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UNITED STATES OF AMERICA
Before the
COMMODITY FUTURES TRADING COMMISSION

FILED

Donald G. Parkhurst,
Complainant,

v.

Ronald L. Guertin and
Smith Barney, Inc.,
Respondents.

CFTC Docket No. 95-R138

Appearances:

James Beckley, Esq. for Complainant;

Sean Coughlin, Esq. for Respondents.

Before: PAINTER, Administrative Law Judge

INITIAL DECISION

Procedural History

Complainant Donald Parkhurst filed this complaint with the Commission on August 21, 1995, alleging that respondents misrepresented the risk of investing in commodities and churned his account, in violation of Section 4c(b) of the Commodity Exchange Act ("Act"). Complainant further alleges that Respondent Smith Barney, Inc. failed to supervise Guertin in

violation of Commission Rule 166.3, 17 C.F.R. § 166.3. As a result of these alleged improprieties, complainant claims that he suffered damages in the amount of \$75,000.00.

Respondents filed a timely answer to the complaint, denying any wrongdoing in connection with the handling of complainant's account. A hearing was held on September 5, 1996, in Chicago, Illinois. Complainant and respondents have filed their post-hearing briefs. This matter is ready for decision.

Findings of Fact

1. **SMITH BARNEY, INC.** ("Smith Barney") was at all relevant times a registered Futures Commission Merchant ("FCM"). (NFA Registration Documents)
2. **RONALD GUERTIN** ("Guertin") was at all relevant times a registered Associated Person ("AP") of Smith Barney. (NFA Registration Documents)
3. **DONALD PARKHURST** ("Parkhurst") lives with his wife in Kankakee, Illinois. (Transcript ["T."] 11, 12) He has been a radiologist for 30 years. (T. 11) At the time he opened the

account at issue, Parkhurst had a liquid net worth of \$2,390,000.00 and an annual income of approximately \$900,000.00.

(T. 37; Answer Ex. 1; Ex. B)

4. In 1969, Parkhurst and Guertin met through a mutual friend, and Guertin became Parkhurst's sole stock broker at Smith Barney.

(T. 14, 56) Parkhurst's investments were primarily in stocks, municipal bonds and mutual funds. (T. 14; Answer 2)

5. In May 1991, Guertin began trading a futures program in his own account, funded with \$100,000.00 of his own money. Guertin described this as the "pilot account." In September 1992 Guertin opened a customer account using this futures program, with discretion vested in Guertin, and this account was traded in accord with the pilot account. (T. 56-60)

6. In September 1993 Parkhurst approached Guertin to inquire into growth opportunities for his investments. (T. 16, 37; Answer

2) Parkhurst had been planning to retire in 1999, and he was concerned that he had not set aside enough to cover his and his ill wife's retirement. (T. 17) Guertin, as per his routine, gave Parkhurst a list of alternatives, one of which was investing in his "managed futures trading program." (T. 15, 16, 49, 57)

Guertin testified that he based his program on "Donchian's four-

week rule,"¹ which took advantage of market trends. (T. 71-72) Guertin testified that he controlled losses by setting stop-loss orders for all transactions except those in cattle futures. (T. 73) He did not place stop-loss orders in cattle futures because he did not want to alert other traders to his positions. However, he did place "mental stops" for the cattle futures. (T. 73)

7. Two months later, in November 1993, Parkhurst invested \$150,000.00 in a futures program managed by Smith Barney and unrelated to Guertin's program. Although the complaint lists a \$13,422.00 loss in the account, the record is devoid of any evidence, or even an allegation, that the loss was the result of wrongdoing on the part of respondents. (T. 32-34)

8. In March 1994, six months after talking to Guertin about new investments, Parkhurst opted to invest \$100,000.00 in Guertin's managed futures trading program. (Complaint 1-2; T. 18-19, 29-30) Parkhurst signed papers leaving all trading decisions and activity to Guertin and he signed risk disclosure statements outlining the risk involved in trading in commodities. (Ex. B; T. 19)

¹ Guertin testified that "Donchian's four-week rule" was a "reversal system where you would purchase on a breakout to the up side, reverse it on a breakout to the down side." (T. 72)

9. Guertin provided Parkhurst with a written summary of the program and a graph showing the two-year success of the pilot account. (Ex. A) The summary included a paragraph on the program's volatility and its "ups and downs." (Ex. A) It also had a paragraph indicating that the program was managed under criteria to minimize risk. (T. 58; Ex. A) The summary stated that the program took advantage of "trends" and "temporary market reversals." (Ex. A)

10. After opening the account, Smith Barney sent a letter reminding Parkhurst that he should only invest at-risk dollars. (T. 41; Ex. B) The letter stated:

Since the risk factor is high in futures trading, only genuine 'risk' funds should be used in such trading. A person who does not have extra capital he or she can afford to lose should not trade in the futures market. No 'safe' trading system has ever been devised, and no one can guarantee you profit or freedom from loss. In fact, no one can even guarantee to limit the extent of your loss.

