

UNITED STATES OF AMERICA
before the
COMMODITY FUTURES TRADING COMMISSION

Clifford W. Hedrick,	*
	*
Complainant,	*
	*
v.	*
	*
Richard Allen Estrada, Farr Financial, Inc.,	*
Will S. McCoy and Richard Allen Estrada	*
d/b/a the Trading Club,	*
	*
Respondents.	*

CFTC Docket No. 05-~~R067~~

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INITIAL DECISION

Appearances:

On behalf of Complainant Clifford W. Hedrick
Clifford W. Hedrick, *pro se*

On behalf of Respondents Richard Allen Estrada, Farr Financial, Inc., Will S. McCoy and
Richard Allen Estrada d/b/a The Trading Club.

Richard E. Nathan, Esq.
123 South June Street
Los Angeles, California 90004

Opinion of Painter, Administrative Law Judge

PROCEDURAL HISTORY

On July 5, 2005, Complainant Clifford Hedrick filed a Complaint against Respondents Richard Allen Estrada, Farr Financial, Inc., Will S. McCoy, and Richard Allen Estrada d/b/a The Trading Club. Complainant alleges that Respondents violated the Commodity Exchange Act and implementing regulations in connection with the solicitation and handling of his account. He further alleges that he sustained direct monetary damages in the amount of \$110,716.20 by reason of the Respondents' unlawful conduct.

Respondents filed timely answers and denied any wrongdoing. Respondents assert that Complainant authorized and ratified each and every trade, and that the account was handled in a lawful manner.

On completion of discovery, the parties filed pre-hearing memoranda. The trial of the matter took place on May 1, 2006, in Kansas City, Missouri.¹ The parties filed post-hearing briefs, and this matter is ready for decision.

Findings of Fact

The Parties

1. Clifford W. Hedrick ("Complainant" or "Hedrick"), 5727 Perryton Street, Bel Aire, Kansas 67220, is an accountant by profession. (Transcript ("Tr") pages 22-23 ("Tr. 22-23")). Prior to the account at issue he had never traded commodity futures or options (Complaint;

¹ The principal documents and items in the evidentiary record include, but are not limited to Hedrick's Complaint and its exhibits, the Transcript of the May 1, 2006 Hearing before this Court, the available account statements, the other exhibits provided by the parties, and the additional submissions requested by the Court during the proceeding.

Respondents' Exhibit 1, Hedrick account opening documents). The Court finds that Hedrick was a rank novice at the time he opened his account with Respondents.

2. Will McCoy ("McCoy" or "Respondent"), NFA ID 0316249, 14602 Sail St., Garden Grove, California 92843, was at relevant times registered as an Associated Person ("AP") with the Trading Club.² He contacted Hedrick at least fourteen times, beginning in early November 2003, by email and telephone. McCoy solicited Hedrick's account for Respondent Farr Financial, Inc., with "conservative" trading models "documenting" hedged trading of corn and Eurocurrency futures and options. (Complaint). The discussions and the models suggested that it was possible to trade safely in the commodity futures and options marketplace. (Complaint). Despite McCoy's absence of trading experience,³ McCoy exercised discretion in trading Hedrick's account. (Complaint, Tr. 14-15, and 17-18, Tr. 135 (McCoy's testimony)).

3. Richard Allen Estrada ("Estrada" or "Respondent"), NFA ID 0283942, 12348 Circula Panorama Pl., Santa Ana, California 92705, is President, Owner, and registered AP and Principal of the Introducing Broker ("IB") and Commodity Trading Advisor ("CTA") The Trading Club ("Trading Club"). Prior to forming the Trading Club, Estrada was an AP with other IBs selling commodity futures and options, including Main Street Trading Company, Bruce S. Pattison, and Tradeline Brokerage Services LLC. (NFA BASIC Records). Estrada established the procedures for the sale of commodity futures and options at the Trading Club (Tr. 139) and was responsible for the supervision of the APs that directly handled the sales and confirmations process for the Trading Club, including McCoy. (Tr. 138-39).

² McCoy's NFA registration is limited to his tenure as an AP at the Trading Club between February 15, 2002 and June 4, 2004.

