U.S. COMMODITY FUTURES TRADING COMMISSION
Three Lafayette Centre
1155 21st Street, NW, Washington, DC 20581

OFFICE OF
PROCEEDINGS

JOHN C. EMMETT, Complainant	)	
v.	)	CFTC Dkt. No. 95-R135
COMMONWEALTH FINANCIAL GROUP, INC., and ALLAN STEVEN ADER, Respondents	)	

INITIAL DECISION AND REPARATION AWARD

Background: Complainant alleges that respondents inveigled him to purchase numerous commodity futures options by touting the profit potential of heating oil in various seasons, by guaranteeing profits, and by pressuring him to more than quadruple the size of his initial investment through misrepresentations that he could make money regardless of which direction the markets went. Furthermore, complainant contends, respondent Ader took advantage of his inexperience to obtain virtual control over his account to trade in other commodities in order to maximize commissions. Respondents deny any liability.

The record consists of the complaint and respondents' joint answer. Respondents sent discovery requests to complainant, but it appears that no answers were filed. Respondents did not file a motion to compel. An oral hearing in this matter was scheduled, but due to connection problems, did not occur. Thereafter, in light of subsequent developments in Commission caselaw regarding churning in options accounts, it was determined that the parties' documentary submissions were adequate to resolve the matter and the oral hearing was canceled.

Unrebutted allegations: The original complaint included several additional proposed respondents, including the associated person with whom complainant first spoke in deciding to open his account, Louis Conn. The rest of the complaint focuses on the activities of respondent Ader (mislabeled "Alder" in the complaint narrative but correctly spelled on the complaint form itself). The complainant was asked to elaborate as to Mr. Conn's actions if he wished to have him named as a respondent, and he responded by withdrawing Mr. Conn's name as a respondent (as he did two other proposed respondents whose involvement also was not previously demonstrated).

Complainant's allegations regarding the account opening have been reviewed in light of the remaining record, including the solicitation materials he submitted with the complaint. Those statements appear credible and believable. In contrast, respondents did not secure an affidavit from Mr. Conn responding to any of complainant's statements about the solicitation discussions. Accordingly, complainant's statements about the solicitation of his account and his discussions with Mr. Conn are unrebutted.

The solicitation packet: Complainant responded to a television advertisement that extolled, in his words, "the tremendous amount of money that could be made on Heating Oil." He has explained that he was interested because he is a convenience store owner who also sells heating oil, so he was familiar with the seasonal price changes that occur in heating oil. As noted, respondents have not provided any rebuttal to this solicitation allegation. Accordingly, it is determined that complainant was induced into requesting additional information through advertisements made by respondents, or their soliciting agents, that contained an overemphasis on profits possible in heating oil.

Respondents have claimed that complainant was fully apprised of the risks of trading. A review of the solicitation materials is in order to determine whether he was provided with materials that counteracted the profit-expectation engendered by the advertisement.

Complainant submitted with his complaint a packet of solicitation materials on which he wrote a note saying that these materials were sent to him by Commonwealth after he called the "800" number in the advertisement. Included in the Commonwealth packet were a cassette tape recording labeled "Options for Success"; a Commonwealth brochure welcoming investors to "the exciting world of EXCHANGE-TRADED OPTIONS"; a packet of account-opening documents for American Futures Group ("AFG" was the clearing brokerage firm); and Commonwealth's brochure entitled "A SPECIAL REPORT ON HEATING OIL" discussing the seasonal changes in heating oil cash and futures prices. Included in the AFG and Commonwealth packets were standardized risk disclosure documents and a Commonwealth listing of fees and commissions. This latter document shows a $200 commission on options "per round-turn" where the premium cost was $600 and over, but does not disclose that this is the commission cost for ***each*** option; in contrast, the commissions for futures contracts specifically say that the commission charge is "per round-turn contract."

Although it must be noted the documents included in this packet sent to complainant have occasional warnings regarding risk, the evidence is not convincing that complainant was aware of the risks when he made his investment, or that he was aware not to believe any statements that would encourage him to expect profits from his investments. First, as a general matter respondents have not provided any evidence proving their contention that these documents were reviewed or signed by complainant.