(Ex. B)

11. Throughout the period that his account was open, Parkhurst received monthly account statements and monthly letters explaining the prior month's activity in the account. (Ex. C, F)

12. Parkhurst admits that he did not spend much time on the correspondence from Guertin or the account statements. (T. 71, 42, 43-47) He was busy with work and caring for his ill wife.

13. Occasionally during the seven months that the commodity account was open, Parkhurst and Guertin met to examine Parkhurst's account documents. (T. 20-21; Ex. E) Parkhurst does not remember exactly what they discussed, but he knows that Guertin "went over each page with [him]" for about one hour. (T. 21)

14. In June 1994 major problems started to occur with Guertin's program. In July, Parkhurst received a telephone call and a letter from Guertin informing him of a large loss in his account for the month of June.² (T. 25; Ex. F) In July Parkhurst lost \$17,000.00. As a result of this loss, Dennis Hess sent Parkhurst an activity letter. (T. 106-09; Answer Ex. 2) In the letter, Hess gave Parkhurst an opportunity to complain about the activity in his account. The letter stated: "If you are in agreement with the activity reflected on your trade confirmations and monthly statements, please sign and return this letter. . . Any

² In his monthly letter, Guertin wrote that because "most accounts ended the month down 30-35%," he decided to make some minor changes in the program to reduce risks of further substantial losses. (Ex. F)

monthly statements, please sign and return this letter. . . Any discrepancies which you believe may exist in your account should be immediately brought to my attention." (Answer Ex. 2)

Parkhurst did not complain about the trading in his account and signed the letter under the statement: "these transactions meet my investment objectives and have been initiated with my full consent and understanding through the discretionary authorization." (Answer Ex. 2; T. 40)

15. In August Guertin informed his clients in the program that he would take time off work to analyze the recent program results and see what changes were possible. (T. 26, 44; Ex. F) He explained that he would continue trading if he could "fix" the program. (Ex. F) Otherwise, he would discard the program and discuss investment alternatives with each client. (Ex. F) On August 15, Guertin sent all of his clients a summary of his modified trading program, which he "backtested" with positive paper trading results.³ (Ex. F)

³ The modified program was renamed "the 82 Program," and used an 8-week "front-weighted moving average" in lieu of the 4-week "break-out signal" to determine price direction. Guertin found that this change worked better in the choppy markets, where the 4-week breakout signal was too sensitive and gave false directional signals. The new program also used a more efficient entry system, assumed a 5% risk exposure rather than a 10% risk exposure, and avoided markets with unusually high or historically high volatility. (Ex. F)

16. Initially, the changes produced positive results. However, by the end of September 1994, after each account suffered large losses, Guertin informed his clients that he would discontinue the program indefinitely. (Ex. F; T. 25-26; A. 4) Guertin closed Parkhurst's managed futures account with a \$27,763.45 loss.

17. Parkhurst never complained about his managed futures account to anyone until after he transferred all of his accounts with Guertin to an unnamed financial advisor. (T. 108, 26-27) Parkhurst's new advisor was not a witness at the hearing. This advisor recommended that Parkhurst file a complaint with the Commission. (T. 27)

18. Guertin testified that orders for his own account and for the account of his brother-in-law were always placed after customer orders were entered, never before. (T. 81-82) Guertin also testified that he would place orders for the managed non-family accounts in a "bunch" order. (Id.) On a few occasions, according to Guertin, there would be price variations, and he attempted to be totally fair in assigning the trades to the managed non-family accounts. (T. 82) The evidence does not establish that Guertin allocated trades to the detriment of Parkhurst.

19. Of the 10 accounts in Guertin's managed futures trading program, all but two were closed at a loss. (T. 64, 67; Ex. K) Guertin's account made a \$25,000.00 profit. Guertin testified that he profited while most of his program clients lost money because he had the "longest-lived" account and the first two years were the most successful. (T. 67-68, 76) This Court finds Guertin to be a credible witness.

