



### III.

The Commission finds the following:

#### A. SUMMARY

From approximately January 1996 through December 1999 TradeWins, Schmidt and a system developer defrauded clients and prospective clients through material misrepresentations in promotional brochures for the 1995 version of the LSS Day Trading System (“LSS System”). The LSS System, a signal-based computerized commodity futures trading system, was marketed to the public through several versions of direct-mail promotional brochures which touted, without any basis, the potential for large profits which could be realized by using the LSS System. TradeWins sold copies of the LSS System for \$3,400 each.

Schmidt and the system developer designed the promotional brochures to mislead potential customers into believing that the LSS System performance record was based on actual trading when, in fact, the results were derived from hypothetical back-testing. The misrepresentation that the reported performance was based on actual trading was reinforced throughout the promotional brochures by frequent references to the system developer’s purported successful personal day trading using the LSS System. The promotional brochures also failed to include a hypothetical trading disclaimer that conformed to Commission Regulation 4.41(b).

Additionally, the promotional brochures falsely represented that the performance results had been independently audited and verified and invited potential customers to personally review the system developer’s personal account statements. In fact, the firm that conducted the auditing and testing was not at all “independent.” Rather, the firm was compensated on the basis of a percentage of the profits earned from the sale of the LSS System – a material fact that was never disclosed to potential customers.

Finally, an invitation to review the system developer’s personal account statements was never removed from the promotional brochures, even after Schmidt knew that the system developer no longer had most of the statements to show potential customers.

#### B. RESPONDENTS

TradeWins Publishing Corp. is located at 19 Bellemead Avenue, Smithtown, New York 11787, and is a publisher and marketer of investment related books and products, including trading systems. Trade Wins was incorporated in New York in 1994 and has never been registered with the Commission in any capacity. TradeWins funded the development and

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(.... footnote continued)

TradeWins and Schmidt consent to the use of the Offer, or the findings in the Order consented to in the Offer, by any other person or entity in this or any other proceeding. The findings made in the Order are not binding on any other person or entity named as a defendant or respondent in any other proceeding.

marketing costs associated with the LSS System, prepared promotional brochures and performed administrative tasks relating to the sale of the LSS System.

**Stephen A. Schmidt** resides at 4 Tide Mill Lane, Saint James, New York 11780, and is the president of TradeWins. Schmidt has never been registered with the Commission in any capacity. Schmidt was responsible for the preparation and dissemination of the promotional brochures used to market the LSS System that were mailed to prospective customers over a two-year period beginning in late 1995.

### C. **FACTS**

#### 1. **Schmidt's Promotion of the LSS System**

Beginning in late 1995, Respondents designed, oversaw the production of a series of fourteen page promotional brochures that offered the LSS System to the investing public. Additionally, Schmidt financed and maintained exclusive control over direct-mail marketing efforts for the LSS System. The promotional brochures, which contained three basic misrepresentations, were presented in the form of a letter from the system developer, a Commodity Trading Advisor ("CTA"), to investors. These false statements were (i) the system's performance summaries and "track record," dating back to January 1987, were based on actual trading by the system developer of the LSS System and not on hypothetical back-testing; (ii) the system's performance had been audited and verified for accuracy by an independent third-party; and (iii) account statements reflecting actual trading over an eight year period using the LSS System were available in the system developer's office for review by prospective LSS System purchasers. Approximately 375 individuals each paid \$3,400 for the rights to use the software needed for the LSS System to generate signals recommending trades in nine commodity futures markets.

#### 2. **Misrepresentations Concerning the LSS System's Performance, Availability of Account Statements and Independent Verification.**

Based on the misleading nature of the promotional brochures, many subscribers understood that the performance results set forth therein represented actual trading, not simulated or hypothetical results. The promotional brochures led readers to conclude that the LSS System had generated \$1,426,830 in actual day trading profits for the system developer since 1987. The approximately \$1.4 million was touted as representing "real time performance verified on actual tick-data *since* the system was developed, not overoptimized hypothetical past history." In fact, this performance claim was based solely on hypothetical past history, generated through back-testing conducted between 1992 and 1997 by a software writer retained by Schmidt and the system developer. The profit figure of over \$1.4 million appeared in three places on the cover page preceding the actual letter without any accompanying disclaimer indicating that it was derived from hypothetical back-testing. The cover page also included an invitation by the system developer to "duplicate my trading" and, under his picture, the representation that the system "ha[d] been successfully traded, both historically and in actual accounts."<sup>2</sup>

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(Footnote continued . . .)