Secondly, in the context of the overall solicitation, any such warnings are effectively negated by the emphasis on opportunities for profit that permeate the materials. In fact, the risks are disclosed in a fashion that increases the "act fast" pressure of the solicitation. For example, in a paragraph headed "LET'S TALK RISK" in the basic Commonwealth brochure, the entire discussion of risk is limited to the following paragraph:

LET'S TALK RISK. Exchange-traded options are not for everyone. There is risk. People can and do lose money. When one buys options, the risk is the amount of money that is invested, i.e., the premium, commission and transaction fees. There are no guarantees, but, if options are for you, now is the time to act. All it takes is a simple phone call.

No effective disclosure of risk sufficient to cure comments regarding expectability of profit is possible when the risk warning is worded as "people can and do lose money"--that would be true of almost every investment, including blue-chip securities. Nothing in this "warning" conveyed the exceptionally strong risk of futures-related investments, i.e., the fact that futures options are among the riskiest investments possible. Moreover, it is absurd to expect a risk disclosure to be effective where the risk disclosure ends with both an emphasis on the need to act quickly and a statement indicating that the investor merely has to make a "simple phone call" to participate in the options market. The decision to invest in options on futures should be presented as a complex one, entailing a detailed analysis of the risks. The paragraph could easily have been titled "Let's Go" for all the information it contained.

On the following page of the same brochure, in a question-and-answer section, there is a single question about risk and a two-paragraph answer that mentions the speculative nature of options but again provides no real disclosure:

Q: Is there risk?

A: Certainly. Because of the many variables which can influence prices and market conditions. Exchange-traded options are very speculative, but your risk is limited to the total cost of your option.

Your Account Executive will discuss with you the risks involved in an options purchase. In addition, Commonwealth Financial Group provides you with a full disclosure of the risks of exchange-traded options *in writing*, and this should be read carefully before any purchase is made.

It will be noted that the language "very speculative" is immediately followed by language discussing the "limited" risk in options. More importantly, nothing in this "disclosure" provides even the slightest hint that the potential investor stands a better than even chance of losing on the proposed investment, especially when, as here, the commissions and fees consume as much as a fourth of every purchase.

In combination with the minimal, or perhaps it should be termed oblique and disguised, disclosure of risk, respondents' "Special Report on Heating Oil" is rife with false or misleading statements that would have effectively negated any perfunctory risk disclosures. For someone such as complainant, who responded to the television advertisement because of prior knowledge of heating oil price swings, the "report" was clearly a means to create expectations of profit and to discourage a careful examination of the proposed transactions. As noted above, the "report" does not address options on futures or the historic performance of trading in options markets. Moreover, even the warning "past results are not necessarily indicative of future results" contains an implicit statement that there in fact ***have been*** past successes, when that is not likely in view of the misfocused nature of the statistics (i.e., on futures and cash prices rather than options). Further, the document does not reveal that seasonal price swings will be known to the markets and that options prices will reflect that knowledge. Finally, the final page of the "report" specifically represents that options are the means of "maximizing your profit potential while controlling risk" and are the "ideal way to speculate in these enormously promising markets." That page also discusses the "tremendous profit potential" and the "enormous" "potential for substantial upward price moves," and emphasizes that the time to act is "**NOW!**" (emphasis in original). Thus, the report presents options as "ideal" methods of speculating, and discusses risk as something that can be controlled. In fact, only the total financial exposure is controlled; the chances of success in futures are low and cannot be "controlled" by using options.

The tape recording, entitled "Options for Success," presents a slick oral sales pitch that again overemphasizes profit potential with minimal discussion of risk. The tape begins by talking about the "profit opportunities" that exist in futures trading, and then discusses options as the means of taking advantage of those opportunities while limiting one's losses. The question, "How do I profit from options?" is answered by saying that the process is no more complicated than purchasing or selling common stock--i.e., when the price moves favorably, sell. It does not discuss adverse price moves.