20. All accounts were charged the same commission rate, which was printed on the monthly account statements. (T. 66; Ex. C, F) Guertin testified that he told Parkhurst that the commissions would be "significant." (T. 79) Guertin provided a 30% discount on commissions for all customers involved in his program.⁴ (T. 84; Ex. F, I) Commissions in Parkhurst's account totaled \$28,072.40. (Ex. F)

21. Parkhurst and respondents provided expert testimony on the issue of churning. Parkhurst's expert, Linda Frazier, found that the commission-to-equity ratios were as follows:⁵

March 5.59%

⁴ Guertin received an employees commission discount of 40% for all trades in his account. (Ex. F; T. 66)

⁵ She calculated the commission-to-equity ratio in Parkhurst's account by taking the total monthly commission and dividing it by the average daily account equity for each month. Respondent's expert witness, on the other hand, calculated the monthly commission to equity ratio by taking the weighted average of each month. (T. 115; Ex. K)

April	9.86%
May	7.81%
June	14.12%
July	11.16%
August	11.40%
September	18.64%

(Ex. J) Respondents' expert, Michael Loconte, found that the commission-to-equity ratios were as follows:

March	7.16%
April	10.29%
May	7.64%
June	13.64%
July	11.35%
August	12.01%
September	19.61%

(Ex. K) Both experts found that the ratio exceeded 18% in one month only--the last month of trading. This higher ratio is attributed to the program's liquidation costs. In September, all open positions were liquidated with no added capital. (Ex. C)

22. Parkhurst's expert calculated that 31 out of 474 contracts were day trades. (Ex. J) She also found that 45% were transactions held for less than 5 days. (T. 97) Respondents' expert counted 30 contracts out of 483 that were day trades and 73 contracts (23 transactions) that were overnight trades. (Ex. K) He also stated that more than half of all transactions were held for more than one week. (Ex. K)

23. Parkhurst's expert found 10 in-and-out trades. (Ex. J) She defined in-and-out trades as "identical trades entered and liquidated in less than one month." (Ex. J)

24. Dennis Hess, the Smith Barney branch manager, testified that he reviewed the order tickets for the program on a daily basis, reviewed Guertin's correspondence and monthly statements, matched Guertin's strategy to the activity in the accounts, and reviewed commission levels. (T. 101, 102, 103)

Discussion

Parkhurst and Guertin maintained a friendly professional relationship for twenty years prior to the filing of this complaint. During the life of the account at issue, Parkhurst at no time uttered a word of complaint about Guertin's conduct or the status of the account. Parkhurst became dissatisfied with Guertin only when an unnamed financial advisor convinced him to file this complaint and charge misrepresentation, churning, and failure to supervise. To prevail in this matter, Parkhurst has the burden of showing by a preponderance of the evidence that he

sustained monetary damages by reason of wrongdoing on the part of respondents.⁶

Misrepresentation and Nondisclosure

Parkhurst argues that Guertin misrepresented the risks involved in commodity trading, particularly in regard to his managed futures program. He also claims that Guertin misrepresented his expertise in trading commodity futures and his involvement in the program. (Complainant's Post-Hearing Brief ["Complainant's PHB"] at 17, 18)

To prove that Guertin misrepresented the facts, Parkhurst must show that Guertin (1) made a false representation of a material fact, (2) knowing the representation was false and intending that Parkhurst rely on the representation; (3) Parkhurst reasonably relied on that representation; and (4) Parkhurst suffered monetary damage because of his reasonable reliance. Shores v. Sklar, 647 F.2d 462 (5th Cir. 1981).

⁶ In his complaint, Parkhurst listed a \$13,422 loss in the Smith Barney managed program. (See Finding of Fact 7) The record is devoid of even a scintilla of evidence as to any wrongdoing that could have caused this loss. Accordingly, all claims regarding this loss are dismissed.

Parkhurst has failed to prove by a preponderance of the evidence that Guertin misrepresented any material fact. There is no question that Guertin and Smith Barney employees repeatedly warned Parkhurst of the risks involved in commodity trading. The risk was disclosed in the risk disclosure statement signed by Parkhurst, in the summary of the managed futures trading program, and in various letters sent to Parkhurst from Guertin and Smith Barney with the sole purpose of reiterating the risk involved. The first Smith Barney letter spelled out the risk in no uncertain terms, stating that there was no safe or guaranteed trading. (Ex. B) The second Smith Barney letter gave Parkhurst a chance to complain about the large loss in his account. This letter should have given Parkhurst some indication of the risk involved. Parkhurst even testified that he knew that the program engaged in up-and-down trading. (T. 17)

Parkhurst was sufficiently warned of the risks before he elected to participate in the program and during his participation in the program. Respondents cannot be liable for Parkhurst's lack of attention to the numerous warnings and reminders of the risks of investment.