³ The NFA BASIC records indicate that McCoy lacked the two years of experience requisite for discretionary handling of a customer account.

4. The Trading Club ("Trading Club" or "Respondent"), NFA ID 0293945, located at 3128 East Chapman Avenue #313, Orange, California 92859, is a registered CTA and IB that currently is guaranteed by Dorman Trading LLC. Between April 11, 2003, and December 22, 2005, however, Farr Financial served as the Trading Club's guarantor. (NFA Records). McCoy and Estrada represented the Trading Club in their handling and supervision of Hedrick's account.

5. Farr Financial, Inc. ("Farr" or "Respondent"), NFA ID 0265977, located at 1073 S. Winchester Boulevard, San Jose, California 95128, is a registered "nonclearing" Futures Commission Merchant ("FCM") (Tr. 111) and registered broker dealer that handled trading for the Trading Club, operating, at least in this matter, through Refco as the ultimate clearing agent (Tr. 102, 112). Farr manages records and confirmations electronically and does not provide direct mailing of confirmation and statements to the customers of its IBs. (Tr. 105-110). Farr has been registered in various capacities since 1995, and has been the subject of one arbitration (in which claimants failed to prove their claims) and 12 reparations matters. (NFA BASIC Records). It appears that generally, as a "nonclearing" FCM, Farr cleared through Refco, a division of Man Financial. (Tr. 102, 106, 111-112). Claiming that the IB order is directly routed to clearing firm Refco's order desk in the pit (Tr. 102, 106), Farr alleges that "they're not really Farr orders because it's all done electronically" (Tr. 80). The Court firmly disagrees with Farr's conclusion, and finds that Farr is responsible for the orders placed for Hedrick as a Trading Club customer.

Solicitation and Account Management

6. Will McCoy began his solicitation of Hedrick's account with a telephone call and email by November 3, 2003. (Complaint). McCoy made at least twelve calls to Hedrick before

Hedrick opened his account on December 17, 2003. (Complaint). Over the two and a half month life of the account subsequent to the solicitation, McCoy made only fifteen additional calls to Complainant concerning the trading and management of the solicited account. (Complaint).

7. McCoy emailed "conservative" models of corn and Eurocurrency trading in futures and options that suggested that if a trader lost money one way, he could be assured of making money another way. (Complaint; Estrada email dated November 4, 2003, appended to Complaint; McCoy email dated November 24, 2003, appended to Complaint). Specifically, Respondents mailed Complainant two highly relevant models by email. On November 4, 2003, McCoy forwarded a model labeled "The Trading Club Euro Outlook: Will McCoy," and on November 24, 2003, a model labeled "new position trade/Corn." Both trading models presented the purchase of futures or options as a hedge against the risk of an initial position in futures or options, based on an ongoing assessment of price movements. Hedrick believed his trading in precisely those specific commodities would follow these models and assured his wife that "they would not be risking the whole thing (financial investment) anyway and I felt that their models they had emailed were using conservative trading scenarios because of the way they buy and sell options and futures at the same time, so if one loses the other makes money." (Complaint, emphasis added). Hedrick's assessment of the size of his financial investment was based "upon their model" as well as upon his net worth. (Complaint).

8. Hedrick "knew nothing about commodities whatsoever never had...understood anything about it." (Complaint). His understanding was that he would be entering into an investment strategy involving related trades that would assure "because of the way they buy and sell options and futures at the same time.....if one loses the other makes money." (Complaint). Since he was a novice and because of what he viewed as a complex strategy, Hedrick "totally

relied” on CTA Estrada’s advice to McCoy. (Complaint). “I never gave them any orders (not one) specifically. He always called me and told me ‘I got you into corn today’ telling me of possible gains.” (Complaint; *see also* Tr. 140-41). “I wasn’t watching my account and I wouldn’t no (*sic*) what to do if I was. They did all the trades not me.” (Complaint). “I had no idea McCoy was risking so much in one trade and did not make these risks clear. I was not capable of evaluating risk and had he made it clear, I would never have bore (*sic*) the total account risks. He was recommending and doing all trades on his own.” (Complaint). McCoy acknowledged that all the trading that occurred was based on his recommendations. (Tr. 135).