Repeated claims that the system developer is an active trader appeared throughout the promotional brochures. For example, the promotional brochures called on subscribers to use the LSS System “as I [the system developer] used it to make my profits. So you can duplicate my commodity trading success.” In fact, the system developer’s personal trading successes were considerably more modest than that suggested in the promotional brochures and were concentrated in only two financial futures markets, not in the nine futures markets included in the performance results. The system developer informed prospective subscribers that “LSS is consistent...it’s profitable and it’s working in the markets right now. Like it’s done for me for eight years.” In another attempt to add credibility to the promotional brochures, on the thirteenth page, the capitalized bold-type statement, “**PROVEN SUCCESSFUL IN REAL TIME, ACTUAL TRADING,**” appeared as a heading for text that included a statement that “[t]his system is proven in the real world.” Four monthly account statements purportedly showing profitable trading by the system developer were depicted immediately below the heading and cited text. In fact, most of the performance results reported in the promotional brochures, including the \$1.4 million in trading profits, were based on hypothetical back-testing conducted by the system developer’s software programmer prior to the introduction of the LSS System to the investing public.

Respondents knew that the promotional brochures falsely suggested that performance results were based on the system developer’s actual trading, yet nevertheless he included this material misrepresentation in the promotional brochures that TradeWins widely disseminated. Similarly, Schmidt knew the promotional brochures invited customers to review the system developer’s personal account statements, even after Schmidt knew that the system developer did not have most of the statements to show potential customers.

Respondents represented to prospective customers that “[a]ll the information was independently audited and verified for accuracy by...a leading producer of proprietary commercial software.” Respondents, however, failed to disclose the fact that the purportedly independent firm that had “audited and verified” the performance record was not, in fact, independent. That firm actually received as compensation 30 percent of the profits from the \$3,400 fee paid by each subscriber for the LSS System. The compensation was for software development and back-testing services. Moreover, no auditing was ever performed.

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(.... footnote continued)

<sup>2</sup> The representation that the \$1.4 million results reflected actual trading was reinforced on the second page of the promotional brochures wherein the system developer introduced himself as a “professional futures trader” who made his living “trading the futures markets.” Along similar lines, the brochure highlighted that the system developer and other traders had made “huge profits” and that “his method ha[d] generated results over \$1,400,000.” The two references to the \$1.4 million on this page were not only misleading, but were also not accompanied by either risk disclosure or a cautionary statement explaining the limitations inherent in relying on hypothetical performance results.

### 3. Failure to Include Risk and Hypothetical or Simulated Performance Disclaimers

Respondents failed to adequately disclose the simulated nature of the system developers trading claims in the LSS System promotional brochures. The only significant risk and hypothetical performance disclosure statements appeared in a boxed format on the third and eleventh pages of the promotional brochures, but were not linked to any specific performance claims. These statements along with other limited references within the body of the brochure, failed to adequately disclose which profit claims were based on hypothetical results. Moreover, any possible effect of the limited fine-print risk and hypothetical performance disclosure statements was vitiated by the overwhelming frequency and prominent misrepresentations regarding trading activity and actual profits.

