah's phone inquiry, Salveggi falsely confirmed that Hay was making a great deal of money, that First American was a large national firm that traded money for banks, and that generally maintained positions for financial institutions. (Tr. 93-94). Salveggi did not disclose that customers at First American encountered negative trade performance or that certain First American's principals and APs had been found guilty of fraud. (Tr. 187-188).

10. Darrah informed Salveggi that he had no experience trading commodities or options (Tr. 114). In response, Salveggi represented to Darrah that he could make a large profit by relying upon First American's expertise and the firm's access to privileged sensitive and non-public information from Government sources. (Tr. 115; Tr. 119). Despite her assertions of expertise, Salveggi had never traded options for her own account. (Tr. 247). Based upon Salveggi's assertions, Darrah determined to open a trading account with First American, agreeing to an initial investment of Twenty Thousand Dollars ($20,000) for heating oil trades

that, as described by Salveggi, would be benefited by seasonal factors and events in the Middle East.

11. Salveggi forwarded account-opening documents and Darrah returned the forms on January 27, 2003. The forms included the Regulation 1.55 Risk Disclosure Statement. On the form entitled "Additional Risk Disclosure," executed and signed by Salveggi on January 27, 2003, she acknowledged that "Customer ("Alexander Darrah") has no previous futures or options trading experience." Based upon Darrah's expressed interest in energy markets, Salveggi suggested that Darrah trade through AP Greg Peter Allotta,[12] describing Allotta as a "genius," and the best in the business, with years of trading on behalf of major banks. Salveggi instructed Darrah "to do exactly as he (Allotta) says." (Tr. 126-128; Tr. 149-50). She told Darrah that if he followed Allotta's expert instructions he would make Five Million Dollars (Tr. 129).

12. Salveggi shared in all commissions of persons she referred to Allotta. (Tr. 199). Ultimately, Salveggi's single largest pay day "ever" was February 28, 2003, the day on which Allotta first placed all of Darrah's retirement funds in a deep-out-of-the-money crude oil options straddle. (Tr. 248).

13. In his initial conversations with Darrah, Allotta promised Complainant that because he understood market volatility, he would enable Darrah to make money no matter which way the market moved (Tr. 143). He also informed Darrah that the crude oil market, with low stockpile holdings and a second pending Iraqi war was what Allotta had been waiting for during 13 years. With Salveggi, Allotta assured Darrah that if he followed Allotta's recommendation of an undisclosed "strangle" position (a spread consisting of deep-out-of-the-

[12] It appears to have been Salveggi's characteristic pattern to refer customers to Allotta after a few initial trades. Witnesses Hay (Tr. 35), Captain Geoff Lloyd (Tr. 52-53), and Laurence Hawthorn (Tr. 62-64) testified that Salveggi referred them to Allotta as well, with the same general characterization of expertise and mandate ("to do exactly as he says"), and with subsequent assurances that they would derive large profits from their association with Allotta .

money options) strategy, Darrah would make at least Five Million Dollars. (Complaint pages 14-15, ¶ 28). Allotta assured Darrah "You are going to make so much money, you'll keep your children, grandchildren for generations to come. This is the key that opens the vault to enormous wealth." (Tr. 130). Allotta confirmed Salveggi's statements that he was operating with non-public information of substantial import that guaranteed large profits. (Tr. 114-115). Allotta did not inform Darrah that deep-out-of-the-money options of short duration were to be purchased on his behalf or of the concomitant risks. (Complaint page 16, ¶ 31).

15. While Allotta subsequently attempted to justify his failure to specifically disclose the risks associated with the deep-out-of-the-money options purchases by claiming that Darrah authorized all the trading, his testimony was contradictory on this point. (Tr. 312). Allotta explicitly acknowledged that Darrah simply and routinely followed his trading. recommendations. (Tr. 316). The Court did not find Allotta's testimony to be consistent, nor his demeanor open, and did not find his account credible. *See also* Finard Report, *infra,* p. 29.

16. Based upon Allotta's promises and assurances, Darrah cashed in his retirement account with Pacific Cathay Airways and took loans from friends to support Allota's trading enterprise. (November 24, 2004 Letter from Paul Moore, Director, Cannon Trustees Limited, to Darrah; Tr. 72-73; 90; 136-7; 144-5; 146-9; 182). In February 2003, and over the course of the following few months, Allotta entered Darrah's funds into a series of "strangle" positions involving deep-out-of-the-money crude oil options.

The Trades

17. Darrah traded through IB First American for a period of 122 days. As summarized by Darrah's financial expert Lyman, during that time the account established a total

of 82 positions, with the resulting commissions and fees totaling $1,081,412.00. These figures are based upon Lyman's analysis and the May 31, 2003 statement of Universal. (Lyman Report).

Darrah's financial expert Joel Finard ("Finard") concluded that Darrah's account was traded in three phases:

> Phase 1 in which there were some initial trades of smaller size, almost a relationship development period; Phase 2 in which 89% of the commissions were paid in 26 days of trading; and Phase 3, a wind down phase where only limited trading occurred and the DTP (Darrah Trading Portfolio) was allowed to run a dissipated course.

(Finard Report).

18. On approximately January 27, 2003, Darrah opened his trading account with four separate deposits of $5,000.00 for a total of $20,000.00 for the purpose of trading heating oil in accordance with Salveggi's recommendation. He verbally informed Salveggi of his complete absence of knowledge of futures and options trading, as acknowledged and formalized in Salveggi's execution of the January 27, 2003 Additional Risk Disclosure Form.