Parkhurst's argument regarding Guertin's misrepresentation of his involvement in the program is unconvincing, as Guertin's

involvement was apparent from his letters to Parkhurst and from the summary of the program. Likewise, Guertin's two-year experience trading in the program was clear from his graph and the summary of the program.

Churning

Churning is defined as a broker's execution of trades in an account that he controls, with a frequency and volume that is excessive for the purpose of generating commissions, without regard for a customer's trading or investment objectives. In re Paragon Futures Ass., [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 25,266 at 38,847 (CFTC April 1, 1992).

Parkhurst must prove three elements to establish a churning claim: (1) Guertin exercised control over Parkhurst's account; (2) Guertin used this control to effect excessive trades for his profit; and (3) Guertin acted in reckless disregard of Parkhurst's interests. Id.

Control

The parties do not dispute that Guertin had control over all trading in Parkhurst's futures account.

Excessive Trading

Parkhurst argues that Guertin traded excessively in light of Parkhurst's trading objectives, and cites five factors which, in the absence of direct evidence, help determine whether a broker excessively traded a customer's account. (Complainant's PHB at 5, citing DeAngelis v. Shearson/American Express, Inc., [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,753 at 31,138 (CFTC Sept. 30, 1985)). It is the relationship between the five factors rather than the independent existence of each factor that helps determine excessive trading. Halterman v. Eastern Capital Corp., [1987-1990 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,222 at 35,036 (CFTC April 15, 1988).

The five factors are: (1) high commission to equity ratio; (2) high percentage of day trades; (3) the broker's departure from an agreed-upon strategy; (4) trading an account while it is undermargined; and (5) in-and-out trading. DeAngelis v. Shearson/American Express, Inc., ¶ 22,753 at 31,138. Parkhurst

has provided meager evidence which is more coincidental than designative of the "specific behavior at issue--trading excessively to generate commissions." In re Paragon Futures Ass., ¶ 25,266 at 38,840, citing Seith v. Van Alen, [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,575 at 30,485 (CFTC Apr. 24, 1985).

A commission-to-equity ratio of 18% or more per month is deemed potentially excessive. In re Lincolnwood Commodities, [1982-1984 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,986 (CFTC Jan. 31, 1984). The two expert witnesses presented different methods of calculating commission-to-equity ratios, but even complainant's calculations do not evince excessive trading. According to Parkhurst, the highest monthly ratio and the only time the ratio exceeded 18% occurred in September when the ratio equaled 18.64%. This does not evince any wrongdoing on the part of respondents. It is attributable to the liquidation of all open positions with no added capital when closing out the program.

Parkhurst next argues that although there was not a high percentage of day trades--there were only 6 day trades (a total of 31 contracts out of 474 total)--45% of the total number of trades were held for less than 5 days. (Ex. J; T. 97)

Respondents' expert counts 6 day trades, 23 overnight trades, and the same percentage of trades held for less than one week. (Ex. K) Again, even if the Court relies on the figures offered by complainant's expert, the Court cannot conclude that there was an excessively high number of day trades or short term trades. Quick turn-overs are consistent with the execution of stop-loss orders, and with managed programs designed to take advantage of temporary market conditions.

Parkhurst argues that respondents departed from an agreed-upon trading strategy by failing to control losses.

(Complainant's PHB at 9) Parkhurst points out that Guertin claimed that, through the use of stop-loss orders, the "risk exposure [would be] 5% to 10% of the original account equity per each future position." (Ex. A) Parkhurst claims that Guertin did not use stop-loss orders consistently and allowed losses to mount in Parkhurst's account. (Complainant's PHB at 9-10)

Respondents assert that Guertin used stop-loss orders for all trades except those in cattle futures. For cattle futures, Guertin had "mental stops." The Court finds that the evidence is consistent with Guertin's imposition of stop-loss orders for all trades except those in cattle futures, and that Guertin had mental stops to control the losses on cattle positions. It is not uncommon in the futures industry for conscientious account

executives to use "mental stops" instead of stop orders to limit losses in some markets. See Holmes v. Wheat Investment Advisors, Inc., [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,653 at 33,699 (CFTC June 8, 1987) (where the Honorable Arthur Shipe noted that stop-loss orders are not "universally employed by responsible traders" because "markets can be manipulated for the purpose of reaching stop-loss orders.")