The question, "How are commodities traded as an investment?" is answered by again emphasizing the "opportunities for profit" as being "substantial, as they in other investment opportunities such as stocks or bonds." The tape discusses the possibility that gains from "a few profitable options" "could more than make up for the losses on unprofitable ones." The rest of the tape talks about developing an investment strategy with the broker, the mechanics of opening an account, and similar things. Although the tape mentions that a risk disclosure document will be provided and should be read, there is no mention that options are considered substantially riskier than the other types of investments, stocks and bonds, referred to on the tape.

Discussions with Louis Conn: Complainant received a call from Louis Conn, to whom he explained his "interest in trading on [sic] heating oil only" and with whom he agreed to make a $5,000 heating oil purchase.

Switch to Ader: Statements attached to the complaint (respondents did not submit any documents) reveal that complainant's check for $5,000 was credited to his account on November 3, 1994. This would appear to substantially confirm his statements that he intended to limit his first purchase to $5,000. However, before the first purchase could take place, according to complainant, he was passed from Conn to respondent Ader (the complainant's spelling of Ader's name has been corrected in these quotations):

> A couple of days later I received a call from Mr. Allan Ader. He informed me that he only handled large accounts and urged me to take the opportunity to work with him because he was an expert in the futures market and we could make a large sum of money. I continued to tell how that [sic] I had no experience in this type of market, but

he assured me he could make money. After his persistant [sic] pressure, I agreed to send him an additional $17,000. In a couple days he had this hot tip and needed an additional $5,000.00. Mr. Ader told me he would put 50% of my money on the down side of the market and 50% on the upside of the market. His explanation to this was that if the market increased we made money, if the market decreased we made money. In other words, I couldn't loose [sic].

November 10 trading (20 heating oil puts and calls): The account statements attached to the complaint establish that on November 10, 1994, complainant purchased 5 put options (4900 strike price) in the February 1995 heating oil contract, and 15 call options (5400 strike) in the same contract. The total price of the premiums for these contracts was $17,220, and commissions amounted to an additional $4,000. A "processing fee" of $500 and NFA fees of $1.60 brought complainant's net purchase price for this day's transactions to $21,721.60. At the time of the transaction, complainant had a balance of $5,000, resulting in a deficit in his account of $16,721.60.

Complainant made written notations on his account statements which are considered part of his complaint. On the November 10 statement, he has written that he received the statement on November 18, at which point he started questioning the commissions and processing fees. (The complaint narrative specifically states that he had not been informed of commissions or processing fees until receiving the statement on November 18.) His note also indicates that this statement shows trades made with Ader, and that he "backed out" because he "didn't understand puts, etc."

November 15 T-bond options: Although the complaint narrative itself does not discuss specific transactions after November 10, the statements reveal the trading engaged in, and the written notations on some provide elaboration. On November 15, while complainant's account continued to show a deficit balance of $16,721.60, complainant purchased 7 put options in the March 1995 Treasury Bond contract (92 strike price). These puts cost complainant premiums of $3937.50, commissions of $1,400, the additional processing fee of $175, and NFA fees of $.56, for a total cost of $5,513.06. At the end of the day, complainant's account showed a cash deficit of $22,234.66. The value of his options stood at $15,422.75, resulting in a liquidation value of his account in the amount of negative $6,811.91.

The November 15 statement includes a note that reads:

> Now--Ader starting trading in Bonds--started when Feds raised Int Rates around 11-15-95 [sic]. Bonds would decrease. Bonds actually increased-- JE

Complainant discusses the trading in bonds in paragraph 2 of his complaint narrative:

> Mr. Ader put me in markets such as treasure [sic] bills and bonds which I have never had any experience with what so ever. He was aware of this. This is why he had complete control over my account because he knew of my inexperience with T-bills and bonds. I think that he is guilty of misrepresenting the market to me.

On November 16, 1994, complainant's second check was deposited. This $17,000 check, plus a commission credit of $455 (unexplained, but the numbers translate into a $65 overcharge of commissions on each of the 7 puts), brought complainant's account to a net liquidating value of $10,774.34.

November 17 liquidation of heating oil calls: The 15 heating oil call options were sold on November 17 for $5,985. After fees, the transaction had resulted in a loss of $10,927.40. The account statements themselves do not have any figure revealing the ***net*** outcome of any particular transaction, which can only be arrived at by referring to the November 10 statements and calculating the amount of fees per option since the processing fees for all the trades in a single day are lumped together.