9. Hedrick never exercised authority with regard to his account until he told McCoy to close it and remit the remainder. (Complaint). Based on his absence of relevant trading experience, and “his understanding that Richard Estrada was a CTA,” he fully trusted McCoy for advice. (Complaint). Respondents acknowledged that the implemented trades were “recommended” trades. (Tr. 25, 98; 135). Although Respondents placed limit orders on his trades, Hedrick did not know the definition or use of a limit order. (Tr. 98).

10. Hedrick alleges that McCoy called frequently but “never called with specific, price, date, time-sensitive quantity amounts.” (Complaint; Tr. 141-2). Respondents allege that they consistently implemented their uniform policy of obtaining agreement on all of the specific points, and following-up with timely confirmations (Tr. 134, 139, 142). On the other hand, Hedrick asserts that he was surprised and confused by the trading and absence of information, stating “I never signed a power of attorney” or “discretionary account” form. “Never did I initiate even one single trade. I knew and still know nothing about commodities – no experience whatever.” (Complaint). Moreover, Hedrick alleges that he never received a single phone call or any information related to certain Eurocurrency trades prior to their purchase. (Complaint).

11. The startlingly incomplete documents provided by Respondents at trial and pursuant to the Court's trial orders are, despite their meagerness, replete with instances of improper or questionable performance by Respondents. The documents reflect the following defects:

(a) Vital documents are missing. For most of the trades, there are no floor order tickets that contain Complainant Hedrick's account number. There are no corresponding floor order tickets for any of the Eurocurrency trades. *See* Tr. 49, 59 (Farr tickets "never actually produced"); June 22, 2006 letter from Farr counsel to Hedrick ("Farr financial has been attempting to obtain copies of the documents reflecting "floor orders" for these transactions from the executing broker but has not been able to obtain them as of yet").

(b) The records reflect mismatched account, trade or sequence numbers. As stated above, almost all of the trade records reflect another account number for an unknown account holder.⁴ The testimony of Farr's CEO, Mark Gay, that an account number will be the same on all the records (Tr. 106), is belied by the entirely inconsistent records of trades allegedly implemented on Hedrick's behalf.⁵ In addition, the Trading Club's office order tickets "are a series" with respect to each individual customer, but are not sequential with all of the Trading Club's ongoing orders.⁶ Respondents were not able to provide the Court with the identification of the executing floor broker and the identification of the accounts on the opposite side of each trade, or with the identity of the clearinghouse. (Tr. 57). There is extensive disagreement

⁴ For example the January 22, 2004 buy and sell order tickets for March 2004 Eurocurrency show an account number of 31892010 when Hedrick's account number was 31820371; the same improper number was used for the January 26 and 27 buy and sell order tickets for March 2004 Eurocurrency. *See Complainant's Post-Hearing Memorandum.*

⁵ In fact, the account numbers on the floor order tickets suggest either that Farr or the Trading Club had an omnibus account and that trades were allocated subsequently, or that trades for another customer were allocated to Hedrick.

⁶ Since the Trading Club used sequential tickets to reflect only the trades attributed to Hedrick, there is no discernable sequence with regard to all of the orders placed by the Trading Club, including any of the orders for other accounts or customers, or for its own account.

between all of the Trading Club and Refco order tickets as to timing and account number, and in many instances, as stated above, there are no order tickets with the requisite account number (Tr. 78).

Respondents failed to comply with the recordkeeping requirements of Commission regulations 1.31 (records and maintenance), 1.32 (segregated account records), 1.33 (monthly and confirmation statements), 1.34 (point balance) and 1.35 (records of specific transactions). The Commission's regulations require FCMs to maintain segregated customer accounts with related records (Rule 1.32), make available monthly and confirmation statements that reflect the open contracts in which the customer's funds have been placed (Rule 1.33), retain daily confirmation statements for each customer reflecting all transactions made at the end of each relevant trading session (Rule 1.33), and IBs and FCMs are required to retain the required records for five years. (Rules 1.31. and 1.35). While there are some recordkeeping exemptions for omnibus accounts carried for other FCMs (Rule 1.33 (c)) and in the case of electronic statements (Rule 1.33 (g)), these exemptions carry their own sets of requirements. There are no recordkeeping provisions relieving Respondents of the responsibility to document their trading of Hedrick's account.