19. The trade documentation provided by Universal is difficult to understand and reconcile, particularly for a novice at trading futures and options like Darrah. "An examination of the Purchase and Sales, Confirmations and Statements of Monthly Activity positions generated by Universal could easily confuse an investor." (Financial expert Joel Finard's Report, pages 22-23). Any user of the documents -- including Darrah -- would have difficulty in determining trade outcomes.[13] Consequently, for use in his analysis and for use by the Court, financial expert Lyman prepared a matched trade schedule, incorporating the trades reported in the Universal

[13] Darrah testified that he was unable to understand those account statements he saw. (Tr. 136, 152-153). Moreover, the record evidences that as an airline pilot Darrah traveled constantly and had little access to any trading records over the short period of the life of the account. First American noted that statements and confirms were addressed to Hong Kong, Darrah's primary point of departure, rather than to a consistent domestic address. (Tr. 143). Hay testified that the statements were "gobbly gook" and that since Salveggi could not take the time to explain them, he relied on her for an account of what she falsely claimed were his "profits." (Tr. 28-29).

confirmations and statements, but providing an orderly presentation of opening and closing trades in chronological opening trade date order. (Lyman Report).

20. Allotta instituted the practice of trading "long strangles" for Darrah's account towards the end of February 2003. On February 28, 2003, based upon Allotta's recommendation (Tr. 316), Universal executed two trades for the account. It purchased 500 call contracts for May03 NY Crude Oil with a strike price of 49, and at the same time purchased 500 May 03 NY Crude Oil Put contracts with a strike price of 28. These trades generated a total commission of approximately a quarter of a million dollars. (Lyman Report). In explaining the trades to Darrah, Allotta assured him that the trades reflected Allotta's knowledge of market volatility, and would enable Darrah to make money no matter which way the market moved. (Tr. 143). At trial, when asked about "volatility," Allotta had no knowledge of how to either define or measure it. (Tr. 271-76).

21. In order to pay for this strategy, on February 28, 2003, Darrah wired $900,000.00 to First American for use in his account. (Universal account statement and confirmation dated February 28, 2003). Darrah obtained the $900,000.00 supporting the "long strangle" trades by liquidating the entirety of his retirement funds, accumulated over seventeen years. (Tr. 90; 136-7; Tr. 146-9, November 24, 2004 Letter from Cannon Trustees). When Darrah provided First American with the $900,000.00 withdrawn from his retirement account, First American immediately applied the funds to the purchase of deep-out-of-the-money options. (Finard Report; February 28, 2003 Universal Month End Statement).

22. Darrah believed he was making a long term investment on the up and down side of the underlying value of crude oil, but he did not know his funds had been placed in deep-out-of-the-money options. (Complaint p. 16, ¶ 31, Tr. 143, 145-6). First American failed to produce

any evidence demonstrating that the firm fulfilled its own requirement of review and disclosure when exceeding an undisclosed percentage of customer fund limits, or when placing Darrah in deep-out-of-the-money options. In fact, Salveggi denied that any such disclosure or review responsibilities were applicable. (Tr. 227-28). Allotta also denied that the use of deep-out-of-the-money options required any special disclosure. (Tr. 296).

23. Concerning these trades, Salveggi reported to Hay that Darrah had invested so much that First American would make him very rich indeed, with profits on both the up and down side. In this conversation, Salveggi acknowledged to Hay her awareness of Darrah's use of loans and retirement funds and said these were "good moves." (Tr. 146-9).

24. Subsequently, when aware that Darrah had exhausted his retirement funds and loans from friends, Allotta advised him not to withhold the sole remaining funds with which Darrah intended to purchase a car for his wife. Allotta advised that it would not make sense to purchase a BMW when Darrah would be able to buy his wife a Bentley based upon his First American investments. (Tr. 149).

25. Financial expert Lyman reported that both the calls and the puts constituting the February 28, 2003 executed straddle were too far out of the money to be reasonable. Lyman stated that a sensible straddle must have the strike prices on the Call and the Put closer together in order to provide any possibility the trade could result in profits. The trading "was highly unlikely to achieve any profit for Mr. Darrah" as Respondents knew or should have known. (Lyman Report).

26. Lyman performed a "Cash Flow/Account Equity" analysis and produced a schedule reflecting deposits and withdrawals as well as the net account value on each day of each month the account was opened. On February 28, 2003, with the influx of Darrah's retirement

funds, the account "had already lost $400,000, a remarkable achievement if you do not consider that the commissions alone in the same time frame exceed $440,000." (Lyman Report). Lyman's review led him to conclude that "The most remarkable aspect of the case is the commissions as a percent of the principal amount of each trade." (Lyman Report).

27. Allotta repeated the same unreasonable strangle strategy several times in the Darrah account. For example, on March 19, 2003, First American initiated a trade in Darrah's account for 175 June 03 NY Crude Oil call options. The cost of the calls amounted to $87,500.00, but the commission and fees charged for the trade were another $43,750.00, fifty percent of the principal amount of the trade. Thus, the trade would require a fifty percent return before Darrah could make a dollar on it. (Lyman Report, page 1).

28. Expert Joel Finard studied First American's trading practices and focused particularly on the "long strangle" executed with the June 03 Crude Oil Calls and Puts. Finard reported that the First American selected options were consistently too short in duration, were allowed to depreciate to no value, and that First American failed in the duty to inform Darrah how to execute such a trade effectively. (Finard Report).

29. Finard reported that First American's trade execution consistently was extremely poor, based upon the choice of illiquid contracts. With regard to the vast majority of his trades, Darrah represented more than 70% of the Daily Trading Volume. Fifty Six percent of the time Darrah received the low price of the day, and in seven other sales, he received well below the average price of the day. Finard viewed this outcome as statistically improbable, reflecting First American's failure to effectuate good trade strategy and execution practices, and to follow up with the clearing firm regarding the consistently poor trade execution. (Finard Report).