More T-bond puts: On November 18, complainant purchased 6 more puts in the March T-Bond contract, this time at a higher strike price (94). These puts cost $6,000, plus $1,200 in commissions, $150 in processing fees, and NFA fees of $.48, resulting in a total cost of $7,350.48. At the time of the transaction, the complainant had a cash balance in his account of $1,204.14. After the transaction, he had an equity deficit of $6,146.34. The 7 original puts in T-bonds (at the 92 strike price) had fallen in value by approximately $400 when this transaction was made.

By the close on November 18, complainant's account had a net liquidating value of $8,089.94. He had 7 March T-Bond puts (92 strike), 6 March T-bond puts (94 strike), and 5 February Heating oil puts (4900 strike).

A commission adjustment of $390 was credited to complainant's account three days later, on November 21. The liquidating value of the account that day fell to $7,286.91.

Complainant's check for $5,000 (apparently to cover the November 18 purchase of the 6 T-bond puts) was deposited on November 22. That deposit resulted in complainant's cash equity rising to a deficit of only $756.34, and despite the fact that all three of his options positions had lost money since the 18th, the cash deposit caused the net liquidating value of his account to "rise" to $10,887.91. That figure, 12 days after the beginning of trading, represents less than 40% of complainant's total deposits of $27,000.

Liquidation of T-bond positions: On November 23, complainant liquidated the two T-bond positions. The net result of these trades together was a loss of $7,807.17. The last position, the heating oil puts, had a market value at this stage of $2,730, and complainant's total liquidating value (including the cash in the account resulting from the T-bond liquidations) was $6,941.37.

Final transaction: Complainant's heating oil position actually rose in value, and in fact nearly doubled its worth, from this point until it was liquidated on December 2. On that day, he closed out that position by selling his puts for a premium of $4,620. That figure meant that complainant realized a $945 profit on the ***premiums*** of his five heating oil puts, but after commissions, fees and processing fees, he had an overall loss on the trade of $180.80. It will be remembered that originally, complainant intended to trade only $5,000 in heating oil. Had he done so, he would have nearly broken even.

Complainant closed his account and eventually received a check for $8,815.97. Apparently because he wanted his money without additional delays (his complaint indicates he had to call two additional Commonwealth employees before receiving his funds, respondents sent him the check by overnight delivery and charged him a Federal Express fee of $15. Thus, his overall experience (excluding the Federal Express fee) was a loss of $18,184.03 after originally agreeing with Louis Conn to make a heating oil transaction of $5,000.

Respondents' Answer: Respondents deny any wrongdoing. Although they have provided no documentation, they contend that complainant was provided with all required oral and written disclosures necessary to inform him of the risks and mechanics of trading options on futures. In addition, they claim, the complainant was subjected to a compliance review designed to ensure his awareness of the risks and the commissions to be charged. They deny using high-pressure tactics on complainant.

With regard to the November 10 spread transaction, this is the only trading day specifically addressed by respondents in their submission. According to respondents, Ader provided complainant all the information available regarding these transactions, which were based on his "opinion of the markets" and revealed as such to complainant. Ader claims he did not advise complainant to put 50% of his money on each side of the market so he would make money whichever way the market moved. The respondents contend instead:

> What [Ader] did tell Complainant was that it was his recommendation to purchase a few heating oil put options in case the heating oil market did not increase as they hoped it would. However, this still did not mean he would make money on those put options because if the market did not move far enough down, he would lose money on both his call options and his put options. Furthermore, Mr. Ader told Complainant that he had customers that had made money and who had lost money trading in commodity options and that this was a very speculative investment in which one should only invest risk capital that he could afford to lose.

That the trades reflected Ader's "opinion" is the sum total of respondents' rationale for how they managed to lead complainant from a $5,000 investment in heating oil to an $18,000 loss in a matter of weeks.