## **D. LEGAL DISCUSSION**

### 1. Respondents Violated Section 4o(1) of the Act and Commission Regulations 4.41(a) and 4.41(b)

The system developer of the LSS System violated Section 4o(1) of the Act and Section 4.41 of the Regulations.<sup>3</sup> Section 4o(1) of the Act prohibits CTA's from: (A) employing any device, scheme or artifice to defraud any client or participant or prospective client or participant, or (B) engaging in any transaction, practice, or course of business which operates as a fraud or prospective client or participant. Section 4.41(a) of the Regulations prohibits a CTA or principal thereof from advertising in a fraudulent or misleading manner. Section 4.41(b)(1)(i) of the Regulations makes it unlawful for a CTA to fail to include the required warnings about the limitations of trading performance numbers based upon hypothetical or simulated data.

The system developer, acting as a CTA,<sup>4</sup> participated in the creation and dissemination through direct-mail of promotional brochures for the LSS System which falsely represented that the performance record reported was based on the system developer's actual trading. Additionally, the promotional brochures falsely stated that the system developer's personal trading account statements were available for review by prospective subscribers, when they were not. The promotional brochures also represented that that the performance record had been audited and tested by an independent firm when, in fact, the firm was compensated on the basis of a percentage of the profits of the profits earned from the sale of the LSS System – a material fact that was never disclosed to potential customers.

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<sup>3</sup> On March 6, 2002, the Commission issued an Order in a related proceeding. *See In the Matter of George Angel*, CFTC Docket No. 02-08, (Order Instituting Proceedings Pursuant to Sections 6(c) and 6(d) of the Commodity Exchange Act, Making Findings and Imposing Remedial Sanctions against George Angell).

<sup>4</sup> Former Section 1(a)(5) of the Act, redesignated as Section 1(a)(6) under the Commodity Futures Modernization Act, defines a CTA as a person who “for compensation or profit, engages in advising others, directly or indirectly or through publications, writings or electronic media as to the value or advisability of trading” in futures or options contracts. The system developer meet this definition because, for a fee, he gave advice to others concerning futures or options contracts. The system developer made recommendations through a computerized trading system that issued specific buy and sell signals to LSS System subscribers.

Finally, the promotional brochures failed to include a hypothetical trading disclaimer that conformed to Commission Regulation 4.41(b).

a. Aiding and Abetting Liability

Under Section 13(a) of the Act, a person aids and abets another's violation if (1) the Act was violated, (2) the person had knowledge of the wrongdoing underlying the violation, and (3) the person intentionally assisted the primary wrongdoer. *In re Nikkiah*, [Current Transfer Binder] Comm. Fut. L. Rep. ¶ 28,129 at ¶49,888 n. 28 (CFTC May 12, 2000); *In re R&W*, [1998-1999 Transfer Binder] Comm. Fut. L. Rep. ¶27,582 at 47,746 (CFTC March 16, 1999), *aff'd in relevant part*, *R&W Technical Services, Ltd., v. Commodity Futures Trading Commission*, 205 F.3d 165 (5<sup>th</sup> Cir.), *cert. denied*, 531 U.S. 817 (2000).

Schmidt engaged in the fraudulent promotion of the LSS System from July 1997 to December 1999. Schmidt designed the layout of the promotional brochures for the LSS System. Schmidt knew that the performance results used in the promotional brochures were based solely on simulated trading, but he did not disclose this fact. He also knew that the system developer was not retaining most of his personal trading account statements and thus the brochure's invitation to prospective customers to review those account statements was misleading. Although the system developer reviewed the promotional brochures immediately prior to their actual dissemination to the public, Schmidt ignored the system developer's requests to not "exaggerate" his trading record and to remove claims that his account statements were available for review in his office by prospective subscribers of the LSS System. Schmidt further knew that the performance results and trading record had not been independently audited or verified. Through his knowledge of the misleading and fraudulent claims in the promotional brochures and his intentional participation in the creation and dissemination to the public of the same, Schmidt aided and abetted the system developer's violations.

Section 4.41(b)(1)(i) of the Regulations makes it unlawful for a CTA to fail to include the required warnings about the limitations of trading performance numbers based upon hypothetical or simulated data and §4.41(b)(2) requires that such statements be "prominently disclosed" if the hypothetical data is presented in writing.