In the suspect circumstances surrounding the peculiar absence of records for Hedrick's account, Respondents were required to acknowledge whether an omnibus account was used for the electronic trading of his funds through Refco, and if so, what allocation methodology was used. (Rule 1.35 (a-5)). Respondents have not acknowledged the use of an omnibus account, continuing to assert that Hedrick's sole account number would be used throughout (Tr. 106). Nor have Respondents produced the independently verifiable allocation methodology and composite data that would be required for use of an omnibus account pursuant to Rule 1.35(a) (5). In the

absence of an omnibus account, Respondents have failed to comply with all of the recordkeeping requirements described above.

(c) The timing of the trading, fills and confirmations appears largely unrelated to any trading order by Complainant. There are problems with the time of recordation. In many instances, there are no times recorded at all. In other instances, the recorded times vary greatly between the records of different Respondents or even internally, in the records of a single Respondent. (Tr. 120-121).⁷ There are missing confirmation calls (Tr. 84). In some instances, the “trade” is placed two days after the alleged “order” (Tr. 85).⁸ Respondents provided insufficient explanations for their recordkeeping omissions, claiming that time stamps were unnecessary because of electronic trading or that it might have been busy on the floor so Refco didn’t “get it (the order) filled to where we could see that it was filled” (Tr. 94); (*See also* the summary of inconsistencies and omissions in Hedrick’s Post-Hearing Brief);

(d) The quantity of commodity futures or options purchased in some trades appears largely unrelated to any trading order by Complainant. *See* Complaint language *supra*; and the summary of omissions and inconsistencies from the Hedrick post-hearing brief;⁹ and

(e) There are price differentials between the Hedrick account and the fill orders.¹⁰

12. To rationalize their account maintenance and recordkeeping violations, Respondents allege that they had received both time and price discretion from Hedrick (Tr. 143-

⁷ *See, e.g.*, the January 14, 2004 buy and sell orders for March 2004 Eurocurrency, where the call was placed on January 13th, but the order was placed on the 14th. *See also* the two day delay between the call and order with regard to the January 15, 2004 March Corn trades. *See* omissions of any time data on the February 19, 20 and 27, 2004 trades. *See* Complainant’s Post Hearing Memorandum.

⁸ *See* n. 7, *supra*.

⁹ *See, e.g.*, January 22, 2004 trades (would have been a sale of 10 and not 3 March 2004 Eurocurrency); January 26 and 27, 2004 trades (would have been a purchase of 12 instead of 3 March Eurocurrency); February 19 and 20, 2004 trades (2004 March Corn tickets show an order of 37 rather than 2). *See* Complainant’s Post-Hearing Memorandum.

¹⁰ *See, e.g.*, the February 19 and 20, 2004 March Corn trades where the Refco ticket showed a price of 2.842 and Hedrick’s account shows a fill at 2.86. Complainant’s Post-Hearing Memorandum.

145), although they did not receive the “discretion” in writing.¹¹ The Court finds that Respondents cannot have it both ways, merging massive recordkeeping failures and the complete absence of an audit trail with defenses of authorization and discretion. The Court draws an adverse inference from the absence of the relevant records, concluding that records were not available because trades were not actually made for Hedrick or were improperly allocated from other accounts.

13. Hedrick “was not capable of evaluating risk and he (McCoy) made it clear “he would never bear the total account risks.” (Complaint). Account statements were not commonly available to Hedrick. Although Mark Gay, CEO of Farr, claimed that Farr posted Hedrick’s account statements online, Farr did not mail statements and confirmations to its customers. (Tr. 103). Hedrick looked at his account online for the purpose of trying to determine the value of his positions (Tr. 63-64, 66-68), but he did not understand or believe that he could actually access his account statements. Hedrick’s conclusion that he could not access trading information is reflected in his March 9, 2004 note to Betty, a financial broker, describing how, after he closed his account, he requested permission and instructions from Farr in order to access and print his statements. (March 9, 2004 Note appended to the Complaint). The note demonstrates Hedrick’s actual or perceived inability to review his limited “online” account statements and confirmations. In the absence of any mailed account statements or confirmations, and in the context of the significant documentary omissions and inconsistencies, the Court finds that it would have been difficult and of questionable value to ascertain the actual status of Hedrick’s account at any given point in time. In fact, since there are no floor order tickets bearing Hedrick’s account number for