30. Finard constructed a "delta neutral' trade portfolio to compare to the trading in Darrah's portfolio for June 03 crude oil. The results demonstrated the extreme inefficacy of the First American trading since the delta neutral portfolio resulted in commissions that dropped by 83%, and a trade loss of $47,840 compared to the actual trade loss of $350,382. The cumulative result of the model portfolio would have left Darrah in an 84% superior position with $621,062 less cash out of his pocket. Finard concluded that as to this trading sample First American did 83% more trading than necessary and that four out of five trades were not necessary to achieve the alleged strategy. (Tr. 108-112; Finard Report page 40).

31. Finard's analysis also revealed that the recommended purchase of deep-out-of-the-money options resulted in the selection of put options that were on the average 21% away from the at-the-money price, and call options that were on the average 46% away from the at-the-money price. (Finard Report, page 42). These selections were unlikely to succeed for Darrah in the absence of enormous market moves. The deep-out-of-the-money options were cheaper, and more illiquid, enabling First American to charge greater commissions, while causing Darrah to incur greater financial loss. (Finard Report, page 42).

32. Finard concluded that the average commission charged on the Darrah trading portfolio was 43.5 % of the principal paid for the option. (Finard Report, p. 32),[14] and that the strangle strategy could not be effective with a high commission structure and deep-out-of-the money options. Like Lyman, Finard concluded that the most rational explanation of use of short expiring options was to optimize commissions charged or churn the Darrah trading portfolio. (Finard Report pages 44-45, and throughout).

[14] First American charged commissions of $250 per round trip which were well outside the normal and customary rates for the industry. (Finard Report, page 6). In addition, the Darrah account trades were held on average for a period of merely 14 days, which was too rapid a turnover for a "long strangle" strategy. *Ibid.*

33. Since filing his Complaint, Darrah repeatedly, and by various means attempted to discover and subpoena the Floor Tickets related to the February 28, 2003 trades. Despite the Court's grant of a subpoena, Respondents never have produced the trade documents. (Tr. 318). Nor has First American even marginally explained the absence of any relevant trade documents. Despite the judicial order resulting from the Commission's successful prosecution of First American, Knowles and Allotta, requiring retention of First American documents, Respondents claimed that they "lost track" of the required supporting documentation (Parties Conference Report), exhibiting their conscious disregard of the explicit judicial order.

34. There were additional serious flaws in First American's handling of Darrah's trading account. Lyman identified "as of" trades in Darrah's account, reflecting the removal of successful trades and placement of losing trades in the account without explanation. (Lyman Report). First American failed to provide documents or explanation related to these alterations.

35. Lyman pointed out that on May 1, 2003, Universal executed two trades for Darrah, purchasing 3 T-Bond contracts and then selling five of the same contract. Respondents have provided no grounds for these trades. (Lyman Report).

36. As principals at First American, with responsibility for the conduct of the firm's business pursuant to Section 2(a)(1)(B) of the CEA, 7 U.S.C. § 2(a)(1)(B), Knowles and Plunkett also were responsible for implementing the First American procedures and practices related to the conduct of firm business.

37. First American's rules were contained in the First American Policy and Procedures Manual ("Manual").

The Manual merely and incompletely states at 3.02:

> The setting of dollar limits on all futures and options on futures accounts is designed to maximize the client's financial exposure and to protect the client's

> ability to meet obligations to the Firm as they might arise. The dollar limits imposed on an account should represent the maximum of percent (-%) *[sic]* of their stated net worth if the net worth is $? to $ percent (%) *[sic]* if the net worth is $ to $ *[sic]* and percent (%) *[sic]* if the net worth is $ *[sic]*or over, or their otherwise stated lower risk capital amount given to in writing. A client may only add funds in excess of either of the above amounts if the addition is accompanied by an updated net worth letter or an increased risk capital amount. If the client fails to provide with an original copy of such letter the AP may be held responsible for any resulting loss to the Firm and will forfeit the commission.
>
> It is the responsibility of First American to initially determine the credit worthiness of a client. This review should include verification with the client's bank. Senior management is responsible for reviewing large accounts and the limits assignment.

Although the Manual is entirely and suggestively unclear about the dollar limits and percentages in question, it suggests the intention that Senior Management -- Plunkett and Knowles -- review large accounts and limits assignments. If there ever was any evidence to support review by Plunkett and Knowles, First American, Plunkett and Knowles have failed to produce it. Similarly, Manual sections 3.02 and 3.04 required management scrutiny and approval for investments exceeding 10 % of a client's net worth but the record discloses no review or approval with regard to First American's trading of Darrah's account.

38. With regard to "deep-out-of-the-money options," the Manual states at 13.30:

> Each broker must be issued exchange definitions of Deep-out-of-the-Money options. Due to the confusing nature of the definitions, all individuals responsible for placing trades are under direct orders to report any trades which may be considered unusual or deep-out-of-the-money to the compliance department.

First American and the individual Respondents have provided no evidence of a relevant review of the deep-out-of-the-money options placed in Darrah's account or of a compliance department that served the appropriate function in Darrah's case.

39. As stated below, Manual Section 11.02 provides the "bedrock" of First American's account management policy:

11.02 Client Asset Management Guideline

> First American provides Associated Persons with certain guidelines in order that they may assist clients in arriving at decisions with regard to asset allocation alternatives. In doing so, it is First American policy to refer to (1) NFA Rule 2-30, and (2) to adhere to the basic principals *[sic]* of the Prudent Man Rule." *[sic]*. In terms of NFA Rule 2-30, special emphasis is given to clients: (1) occupation, (2) annual income and net worth; (3) age and (4) investment experience when presenting asset allocation alternatives. The theme of the "Prudent Man Rule" is the bedrock upon which FIRST AMERICAN builds its policy.
>
> In 1830, Judge Samuel Putnam, presiding in the Massachusetts Supreme Court, created the Guiding Principle for professional money management. His "Prudent Man Rule" states that when managing a client's investments one should be prudent, and treat them as safely as if they were one's own. When making recommendations to clients and/or suggesting alternative strategies for client consideration, FIRST AMERICAN Associated Persons are encouraged to follow the "Prudent Man Rule." (Emphasis Added).