Schmidt violated this Regulation by aiding and abetting the system developer in presenting simulated performance results without prominently accompanying those results with the prescribed cautionary statement in a way designed to effectively reach the reader of the hypothetical results. Although the promotional brochures contained some disclaimer language regarding hypothetical or simulated results, Schmidt and the system developer undermined the effectiveness of the disclaimers by placing them in an unreferenced boxed format at the bottom of the fourth and eleventh pages of a fourteen (14) page promotional brochure, a different location from some of the reported simulated results. *See, e.g., Vartuli v. CFTC*, 228 F.3d 94, 106-107 (failure to have risk disclosure statement accompany the representations to which disclosure was meant to apply results in violation of Commission Regulation 4.41(b)).

b. TradeWins is Liable for Schmidt's Violations of the Act and Regulations Pursuant to Section 2(a)(1)(B)

Section 2(a)(1)(B) of the Act states that “the act, omission, or failure of any...person acting for any individual, association, partnership, corporation, or trust within the scope of his employment or office 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.” Schmidt was the president of TradeWins throughout the period the promotional brochures were created and disseminated. Schmidt acted within the scope of his employment or office in preparing the actual text and design of the promotional brochures. Accordingly, TradeWins is liable as a principal for the actions of Schmidt acting within the scope of his employment or office.

**IV.**

**OFFER OF SETTLEMENT**

Respondents have submitted an Offer of Settlement in which, without admitting or denying the findings herein, and prior to any adjudication on the merits, they acknowledge service of the Order, admit jurisdiction of the Commission with respect to the matters set forth in this Order and for any action or proceeding brought or authorized by the Commission based upon violations or for enforcement of the Order; waive service of a complaint and notice of hearing, a hearing, all post-hearing procedures, judicial review by any court, any objection to the staff's participation in the Commission's consideration of the Offer, any claim of double jeopardy based on the institution of this proceeding or the entry of any order imposing a civil monetary penalty or other relief, and all claims which he may possess under the Equal Access to Justice Act, 5 U.S.C. § 504 (1994) and 28 U.S.C. Section 2412 (1994), as amended by Pub. L. No. 104-121, §§ 231-232, 110 Stat. 862-63, and part 148 of the Commission's Regulations, 17 C.F.R. §§ 148.1, *et seq.* (2000), relating to, or arising from, this action; stipulates that the record basis from which this order is entered consists solely of this Order, including the findings in this Order; and consents to the Commission's issuance of this Order, in which the Commission makes findings, including findings that Respondents violated Sections 40(1)(A) and (B) of the Act and Commission Regulations 4.41(a) and 4.41(b)(1)(i) and orders that they cease and desist from violating the provisions of the Act and Regulations they have been found to have violated; that they pay a civil monetary penalty of one hundred thousand dollars (\$100,000.00) within ten (10) business days of the entry of this Order, and that they comply with their undertakings as set forth below.

**V.**

## FINDING OF VIOLATIONS

Based on the foregoing the Commission finds that Respondents violated Sections 4o(1)(A) and (B) of the Act, 7 U.S.C. §§ 6o(1)(A) and (B), and Commission Regulations 4.41(a) and 4.41(b)(1)(i), 17 C.F.R. §§ 4.41(a) and 4.41(b)(1)(i).

### VI.

#### ORDER

Accordingly, **IT IS HEREBY ORDERED THAT:**

1. Respondents shall cease and desist from violating Sections 4o(1)(A) and (B) of the Act, as amended, and Commission Regulations 4.41(a) and 4.41(b)(1)(i).