Respondents also have asserted four specific affirmative defenses, including estoppel (based on alleged failure to complain timely after receiving his account statements); ratification (for the same reason); failure to state a claim; and independent intervening causes of complainant's damages. None of these defenses have been supported with any facts by respondents. These defenses are clearly inapplicable here and are perhaps best viewed as mere reckless overreaching of counsel. Among other things, it is hard to imagine how complainant could be determined to have been under a duty to object more quickly--the account was closed only three weeks and two days after trading began, and within ***two*** weeks of complainant's receipt of his first statement--nor is it clear on what basis respondents argue that allegations of guaranteed profits and churning do not constitute claims.

DISCUSSION

Guaranteed profits/misrepresentation of risks: Complainant has contended that respondents guaranteed profits. This claim included, as noted above, Ader's alleged assurance that he could make money regardless of which way the market went. This claim finds support in the fact that complainant intended to enter the market with only $5,000, but was instead immediately induced into an imperfect spread during the discussions with Ader. That spread vastly increased complainant's exposure to over four times what he initially planned. Moreover, considering that complainant had responded to an advertisement touting seasonal investment opportunities in heating oil, this spread of both puts and calls in the same contract month (thus putting complainant in a position of investing ***against*** his initial market expectations) could well indeed have been the product of the type of win-either-way solicitation charged by complainant.

The written materials and the tape recording all support complainant's claim that he was guaranteed profits. Respondents may not have used the word "guarantee" in discussing the profit expectations they were creating, but there is no doubt that complainant reasonably interpreted their solicitation materials as meaning that profits could be expected. The repeated use of phrases such as "tremendous profit opportunity" and "substantial" profits, the emphasis on the need to act quickly, the blatantly distorted "Special Report" that emphasized 15 years of predictable price swings in markets which have no one-to-one correlation to the vehicles in which complainant was investing, and the emphasis that complainant could take advantage by making a "simple phone call," all combined to vitiate any written risk disclosures and to create the profit expectations to which complainant fell victim.

The conclusion to be drawn from the solicitation misrepresentations, distortions, and omissions engaged in by respondents is that complainant was fraudulently induced to open an options on futures trading account in violation of CFTC Regulation 33.10 and Section 4c(b) of the Commodity Exchange Act.

Churning: In view of the result reached as to the solicitation allegations, no extensive analysis of churning need be separately made because the total of commissions is less than the award for solicitation fraud. However, the record is replete with evidence supporting complainant's churning charges: (1) respondents engaged in a "bait-and-switch" solicitation that initially encouraged complainant to invest a limited amount and then pressured him to invest in a huge spread with over $4,000 in commissions and fees--in other words, almost as much as he had intended to invest when he spoke with Conn; (2) respondents made every options purchase when complainant did not have enough money to pay for the transactions, requiring additional deposits and making complainant's statements only neglibly understandable; (3) respondents placed complainant in a positions where he was betting against himself (15 calls; 5 puts in the same contract) and have offered no plausible explanation whatsoever for how these trades were in keeping with complainant's trading objectives, other than the vague reference to Ader's "opinion of the markets"; (4) the options commission disclosure document did not clearly reveal that the commissions listed were for each option rather than for each option transaction; (5) respondents encouraged complainant to deviate from his original intention of trading heating oil options into trading T-Bond options; (6) respondents captured $7,580 in commissions and "processing fees" in a matter of nine calendar days on an account where the customer had originally intended to risk only $5,000; and (7) respondents obtained ***de facto*** control over the account, as evidenced by complainant's agreement to every proposed trade (including contracts unrelated to the area where he had expressed interest), his reliance on their expertise, and his inability to understand that respondents' proposed trades had little, if any, economic justification.

This case, indeed, contains almost all the elements found to have constituted churning in the recent decision in ***Hinch v. Commonwealth Financial Group, Inc.***, [Current Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ ______ (CFTC May 13, 1997) (CFTC Docket No. 95-R66).

REPARATION AWARD

Violations having been found, respondents Commonwealth Financial Group, Inc., and Allan Steven Ader are ORDERED to pay reparations to the complainant in the amount of $18,184.03, plus prejudgment interest compounded annually at the rate of 5.65% from November 22, 1994, to the date of payment, plus $125.00 in costs. ***LIABILITY IS JOINT AND SEVERAL.***

Dated: June 30, 1997

Joel R. Maillie

JOEL R. MAILLIE
Judgment Officer