Respondents Salveggi and Allotta expressed utter ignorance of the "bedrock" of First American client management policy. (Tr. 232, 294-5, 312). Principal and Director Plunkett, who handled compliance training for First American, had never provided training in the "bedrock" of First American's client management policy. (Tr. 330-1).

40. Nor did supervisor Plunkett or either AP acknowledge awareness of or the resultant absence of compliance with the Manual Section 11.03:[15]

> 11.03 Five (5)/Ten (10) Percent (%) of Net Worth Guideline
> In general, and all other things being equal, FIRST AMERICAN views it prudent, (sic)that clients may consider placing five (5%) to ten percent (10%) of their net worth (excluding equity in their home and life insurance).....in speculative futures and options investments For *[sic]* example if a client's net worth is $1,000,000, they may wish to consider investing up to $200,000 in futures and/or options on futures investments If *[sic]* a client's net worth is defined as $50,000 they may consider investing up to $5,000 in futures and/or options of futures.

41. Respondents produced no written reviews or documents supporting or justifying the handling of Darrah's account and merely alleged that Darrah controlled the account trading

[15] At trial, Plunkett testified that he became aware of the Net Worth Guideline "yesterday." (Tr. 332).

and received the standardized warnings, and, in conflict with Salveggi's written acknowledgment, that Darrah was a "sophisticated investor." Salveggi indicated that she had neither been aware of nor ever used First American's compliance manual. (Tr. 203-205). Neither testimony nor documentation established the application of the "Prudent Man Rule," contained as Item 11.02 in the First American compliance manual, or Rule 11.03, limiting trading to five or ten percent of a client's net worth.

DISCUSSION

The cumulative credible evidence in this matter – derived from that presented by the Complainant (including his two experts, Finard and Lyman, and three fellow investors) and the Respondents,[16] dictates the following legal conclusions:

(A) Darrah was not a sophisticated investor capable of evaluating complex futures and options data and planning a trade strategy;

(B) In violation of Section 4c(b) of the CEA, 7 U.S.C. § 6c(b) and Commission Regulation 33.10, Respondents fraudulently solicited Darrah with false promises concerning their expertise and special knowledge, special status and special customers, omitted to inform Darrah of relevant risks (risks affecting options generally, and specifically, of the risks related to trading deep-out-of-the-money options and of their unsuccessful customer trading histories), and neglected to inform Darrah of their own prior adjudications of fraud;

[16] Respondents have produced a minimum of relevant evidence. The court particularly notes the absence of subpoenaed evidence that Respondents failed to produce despite an operative statutory restraining order and a direct Court mandate for its production. In the context of their lengthy histories of fraud, Respondents' failure to produce relevant and credible evidence is not heartening, and does not enhance their arguments based on standardized warnings and Darrah's sophistication.

(C) In violation of CEA Section 4b(a), 7 U.S.C. § 6b(a), and Commission Regulation 33.10, Respondents churned Darrah's account, using illiquid, excessively short-term, deep-out-of-the-money options in trade strategies that would inevitably result in excessive commissions and could not plausibly result in profits to Darrah;

(D) First American is liable for the conduct of its APs pursuant to Section 2(a)(1)(B) of the Act, 7 U.S.C. § 2(a)(1)(B);

(E) As supervisors, Respondents First American, Knowles and Plunkett are controlling persons pursuant to Section 13(b), 7 U.S.C. § 13c(b), responsible for their oversight failures related to solicitation, disclosure, and churning violations. Their failure to establish or implement the required structures for broker supervision and compliance make them liable for the CEA and regulatory violations at issue.

A. Darrah was not a Sophisticated Investor

Darrah was not a sophisticated investor capable of selecting or managing complex trades. While Darrah was well off as a result of his career as a pilot and fortuitous varied business investments, he had no experience with the futures and options markets. Darrah is an intelligent person, and perhaps a sophisticated person, but he is not a sophisticated or even slightly experienced trader of futures and options.

Respondents' arguments that Darrah had the capacity to elect the complex and deleterious trading in his account are belied entirely by Salveggi's collection of the additional risk disclosure statement which indicated that, in fact, Darrah had no relevant futures or options trading experience of any kind. *See, e.g., Skinner v. Gombos International,* 2000 W.L. 155993;

Marcus v. Gartman, [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,487 ("Charles Marcus is not a sophisticated investor, irrespective of his limited trading experience in commodities."); *William O'Hey, Jr. v. Drexel Burnham Lambert, Inc.,* [1984-86 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,754 (CFTC Sept. 23 1985) ("Complainants are attorneys whose practice primarily involved intellectual property law and domestic relations law, respectively. Neither had practiced commodities or securities law or had traded commodities before the transactions giving rise to this proceeding"). While Darrah had pursued some financial investments upon the advice of others, he had no financial expertise, and again, no experience of any kind in the germane area of trading.

The nature of the trades entered into in Darrah's account lends strong support to this conclusion. It is entirely unlikely that a knowledgeable options trader would ever elect the combination of illiquid, deep-out-of-the-money short term options that guaranteed Respondents massive immediate commissions while ensuring the failure of the trades from a profit making perspective.

B. Respondents fraudulently solicited Respondent's business

Section 4c(b) provides "No person shall....enter into or confirm the execution of any transaction involving any.....option.....contrary to any.....regulation of the Commission." More specifically, Commission regulation 33.10 provides

> It shall be unlawful for any person directly or indirectly – (a) to cheat or defraud or attempt to cheat or defraud any other person; (b) to make or cause to be made to any other person any false report or statement thereof or cause to be entered for any person any false record thereof; (c) to deceive or attempt to deceive any other person by any means, whatsoever – in connection with an offer to enter into, the entry into, the confirmation of, the execution of, or the maintenance of any commodity option transaction.