¹¹ While Respondents argue that the failure to receive time discretion in writing does not violate Commission Rule 166.2, they fail to note that the very case upon which they rely indicates that the absence of adequate evidence of authorization nevertheless is a violation of Section 4b. *See Dealers Lift Truck Supply Corp. v. Farmer Grain and Livestock Hedging Corp.* [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,155 at 32,385, n. 4 (CFTC 1986).

much of the trading, it is difficult to construe what data provided the basis for any Farr account statements. In addition, the absence of timely phone calls to Hedrick once he started trading ensured his inability to understand or consent to the ongoing course of trading.

14. With regard to credibility, the Court finds that while Hedrick, to his credit, was loath to overstate his case, Complainant credibly alleged that he had not granted Respondents time or price discretion. The Court also finds that Respondents testified dishonestly or inaccurately (*See, e.g.,* Tr. 143). Respondents' assertions that they were granted complete discretion as to timing are not credible. Moreover, Respondents' defense of specific "authorization" is inconsistent with their defense of complete time discretion and their inability to demonstrate that they provided Hedrick with access to information that would have enabled him actually to authorize their questionable trading.¹² As stated previously, Respondents' failure to produce basic records documenting trading on Complainant's behalf and leaving a minimal audit trail are the subject of the Court's adverse inference, and the basis for the Court's conclusion that Respondents failed to trade for Complainant or improperly allocated trades to Hedrick's account.

15. The cumulative credible evidence establishes that:

(A) Hedrick was not a sophisticated investor capable of evaluating futures or options trading strategies, or assessing the strength of ongoing trading, particularly in the absence of accessible or accurate information;

¹² Respondents claim that no substantive reply to Complainant's factual assertions is necessary because Hedrick failed to meet his burden of making his legal arguments adequately. (Respondents' Post-Hearing Reply Memorandum). However, Commission Rules and case law establish that Complainant need only articulate the facts upon which his claim is based rather than plead precise statutes, regulations, and legal theories. *See Haagen v. Goldstein, Stamm, and Chicago Commodity Corporation* [1990-1992 Transfer Binder] Comm. Fut. L. Rep. ¶ 25,297 (C.F.T.C. June 1, 1992), 1992 WL 121896; *Motzek v. Monex International, Ltd., and Roberts* [1992-1994 Transfer Binder], Comm. Fut. L. Rep. ¶ 26,095 (C.F.T.C. 1994); CFTC rules 12.13(b)(iii), 12.13(b)(iv)(A), and 12.18(a)(2).

(B) Respondents controlled the trading of Hedrick's account, and of any other accounts from which trades were allocated to Hedrick;

(C) Respondents improperly solicited Hedrick's account with the false suggestion that they could and would implement hedged or "conservative" trading strategies on his behalf;

(D) Respondents managed the Hedrick account fraudulently or recklessly, by failing to maintain records reflecting the actual trading in the account, by failing to inform Hedrick of any actual trading strategy, and by allocating trades from other accounts to Hedrick's account;

(E) As supervisor and principal, Estrada is a controlling person subject to Section 13(b), 17 U.S.C. § 13c(b), and responsible for his oversight failures related to the solicitation and trading violation.

DISCUSSION

A. Hedrick was not a Sophisticated Commodities Trader

Respondents suggest that because Hedrick is an accountant, he is a sophisticated commodities trader. Respondents' arguments that Hedrick had the capacity to elect the inconsistently recorded, inconsistently disclosed, and somewhat mysterious trading in his account are belied entirely by the fact that Hedrick 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”).