2. Respondents shall pay a civil monetary penalty of one hundred thousand dollars (\$100,000), for which they shall be jointly and severally liable, within ten (10) business days of the entry of this Order. Respondents shall make such payment by electronic funds transfer to the account of the Commission at the United States Treasury or by certified check or bank cashier's check made payable to the Commodity Futures Trading Commission and addressed to Dennese Posey, or her successor, Division of Trading and Markets, Commodity Futures Trading Commission, 1155 21<sup>st</sup> Street, N.W., Washington D.C. 20581, under cover of a letter that identifies Respondents and the name and docket number of the proceeding. A copy of the cover letter and the form of payment shall be simultaneously transmitted to Director, Division of Enforcement, Commodity Futures Trading Commission, at the following address: 1155 21<sup>st</sup> Street, N.W., Washington D.C. 20581. and to Charles J. Sgro, Regional Counsel, Division of Enforcement, Commodity Futures Trading Commission, The Newport Office Tower, 525 Washington Boulevard, 21<sup>st</sup> Floor, Jersey City, New Jersey 07031. In accordance with Section 6(e)(2) of the Act, 7 U.S.C. § 9a(2), if Respondents fail to make payment of their penalty within fifteen (15) days of the due date, they shall be automatically prohibited from trading on or subject to the rules of any registered entity as defined in Section 1a(29) of the Act, 7 U.S.C. § 1a(29), until they show to the satisfaction of the Commission that payment of the full amount of the penalty with interest thereon to the date of payment has been made.

3. Respondents shall comply with the following undertakings:

A. Fraudulent Misrepresentations

(1) Respondents shall not misrepresent, expressly or by implication:

(a) the performance, profits or results achieved by, or the results that can be achieved by, users, including themselves, of any commodity futures or options trading system or advisory service; and

(b) the risks associated with trading pursuant to any commodity futures or options trading system or advisory service;

(2) Respondents shall not present the performance of any simulated or hypothetical commodity interest account, transaction in a commodity interest or series of transactions in a commodity interest unless such performance is accompanied by the following statement, as required by 17 C.F.R. § 4.41(b):

Hypothetical or simulated performance results have certain inherent limitations. Unlike an actual performance record, simulated results do not represent actual trading. Also, since the trades have not actually been executed, the results may have under- or over-compensated for the impact, if any, of certain market factors, such as lack of liquidity. Simulated trading programs in general are also subject to the fact that they are designed with the benefit of hindsight. No representation is being made that any account will or is likely to achieve profits or losses similar to those shown.

In doing so, Respondents shall clearly identify those hypothetical or simulated performance results that were based, in whole or in part, on hypothetical or simulated trading results;

(3) Respondents shall not make any representation of financial benefits associated with any commodity futures or options trading system or advisory service without first disclosing, prominently and conspicuously, that futures and options trading involves high risks with the potential for substantial losses;

(4) Respondents shall not represent, expressly or by implication:

(a) the performance, profits or results achieved by, or the results that can be achieved by, users, including themselves, of any commodity futures or options trading system or advisory service;

(b) the risks associated with trading pursuant to any commodity futures or options trading system or advisory service;

(c) that the experience represented by any user, testimonial or endorsement of the commodity futures or options trading system or advisory service represents the typical or ordinary experience of members of the public who use the system or advisory service;

(d) that performance, profits or results have been audited or verified by an independent third party; and

(e) that any trader's account statements are available for inspection by potential subscribers;

unless: (i) they possess and rely upon a reasonable basis substantiating the representation at the time it is made; and (ii) for two (2) years after the date of the dissemination of any such representation, they maintain all advertisements and promotional brochures

containing such representation and all materials that were relied upon or that otherwise substantiated such representation at the time it was made, and make such materials immediately available to the Division for inspection and copying upon request; and

B. Public Statements

Respondents agree that neither they nor any of their agents or employees acting under their authority or control shall take any action or make any public statement denying, directly or indirectly, any findings in the Order or creating, or tending to create, the impression that the Order is without a factual basis; provided, however, that nothing in this provision affects their (i) testimonial obligations; or (ii) right to take legal positions in other proceedings to which the Commission is not a party. Respondents will undertake all steps necessary to assure that all of their agents and employees understand and comply with this agreement.

Unless otherwise specified, the provisions of this Order shall be effective on this date. A copy of this Order shall be served on TradeWins and Schmidt at the addresses set forth in the caption of this Order, on all contract markets, and on the National Futures Association.

By the Commission.

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Jean A. Webb  
Secretary to the Commodity  
Futures Trading Commission

Date: April 4, 2002