To establish liability for solicitation fraud, Darrah must demonstrate that Respondents

(1) made misrepresentations or misleading statements; (2) acted with scienter; and (3) that the misrepresentations were material. *R.J. Fitzgerald, supra,* 310 F.3d 1321, 1328 (11th Cir. 2002), *cert. denied,* 125 S. Ct. 808 (2004). The entirety of facts in this matter -- including Respondent's failure to produce the legally required evidence documenting their trades on Complainant's behalf -- lead inexorably to the conclusion that in conducting their business, Respondents misled Darrah as to the nature of their expertise and the nature of the risks to which his options trading would expose him.

Respondents' specific actions with regard to Darrah demonstrate the full spectrum of fraudulent practices prohibited by Section 4c(b). Respondents' fraudulent actions include (1) Respondents' false self-presentation as a well established firm holding long-term investments for institutional customers; (2) Respondents' construction of a straddle using the deep-out-of-the-money options and Respondents' failure to disclose the very real risk of "deep-out-of-the-money options"; and (3) Respondents' promises of large profits. Respondents' promises regarding the benefits of using the entirety of Darrah's financial resources is also supported by the testimony of witnesses Hay, Hawthorn and Lloyd, who all were recipients of the same misleading information.

While Respondents provided Darrah with the standardized disclosure regarding trading in options, they were far more aggressive in making verbal promises concerning their access to special information, First American's expertise, Allotta's expertise, and the promise of riches. At the same time, Respondent failed to inform Darrah of Respondents' dismal customer trading records, of the profound risk of First American's elected deep-out-of-the-money crude oil straddle strategy, and of the individual Respondents' history of adjudicated fraud

Standardized disclosures are not an antidote to the false impressions created by Respondents' intentional and continual false statements and promises. *See, e.g., Sanchez v. Crown,* [2003-2004 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 29,487 (CFTC 2003); *Ferriola v. Kearse-McNeill,* [1999-2000 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶28,172 at 50,153 (CFTC 2000); *Bishop v. First Investors Group of the Palm Beaches,* [1996-1998 Transfer Binder] Comm. Fut. L. Rep (CCH) ¶27,004 at 44,841-44,842 (CFTC 1997); *Levine v. Refco,* [1987-1990 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶24,488 at 36,115-36,116 (CFTC 1989). In addition, it "is misleading to speak of limited risk and high profits without also telling the reasonable listener that the overwhelming bulk of customers lose money." *R.J. Fitzgerald, supra,* 310 F. 3d at 1333. S*ee also Munell v. Paine Webber Jackson & Curtis,* [1986-87 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶23,313 at 32,862-63 (CFTC Oct. 8, 1986).[17] Nor are the Commission's mandated risk disclosures, contained in form 1.55, a cure for Respondents' promises of high profit. *R.J. Fitzgerald,* 310 F. 3d 1329.

Respondents' misrepresentations were material. In this respect, their omissions are as significant as their misrepresentations. It is highly doubtful that Darrah would have traded with First American had he known the Commission and the NFA had previously identified Allotta and Allotta's supervisors as involved in customer fraud. Darrah did not know, nor did Respondents inform him that seasonal trends and the prospective Mideast events were already reflected in the market. Omissions, like misrepresentations, are material when a reasonable investor would consider it important in deciding whether to make an investment or not. *See First American, supra, citing R.J. Fitzgerald & Co., supra,* 310 F. 2d 1321, 1333.

[17] *Cf. Lehoczky v. Gerald, Inc.,* [1994-1996 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,441 (CFTC June 12, 1995), in which the Commission found that the respondents' failure to disclose customer losses, in the absence of affirmative misrepresentations, is insufficient to establish fraudulent solicitation.

The disclosure requirement related to the purchase of "deep-out-of-the-money options" is significant enough that it is the subject of a specific regulation. *See* Commission Rule 33.7(b)(6), 127 C.F.R. § 33.7(b)(6). As stated previously, Respondents' provision of a standardized warning is insufficient to outweigh the duplicitous presentation of the "long strangle(s)" as a protective strategy, guaranteeing no risk and handsome returns.

The scienter requirement need not be satisfied by direct evidence, although the knowing use of Darrah's retirement funds in the impossible, commission-generating "long strangle" trades would appear to satisfy any intent requirement. The Commission

> need not show that defendants acted with an evil motive or an intent to injure; rather, recklessness is sufficient to satisfy the scienter requirement.

Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976).The scienter requirement also is satisfied when the principals and brokers are aware of the significant losses suffered by their customers and fail to disclose them. *CFTC v. Commonwealth Financial Group, Inc.,* 874 F. Supp. 1345, 1354-55 (S.D. Florida, December 28, 1994), *vacated on other grounds,* 79 F. 3d 1159 (11th Cir. 1986).

In addition, Darrah and his witnesses are far more credible than Respondents. While Darrah, Hay, Lloyd and Hawthorne told a straightforward story that is consistent with the available evidence, Respondents failed to provide relevant evidence in violation of their legal obligations to maintain trading and supervisory records. Respondents also professed lack of knowledge of basic tenets of futures and options trading,[18] and of the fundamental rules of net worth, trading limitations, disclosure, and supervision applicable to their work.[19] Respondent

[18] *See, e.g.,* Allotta's response to the request for a definition of volatility, above.
[19] *See, e.g.,* Salveggi, Allotta and Plunkett responses to questions about the "prudent man rule" and net worth and trading limitations, above.

Knowles asserted his Fifth Amendment privilege, and in response to Motion, this court has ruled that Knowles' refusal to testify will result in the relevant negative inference(s). (Tr. 345).