Parkhurst argues that there were 10 in-and-out trades. In-and-out trading occurs when a broker re-establishes a previously liquidated position with no apparent regard to strategy. Fields v. Cayman Ass., [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,688 at 30,929 (CFTC Jan. 2, 1985). Parkhurst has failed to show through testimony or other means that the ten transactions were made solely to generate commissions. Parkhurst's expert witness defines in-and-out trading as identical trades entered and liquidated within one month. (Ex. J) In the circumstances of the case at hand, a one-month lapse of time contra-indicates in-and-out trading. It is more plausible to attribute these few trades to market conditions rather than unlawful churning by Guertin.

Reckless Disregard of Customer's Interests

Parkhurst also fails to prove by a preponderance of the evidence that Guertin acted in reckless disregard of Parkhurst's interests. Parkhurst's objective was to increase his retirement savings. Guertin suggested several methods to accomplish this objective and after Parkhurst took six months to considered each alternative, he chose to participate in the managed futures trading program. Guertin's program was aimed to achieve significant capital gains and did during the program's first two years. There is no evidence that Guertin acted in reckless disregard of Parkhurst's interests.

Failure to Supervise

In his complaint, Parkhurst argues that respondent Smith Barney failed to supervise Guertin in violation of Commission Regulation 166.3. Rule 166.3 states that "each Commission registrant . . . must diligently supervise the handling by its . . . officers . . . and agents . . . of all commodity interest accounts carried . . . by the registrant and all other activities of its . . . officers . . . and agents . . . relating to its business as a Commission registrant."

Failure to supervise is an independent and primary violation of the Commission Rules, requiring the Court to determine whether Parkhurst established that Smith Barney failed to supervise Guertin even though the Court finds no churning or misrepresentation by respondents. In re Paragon Futures Ass. ¶ 25,266 at 38,849-50 (citing In re Big Red Commodity Corp., [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,623 at 30,667 (CFTC June 7, 1985)). The point of this rule is to protect customers by ensuring that brokers' decisions are reviewed by other officials in the firm. A diligent review by other officials is the main focus of determining a failure to supervise.

In this case, the evidence establishes that Smith Barney diligently reviewed Guertin's trades, the commission amounts, and all correspondence sent by Guertin. Dennis Hess, the branch manager of Smith Barney, sent various letters to Parkhurst reminding him of the risks involved in investing in futures and giving Parkhurst the opportunity to complain about Guertin's handling of the account. Parkhurst never complained.

Respondent Guertin admitted in his testimony that he entered "bunch" orders for the accounts he managed, and allocated the trades in a fair and impartial manner. The entry of bunch orders

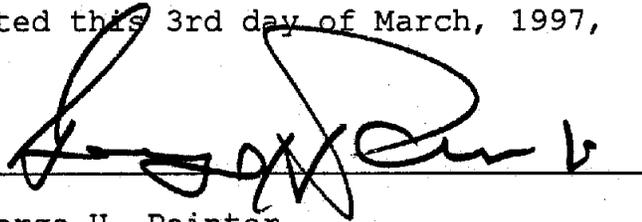
is prohibited by Commission Regulation 1.35. However, Parkhurst made no effort to show that he was damaged by the use of this trading technique, and in this instance there is no nexus between the violation and the losses sustained by Parkhurst.⁷ The use of bunch orders is contrary to law, and nothing in this decision should be construed as approval of the practice.

⁷ Guertin also testified that he always entered and filled his customers' orders before he entered and filled his own. Parkhurst's expert witness analyzed two-weeks of order tickets and concluded Guertin's order "may have been filled before or at the same time as his customers." (Ex. S) However, Parkhurst has failed to show by a preponderance of the evidence that he suffered any monetary losses by reason of such alleged irregularity.

Order

Complainant Parkhurst has failed to establish by the weight of the evidence that he sustained monetary damages by reason of unlawful conduct on the part of Respondents. Accordingly, this matter is **DISMISSED WITH PREJUDICE.**

Dated this 3rd day of March, 1997,

A handwritten signature in black ink, appearing to read "George H. Painter", is written over a horizontal line.

George H. Painter
Administrative Law Judge

Attorney-Advisor:
Elizabeth V. Parker