B. Respondents fraudulently solicited Complainant’s business

Section 4b(a) provides “It shall be unlawful (1) for any member of a registered entity, ... for any...agent, or employee of any member, in or in connection with any order to make, or the making of, any contract of sale of any commodity in interstate commerce....(i) to cheat or defraud or attempt to cheat or defraud such other person; (ii) willfully to make or cause to be made to such other person any false report or statement thereof.....; (iii) willingly to deceive or attempt to deceive such other person by any means whatsoever in regard to any such order or contract or the disposition or execution of any such order or contract....; or (iv) to bucket such order, or to fill such order by offset against the order or orders of any other person, or willingly and knowingly and without the prior consent of such person to become the buyer in respect to any selling order of such person, or become the seller in respect to any buying order of such person.”

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, Hedrick 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 Respondents' failure to produce the legally required trade tickets and other evidence documenting their trades on Complainant's -- and not another account's -- behalf -- lead inexorably to the conclusion that in conducting their business, Respondents misled Hedrick as to the nature of the trading and the risks to which they would expose his funds.

Respondents' aggressive presentation of conservative "models" of trading strategies that would moderate risk and loss, and that involved hedged trades of futures and options, misled Hedrick as to the actual trading and risk to which his funds would be exposed. Respondents used the entirety of Hedrick's inheritance and half of his net worth¹³ (Complaint) based on his fraud-induced assumption that he was entering into protective trading that would not place all his funds at risk. (Complaint).

While Respondents provided Hedrick with the standardized disclosure regarding trading in futures and options, they misled him as to their intention and their ability to protect him in the commodity markets by "hedging" strategies. In fact, Respondents did not enter into hedged trades on Hedrick's behalf. While they traded in the corn and Eurocurrency markets -- the

¹³ As stated in his Complaint, Hedrick's actual loss was \$110,716.20, reflecting an initial deposit of \$150,000 less the \$39,284.80 ending value of the account (Complaint).

markets represented in their marketing “models” – their trading was not based on the hedging strategies they advertised. In fact, their trading often was not conducted for Hedrick’s account or at the quantities or prices disclosed to him – in those instances when the quantities and prices or times¹⁴ of trade and fill actually were disclosed.

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 (emphasis added). *See 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).¹⁵ Nor are the Commission’s mandated risk disclosures, contained in form 1.55, a cure for Respondents’ promises of protected trading and limited risk. *R.J. Fitzgerald*, 310 F. 3d 1329.

Respondents’ misrepresentations were material. It is clear that Hedrick’s decision to open an account and enter into trading was based on the disingenuous and improper marketing of the

¹⁴ *See* as an additional example Hedrick’s note on the handwritten accounting statement he appended to his Complaint, in which he said Respondents had promised they “wouldn’t be selling today....(He had) been up all night worrying.”

¹⁵ *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. Of course, in this instance, Respondents actively misled Hedrick as to the protected nature of the trading that would take place.

possibility of conservative trading and ongoing decision making and hedging that could or would protect his investment.

The scienter requirement need not be satisfied by direct evidence. The Complainant

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). Respondents' reckless misrepresentation involving models of limited risk satisfy the "reckless" standard. In addition, Hedrick is far more credible than Respondents. While asserting their total compliance with statute and regulation, and asserting that Hedrick was a liar (Tr. 143), Respondents sold a model of hedged trading while failing to maintain records or even demonstrate actual trading on Hedrick's behalf. Respondents can not produce records documenting the actual trades on Hedrick's behalf, and the handling of his account demonstrates noncompliance with the fundamental rules of net worth, trading limitations, disclosure, and supervision applicable to their work. It is safe to say that Respondents' solicitation was completely inconsistent with Complainant's trading experience.

C. Respondents Controlled and Fraudulently Managed Hedrick's Account

As set forth above, scienter may be established indirectly, and may be satisfied by indirect evidence of recklessness. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976). The absence of trading documents for Hedrick's account, along with his substantiated allegations of unauthorized trading, nondisclosure, and price, quantity, timing, and account identification inconsistencies provide other bases for the conclusion that Respondents fraudulently or recklessly allocated trades to Hedrick's account, misusing his funds for trading on behalf of unknown beneficiaries.