Thus, it is clear that Respondents induced Darrah's trading with fraudulent solicitation. However, the failure to disclose the risks inherent in the construction of the "long strangle(s)" using "deep-out-of-the-money options," as well as some of the unauthorized trading in his account provide additional evidence of Respondents' churning of Darrah's account. *Fields v. Cayman Associates, Ltd.* [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,688 at 30,928 (CFTC 1985).

C. Respondents Churned Darrah's Account

The Commission has determined that churning occurs when a broker who has control over a customer's account trades the account excessively for the purpose of generating commissions, without regard to the customer's interest. *Fields, supra,* citing *Smith v. Siegel Trading Co.* [1980-82 Transfer Binder] Comm. Fut. L. Rep. ¶ 21,105 at 24,452-53 (CFTC 1980). Thus, in assessing Darrah's claims we look to see whether Respondents controlled his account, whether they traded his account excessively, whether the trading strategy or pattern of trading was intended to generate commissions, and had no legitimate purpose in serving the customer's trading objectives.

1. Respondents Controlled the Trading for Darrah's Account

While an associated person may act for some customers only as the conduit for order transmission, for other customers the associated person may act in an advisory capacity. In such a case, the associated person's duties to that customer broaden substantially. *Siegel Trading Co., supra. See also* Finard Report. As a result, "a finding of control is not dependent on the account

being formally labeled discretionary but is based rather on who in fact was making the decisions." *Siegel Trading Co., supra, citing Newberger, Loeb & Co., Inc. v. Gross,* 365 F. Supp. 1364, 1371 (S.D.N.Y. 1973), citing *Hecht v. Harris, Upham & Co.,* 283 F. Supp. 417, 432-33 (N.D. Cal. 1968), *mod. as to damages*, 430 F. 2d 1202 (9th Cir. 1970).

In making an assessment of where actual control lies, the factors include (1) a lack of customer sophistication; (2) a lack of commodity trading experience on the part of the customer and a minimum of time devoted by him to his account; (3) a high degree of trust and confidence reposed in the associated person by the customer; (4) a large percentage of transactions entered into by the customer upon the AP's recommendation; (5) the absence of prior customer approval for transactions; and (6) customer approval for transactions where it is based upon inaccurate or misleading information supplied by the AP. *Siegel Trading Co., supra, citing Carras v. Burns,* 526 F. 2d 251 (4th Cir. 1975). Nor does the absence of a written control agreement foreclose a claim such as Darrah's. *Siegel Trading Co., supra.*

As determined above, the evidentiary record establishes Darrah's lack of commodity trading experience and sophistication in the realm of commodities trading. The record also indicates that Darrah's prior investments were based upon the advice of friends or advisors, rather than upon his own knowledge or expertise. (Tr. 88). Based upon the credible testimony of Complainant and witnesses Hay, Lloyd and Hawthorn, Respondents Salveggi and Allotta went to great lengths to present First American as a highly credible investment company and Allotta as a person of great expertise in trading energy products. Despite Darrah's repeated assertion of lack of knowledge, he was assured that he could rely on Allotta and would need only to follow directions to make a fortune. Consequently, in pursuing trading at First American, Darrah placed a high degree of trust and confidence, i.e., reliance, in Allotta's recommendations -- the

recommendations were his sole source for his trading and all of his trades were based upon Allotta's conduct of his business as his agent-expert. Darrah credibly testified that he placed a great deal of trust in Allotta and invariably followed his recommendations, and Allotta agreed that his recommendations were the basis for the trades (Tr. 316).[20]

Darrah did not have the capacity to knowingly approve the transactions and strategies into which his funds were entered, nor, based upon his employment schedule, was he available for discussion in most instances. To the extent he can be viewed as approving anything, Darrah must be viewed as relying on false information, or information that became false as the result of significant omissions -- as to the nature of highly risky "deep-out-of-the-money options," fast expiring options, and the commissions generated by the Respondents' specific trading arrangements.

Finally, the "long strangle" trades entered into Darrah's account are evidence, by themselves, of his lack of control, knowledge or consent. As explained by both financial experts, the strangle trades were not constructed so as to enhance any possibility of trading success. Instead, they were doomed to failure from the first.[21] Yet, the first such strangle alone -- the February 28, 2003 trades -- converted Darrah's lifetime pension into commissions for Respondents, engendering the largest pay day Salveggi ever has seen. Clearly Respondents exercised sufficient control over Complainant's account to satisfy the first element of the churning determination.

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[20] *Cf. Lehoczky, supra,* in which the complainant failed to establish the respondents' *de facto* control as a result of what the Commission viewed as complainant's ongoing handling of many aspects of his account.

[21] *See Ferriola v. Kearse-McNeill,* [1999-2000 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 28,172 (CFTC 2000) ("Consequently, when customers are paying commissions on a per-contract basis, an account executive seeking to serve his customer's interests will purchase the lower-cost ITM position."). *See also Hinch v. Commonwealth Financial Group, Inc.,* [1996-1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,056 (CFTC 1997) ("Without any showing of how the dynamics of spread trading were expected to operate on this position, we can conclude only that respondent encouraged complainants to bet against themselves.")

2. Respondents' Strategies Were Designed to Trade Darrah's Account Excessively, to Generate Commissions, and Without Regard for Any Effective Trading Strategy

The Commission recognizes that most customers have difficulty detecting excessive trading. *In the Matter of Murlas Commodities, Inc., et al.,* {1994-1996 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,485 (CFTC 1995), *citing Lehman v. Madda Trading Co.,* [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,417 at 29,869 (CFTC 1984). Customers who lack experience and sophistication frequently are deceived, making the customer's timely objection an inadequate evaluation of the trading in their account. *Murlas, supra.*

Darrah was interested in energy trading, but had neither the knowledge nor the intention to elect options trading strategies. Based upon his credible testimony, he believed he was entering into a long term investment on both the up and down side of the strike price. Even, however, if Darrah was viewed as approving some facsimile of Allotta's straddle techniques, "evidence may still establish that [the broker] turned his back on the customer's financial interests by trading simply to generate commissions." *Murlas, supra,* at 43, 157.