Based upon their own inconsistent production of evidence and the lack of documentation of floor trading for Hedrick's account, Respondents placed orders to the exchange floor without proper account identification in violation of Commission Rule 1.35(a-1) and 1.35(a-1)(2), or improperly allocated trades to accounts they controlled in violation of Section 4b of the CEA.¹⁶

While

merely failing to place account numbers on order tickets is not, in and of itself, a fraudulent act.....failing to place account numbers on order tickets does provide an opportunity to direct profitable fills to favored accounts, and Section 4b of the Act prohibits this type of allocation of winning and losing trades. See *In re Lincolnwood Commodities, Inc., of California*, [1992-1994 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,986 (CFTC Jan. 31, 1984).

In the Matter of GNP Commodities, Inc., Ira P. Greenspon, Norman K. Furlett, and Brian P. Monieson, [1990-1992- Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 25,360 (CFTC August 11, 1992), *aff'd sub nom. Monieson v. CFTC*, 996 F. 2d 852 (7th Cir. 1993).

Moreover, even in the few identifiable circumstances where Respondent Farr, as an FCM, clearing through another FCM, was entitled to use an omnibus account, Farr retained considerable recordkeeping responsibilities. Pursuant to Regulation 1.35(a)(5), at a minimum, Farr had the obligations of informing Complainant of the use of an omnibus account, explaining the allocation methodology, and retaining records sufficient to verify the consistency of their allocation approach. Respondents have neither explained the absence of floor trading documents bearing Hedrick's account number or documented and explained the use of an omnibus account.

It is clear that Respondents controlled the trading in Hedrick'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. *Smith v. Siegel Trading Co.*

¹⁶ Respondents' defenses of mitigation and ratification must fail in light of Complainant's inability to access meaningful account information.

[1980-1982 Transfer Binder] Comm. Fut. L. Rep. ¶ 21,105 at 24,452-53 (CFTC 1980). 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 Hedrick's. *Siegel Trading Co., supra*.

As determined above, the evidentiary record establishes Hedrick's lack of commodity trading experience and sophistication in the realm of commodities trading. In entering into trading through Respondents, Hedrick placed a high degree of trust and confidence, i.e., reliance, in their trading recommendations. To the extent that Respondents actually made recommendations, the recommendations were the sole foundation for entering into any trades attributed to Hedrick's account. It is unclear whether Hedrick had access to meaningful account statements and to the extent he can be viewed as approving anything, Hedrick relied on information that was at a minimum defective as to the price, quantity and timing of trades, and

that reflected trading that may have had no connection to his account or consideration of any related trading strategy.

Respondents controlled the trading of Hedrick's funds and yet cannot explain or document the trading that occurred on his behalf. The absence of order tickets with the proper account number may be sufficient to establish an allocation scheme. Even a broker's failure to inform a customer that he allocated trades at his discretion after receiving the fills on the orders is a material omission in violation of Section 4b of the Act. *Parciasepe v. Shearson, Hayden, Stone Inc.*, [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,464 at 30, 068 (CFTC January 2, 1985). Complainant does not have the "heavy burden of demonstrating the smallest details of(an) allocation scheme." See *In re GNP Commodities, supra*.

In any event, even in the absence of a proven allocation scheme, Respondents violated Section 4g of the Act, which requires IBs and FCMs to make, produce and retain records relating to their customers' transactions and position required by Regulation 1.35(a-1),(a-1)(2), and (a-1)(5).¹⁷ Again, the Commission "need not show that defendants acted with an evil motive or an intent to injure." *CFTC v. Savage*, 611 F. 2d 270, 283 (9th Cir. 1979); *In re JCC, Inc.*, [1992-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,080 at 41,579 (CFTC May 12, 1994), *aff'd sub nom. JCC Inc. v. CFTC*, 63 F. 3d 1557 (11th Cir. 1995). Even without determining whether allocation occurred in the instant case, the Court finds that scienter is established by Respondents' extreme departure from the ordinary standards of care. *CFTC v. R.J. Fitzgerald & Co., Inc., supra*, 310 F. 2d 1321 at 1328. Respondents handled Hedrick's account recklessly,

¹⁷ Section 4g(a) provides in pertinent part that "Every person registered as futures commission merchant, introducing broker, floor broker, or floor trader shall make such reports as are required by the Commission regarding the transactions and positions of such person, and the transactions and positions of the customer thereof, in commodities for future delivery on any board of trade in the United States or elsewhere; shall keep books and records pertaining to such transactions and positions in such form and manner and for such period as may be required by the Commission; and shall keep such books and records open to inspection by any representative of the Commission or the United States Department of Justice."

with total disregard for the outcome, in violation of Sections 4b, 4c(b), and 4g of the CEA and Commission Regulation 33.10.

D. Estrada was a Controlling Person Liable for the Violations of the Act

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.¹⁸ *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 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).

Despite Estrada's testimony, claiming that he exercised ongoing daily supervision (Tr. 138-39), and created a firm compliance structure, the facts in this matter tell a different story. After a year of litigation, and despite several orders for production of their order tickets, Respondents cannot produce the floor order tickets for Hedrick's trades. Nor have they explained or resolved the inconsistencies of account number, price, timing and quantity that are contained

¹⁸ 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).

in those documents that have been produced. The resultant uncertainty about Respondents' management of Hedrick's account must be laid unfavorably at their door. Either Estrada failed to supervise McCoy and ensure appropriate customer disclosure and authorization, trading and recordkeeping procedures or Estrada participated directly in the violations. In either case, Estrada is liable as a controlling person pursuant to Section 13c(b).

(E) The Trading Club is liable for the conduct of McCoy and Estrada pursuant to Section 2(a)(1)(B) of the CEA, 7 U.S.C. § 2(a)(1)(B).

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 McCoy was an AP and Estrada a Supervisory Principal, acting within the scope of their employment when they defrauded Hedrick by their improper solicitation and management of his account. As a result, The Trading Club is liable for their unlawful conduct.

CONCLUSIONS OF LAW

Complainant Hedrick has established by the weight of the evidence that:

- (1) Respondents fraudulently solicited and managed his account in violation of

CEA Sections 4b(a) and 4c(b), 7 U.S.C. §§ 6b(a) and 6c(b), CEA Section 4g, 7 U.S.C. § 6g, and Commission Regulation 33.10 (a) and (c), 17 C.F.R. § 33.10(a) and (c).

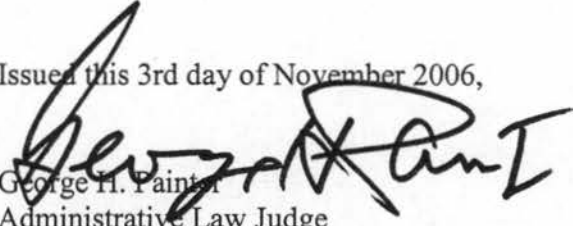
- (2) The Trading Club is liable pursuant to Section 2(a)(1)(B) of the Act for the acts of its agents acting within the scope of their employment.
- (3) Estrada is a controlling person liable pursuant to Section 13 b(c) of the Act.

Respondents' violations of the Commodity Exchange Act and the implementing regulations resulted in direct monetary damages to Complainant Hedrick in the amount of \$ 110,716.20. Hedrick opened his account and entered into trading directed by Respondents McCoy and Estrada based upon their misrepresentations concerning "conservative" models of trading and endured the use of his funds in the absence of required trading information and documentation. Complainant lacked access to a meaningful review of his account. His funds were used in the absence of order records that would reflect any actual trading on his behalf. Respondents created the opportunity for bucketing and allocation, although a beneficiary of the improper trading has not been determined. Since Hedrick's account was fraudulently solicited and traded, and since Respondents have failed to produce records documenting the trading in his account in violation of Commission regulations, Hedrick is entitled to judgment for the full extent of his losses.

ORDER

Respondents McCoy, Estrada, the Trading Club and Farr are ordered to pay to Complainant Hedrick \$ 110,716.20, the out-of-pocket losses sustained on his account, plus interest at the rate of 5.05% per annum from July 5, 2005 until this award is paid in full, and the \$250.00 filing fee. Respondents are jointly and severally liable for the payment of this judgment.

Issued this 3rd day of November 2006,


George H. Painter
Administrative Law Judge

Judith Hutchison
Attorney-Advisor

Brian O'Neill
Extern/Trading Analyst