In this case, the testifying financial experts were unanimous and conclusive in finding that the sole purpose of the deep-out-of the-money, short term and sometimes unmatched options "strangles" was the generation of commissions for Respondents. Generally, the indicia of excessive trading include high commission to equity ratios; high percentages of day trades, a broker's departure from a previously agreed upon trading strategy, trading in an under-margined account, and reestablishment of a previously liquidated position in the same or a related futures contract without any apparent trading strategy. *Murlas, supra, citing In re Lincolnwood Commodities, Inc.* [1982-1984 Transfer Binder], Comm. Fut. L. Rep. (CCH) ¶ 21,986 at 28,251. However, a finding of excessiveness does not require proof of all the listed indicators. *Ibid.*

Due to the mechanical differences underlying futures and options contracts, the precedents for analyzing excessive trading may differ. *See Hinch, supra, citing Johnson v. Don Charles & Company* [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,986 at 37,624 n.5 (CFTC 1991). Nevertheless, the Commission has recognized that the level of commissions charged, where, as here, the commissions amounted to approximately 40 percent of the total investment, and were a consequence of the purchase of deep-out-of-the-money options, demonstrates "facially excessive trading." *Hinch, Ibid.*

The repeated "long strangles" in Darrah's account were not constructed to achieve trading success. The selected options were too far out of the money, too illiquid, too short in duration, and were allowed to depreciate in value, and yet this ineffective, poorly constructed strangle was repeated successively by Respondents. What the trades achieved, however -- the generation of massive commissions -- they did most successfully. As previously described, the average commission charged on the Darrah trading portfolio was 43 percent of the principal paid for each option. The February 28 strangle generated in excess of a quarter of a million dollars in commissions while eradicating Darrah's retirement. The March 19 strangle generated $43,750 in commissions, and during the 122 day life of the account, commissions and fees totaled $1,081,312.00 according to expert Lyman (Lyman Report) and the May 31, 2003 Universal Statement of Account.

In an effort to illustrate the inexplicable inefficacy of Respondent's trading, expert Finard constructed a parallel account for the March strangle (using June 03 crude oil options). Finard demonstrated an excess of 83 percent of commission-generating trading, and an excess of $621,062 in loss based upon reasonably competent delta neutral trading modeled on the alleged "straddle" strategy. (Finard Report).

The continuous selection and use of the deep-out-of-the-money options in the strangles is, in itself, an index of "excessive trading." The choice of the deep-out-of-the-money options even when comparable in the money positions could have been chosen "exponentially increased respondents' commission income.....because commissions (were) based on the number of contracts traded, rather than the value of the position, and because more.....options could be purchased since the premium for a (deep-out-of-the-money) options is substantially lower than the premium for a comparable in the money option." *Sanchez v. Crown, supra;*[22] *Hinch, supra.*

When the Commission assesses "excessive trading," and finds evidence of a trading strategy best suited to generate commissions, the broker is offered the opportunity to and "must be prepared to articulate a reasonable justification for his trading," *Fields, supra,* ¶ 22,688 at 30,929; *citing Lehman, supra,* ¶ 22,417 at 29,868 n.3; *Hinch, supra.* No meaningful rationale has been offered here and none would suffice. The idea that Darrah designed or knowingly authorized the trade strategy or trading is belied by his lack of sophistication,[23] and by expert Finard's proof that the actual trading made an overt departure from any standard for or intention of competent trading on behalf of a customer. Respondents churned Complainant's account in violation of Section 4b(A) of the CEA, 7 U.S.C. § 6b(A), for the sole purpose of filling their own pockets, without regard to the impact on Darrah or his entire universe of financial resources.

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[22] The profit potential of an out of the money option, as measured by its delta, is lower than an in-the-money option of the same type. *Sanchez, supra, citing Ferriola v. Kearse-McNeill, supra,* ¶ 23,172 at 50.154-55. Thus any explanation that the purchase of the deep-out-of-the-money options increased Darrah's leverage or allowed him to buy a greater number of contracts -- and Respondents offered no real explanation with respect to the choice of deep-out-of-the-money options -- cannot be justified for a trader whose objective included a reasonable chance of profit with a reduced risk tolerance. *Sanchez, supra.*

[23] Nor is Darrah responsible for any absence of mitigation. The duty to mitigate doesn't arise until complainant becomes aware of the underlying wrongdoing, and the record doesn't reflect that Darrah ever was aware of any issues in his account when he could have liquidated his account at a profit. *See Ferriola, supra, citing Sansom Refining Co. v. Drexel Burnham Lambert, Inc.,* [1987-1990 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,596 at 36,563-64 (CFTC 1990).

D. First American is Responsible for the Acts of its APs.

Section 2(a)(1)(B) of the Act, 7 U.S.C. § 2(a)(1)(B) provides that the "act, omission, or failure of any official, agent, or other person acting for any individual, association, partnership, corporation, or trust within the scope of his employment shall be deemed the act, omission, or failure of such individual, association, partnership, corporation, or trust, as well as of such official, agent or other person." It is undisputed that Salveggi and Allotta were APs acting within the scope of their employment when they defrauded Darrah, churned his account, and pocketed their excessive commissions. As a result, First American is liable for their unlawful conduct.

E. First American and Principals Knowles and Plunkett Failed to Implement the Supervisory or Compliance Structures or Undertake the Actions Required to Comply with Law and Regulations, to Review Trading by the Firm's APs in accordance with their own Internal Rules, and to Comply with the Restraining Order of the United States District Court

Under Section 13(b), 7 U.S.C. § 13c(b), a controlling person may be held liable either where he has failed to act in good faith or where he knowingly induced the violations.[24] *In the Matter of GNP Commodities, Inc., Greenspon, Furlett and Monieson,* [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 25,360 at 39.216 (CFTC 1992), *aff'd in part and modified sub nom. Monieson v. CFTC,* 996. F. 2d 852 (7th Cir. 1993), citing *In re Spiegel,* [1987-1990 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,103 at 34,766 (CFTC 1988). A fundamental purpose of Section 13(b) is to allow the Commission to reach to the controlling individuals of the corporation and to impose responsibility for violations of the Act. *In re JCC, Inc.* [1992-1994

[24] In addition, "to support a finding that a controlling person knowingly induced conduct which violates the Act, "the Division must show that the controlling person had actual or constructive knowledge of the core activities that constitute the violation at issue and allowed them to continue." *JCC, Inc., v. Commodity Futures Trading Commission,* 63 F. 3d 1557, 1568 (1995).

Transfer Binder], Comm. Fut. L. Rep. (CCH) ¶ 26,080 at 41,578, *affirmed, JCC, Inc. v. Commodity Futures Trading Commission,* 63 F. 3d 1557 (1995). *See also In re Apache Trading Corp.* [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 25,251 at 38,796 (CFTC 1992), *appeal dismissed sub nom. Clancy v. CFTC,* No. 92-4708 (11th Cir. 1993).

Respondents Knowles and Plunkett did not act in good faith in establishing and maintaining a compliance structure at First American, in their supervision of the firm's APs, or even in their failure to fulfill their document retention responsibilities. The resultant uncertainty about the conduct of the Respondents' business must be laid unfavorably at the Respondents' door. Plunkett, Director, Principal and AP, implausibly disavowed any role in or knowledge of compliance and supervision at First American. (Tr. 321-342). Knowles refused to testify at all, relying upon his Fifth Amendment privilege. (Tr.344). The Court granted Complainant's motion to consider Knowles' plea as adverse to his interest as a result of his Fifth Amendment assertion. (Tr. 355). Respondents' failure to produce relevant trade documents, to testify meaningfully or at all, to abide by court orders specifically requiring them to maintain and produce records, and to document any relevant supervisory practices at First American ultimately support the finding that supervisory review and compliance procedures were lacking at First American generally and in the case of Darrah's trading. In addition, the testimony of Salveggi strongly supports the view that First American's APs lacked any knowledge of basic compliance and supervisory requirements at the firm.

Moreover, Respondents had constructive knowledge of the ongoing fraudulent practices at First American. As established by the testimony of Darrah's witnesses, Respondents'

solicitation of Darrah and their handling of his funds were not unique.[25] Even the Compliance Manual provided by Respondents contained incomplete directions and provisions. *See* Section 3.02, as reproduced, *supra.* The previous Commission and NFA actions involving Knowles, Allotta and other APs at First American should have suggested the need for stronger rather than the evidently lax compliance structures that existed at the firm. Consequently, Respondents Plunkett and Knowles failed to act in good faith and, as a result of their constructive knowledge of the ongoing fraud at First American, as controlling persons, also induced the violations in this case.

CONCLUSIONS OF LAW

The credible evidence of record, described in the Findings of Fact and Discussion above, mandates the following conclusions of law:

(1) Salveggi's and Allotta's statements to Complainant Darrah were untruthful and intentionally deceitful, and were communicated with the purpose of soliciting Darrah's account and enlisting his participation in trades designed solely to generate commissions for Respondents in violation of CEA Sections 4b(a) and 4c(b), 7 U.S.C. §§ 6b(a) and 6c(b), and Commission Regulation 33.10(a), 17 C.F.R. §33.10(a).

(2) Respondents' trading of the Darrah account was based on fraudulent statements and consequently unauthorized, and also involved inexplicable "as of" and other trades reflecting additional and intentional account mismanagement in violation of the previously cited statutes and regulation .

[25] Respondents also bear responsibility for the inexplicable "as of" trades and other unauthorized trading of T-bond options in Darrah's account. Again, with regard to these trades, Respondents produced no relevant or credible evidence of trading purpose or of supervisory review.

(3) Respondents Salveggi and Allotta churned Darrah's account in violation of Section 4c(b) of the CEA, 7 U.S.C. § 4c(b) and Commission Regulation 33.10(a), 17 C.F.R. § 33.10(a).

(4)Respondent First American is liable pursuant to Section 2(a) (1)(B) of the Act for the acts of its agents acting within the scope of their employment; and

(5) Knowles and Plunkett are "controlling persons" with regard to the violations reviewed here pursuant to Section 13(b) of the CEA.

Respondents' violations of the Commodity Exchange Act and implementing regulations resulted in direct monetary damages to Complainant Darrah in the amount of $1,512,354.48, including $1,050,858.72 in commissions and fees. Darrah opened his account and entered into trading through First American on the basis of false information about First American. Darrah was misinformed or uninformed about the trading strategy employed by First American and its agents, a strategy designed solely to generate commissions and fees for Respondents. Accordingly, Darrah is entitled to judgment for the full extent of his losses rather than merely the "commissions and fees charged" in the context of the churning violations.[26] *See, e.g., Pacific Trading Group v. Global Futures & Forex, Ltd.*, 2004 WL 2591468.

[26] The "usual measure" for damages in consequence of churning violations is stated in *Hinch v. Commonwealth Financial Group* [1996-1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,056.

ORDER

Respondents are ordered to pay to Complainant Darrah $1,512,354.48,[27] the out-of-pocket losses sustained on the account, plus interest at the rate of 1.30 % per annum from June 30, 2003 until this award is paid in full, and the $250.00 filing fee. Respondents are jointly and severally liable for payment of this judgment.

Issued this 28th day of June 2006,

George H. Palmer
Administrative Law Judge

Judith Hutchison
Attorney-Advisor

[27] The computation of "out of pocket loss" was included in Lyman's Cash Flow and Account Equity Analysis. (Lyman Report).