

UNITED STATES OF AMERICA
Before the
COMMODITY FUTURES TRADING COMMISSION

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12:56 pm, Nov 14, 2017

In the Matter of:

**INTL FCStone Financial Inc. and
FCStone Merchant Services LLC,**

Respondents.

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) **CFTC Docket No. 18-05**
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**ORDER INSTITUTING PROCEEDINGS PURSUANT TO
SECTIONS 6(c) AND 6(d) OF THE COMMODITY EXCHANGE ACT,
MAKING FINDINGS AND IMPOSING REMEDIAL SANCTIONS**

I.

The Commodity Futures Trading Commission (“Commission”) has reason to believe that INTL FCStone Financial Inc. (“FCStone Financial”) and its affiliate FCStone Merchant Services LLC (“FCStone Merchant”) (collectively, “Respondents”) violated Section 4c(a)(1) and (2) of the Commodity Exchange Act (“Act”), 7 U.S.C. § 6c(a)(1) and (2) (2012), and Commission Regulation (“Regulation”) 1.38, 17 C.F.R. § 1.38 (2017), and that FCStone Financial also violated Regulation 166.3, 17 C.F.R. § 166.3 (2017). Therefore, the Commission deems it appropriate and in the public interest that public administrative proceedings be, and hereby are, instituted to determine whether Respondents engaged in the violations set forth herein and to determine whether any order should be issued imposing remedial sanctions.

II.

In anticipation of the institution of an administrative proceeding, Respondents have submitted an Offer of Settlement (“Offer”), which the Commission has determined to accept. Without admitting or denying any of the findings or conclusions herein, Respondents consent to the entry of this Order Instituting Proceedings Pursuant to Sections 6(c) and 6(d) of the Commodity Exchange Act, Making Findings and Imposing Remedial Sanctions (“Order”) and acknowledge service of this Order.¹

¹ Respondents consent to the entry of this Order and to the use of these findings in this proceeding and in any other proceeding brought by the Commission or to which the Commission is a party; provided, however, that Respondents do not consent to the use of the Offer, or the findings or conclusions in this Order consented to in the Offer, as the sole basis for any other proceeding brought by the Commission, other than in a proceeding in bankruptcy or to enforce the terms of this Order. Nor do Respondents consent to the use of the Offer or this Order, or the findings or conclusions in this Order consented to in the Offer, by any other party in any other proceeding.

III.

The Commission finds the following:

A. SUMMARY

On numerous occasions between December 2013 and March 2014 (“Relevant Period”), FCStone Merchant, acting by and through its employees, entered into multiple exchange of futures for physical transactions (“EFPs”) with a counterparty, and FCStone Financial, acting by and through its employees, reported these trades to the Chicago Mercantile Exchange (“CME”) as exchange for related position transactions (“EFRPs”). However, those EFPs were invalid EFRPs because they lacked the necessary corresponding and related cash, over-the-counter (“OTC”) swap, OTC option, or other OTC derivative (collectively, “cash or OTC derivative”) positions. As a result, the futures trades were executed noncompetitively and not in accordance with the CME rules governing EFRPs. Therefore, the trades constituted fictitious sales and resulted in non-bona fide prices being reported to the CME in violation of Section 4c(a)(1) and (2) of the Act and Regulation 1.38(a). Respondents also violated Regulation 1.38(b) by improperly designating the transactions at issue as EFRPs on certain documentation pertaining thereto.

In addition, FCStone Financial failed to diligently supervise its employees that executed, handled, and processed the transactions at issue during the Relevant Period. Specifically, FCStone Financial failed to (1) have adequate policies and procedures designed to detect and deter fictitious sales and the reporting of non-bona fide prices, (2) confirm that the purported EFRPs met the CME requirements for EFRPs, and (3) provide sufficient training to its employees regarding EFRPs. As a result, FCStone Financial violated Regulation 166.3.

B. RESPONDENTS

INTL FCStone Financial Inc. is a registered futures commission merchant (“FCM”) with its headquarters located in Chicago, Illinois. FCStone Financial reported the EFRPs at issue to the CME.

FCStone Merchant Services LLC is an affiliate of FCStone Financial. FCStone Merchant’s customers include the producers, processors, and end users of numerous commodities. FCStone Merchant was a counterparty to the EFRPs at issue in this matter. FCStone Merchant is not registered with the Commission in any capacity.

C. FACTS

On numerous occasions throughout the Relevant Period, FCStone Merchant executed purported EFPs with a counterparty whereby Canadian Dollar (“CAD”) futures were simultaneously exchanged for physical canola seed. However, because CAD futures and physical canola seed are not related products, FCStone Merchant improperly designated those trades as EFRPs and FCStone Financial improperly reported those trades to the CME as valid EFRPs. In addition, FCStone Financial did not have supervisory procedures in place to prevent, detect, or deter the transactions at issue.

1. FCStone Merchants Engaged in Noncompetitive Trading and FCStone Financial Improperly Reported the Trades as EFRPs

On multiple occasions throughout the Relevant Period, FCStone Merchant entered into a complex series of transactions with a counterparty to assist the counterparty in financial inventory storage costs associated with canola production and to limit the counterparty's currency risk.² Part of this series of transactions involved the purported EFPs at issue, which involved the simultaneous exchange of CAD futures and physical canola seed. As a result, the EFPs at issue lacked the requisite exchange of related cash or OTC derivative positions. Simply put, CAD futures and physical canola seed are not related. Nevertheless, FCStone Merchant improperly designated these trades as EFRPs and transmitted the trade documentation and clearing information to FCStone Financial. Relying solely on this improper designation, FCStone Financial reported non-bona fide CAD futures trades to the CME as valid EFRPs without confirming that each EFP was comprised of CAD futures that were simultaneously exchanged for a corresponding and related cash or OTC derivative position.

2. FCStone Financial Had Inadequate Supervisory Systems and Internal Controls

FC Stone Financial failed to have an adequate supervisory system in place with regard to the execution, handling, and reporting of EFRPs during the Relevant Period. In general, FCStone Financial failed to have sufficient surveillance controls to identify trades improperly designated as EFRPs. Specifically, FCStone Financial failed to determine that the EFPs at issue had the necessary corresponding and related cash or OTC derivatives position required for EFRPs. In addition, FCStone Financial failed to ensure that the EFPs at issue were documented properly. FCStone Financial also failed to ensure that its employees involved in the execution, handling, and processing of EFRPs understood the nature of an EFRP and the requirements for executing, handling, and processing valid EFRPs. As a result of these supervisory and internal control failures, FCStone Financial did not detect the noncompetitive execution of the CAD futures trades and the improper designation of the EFPs as valid EFRPs described herein during the Relevant Period.

IV.

LEGAL DISCUSSION

A. Respondents' Noncompetitive Trading Violated Section 4c(a)(1) and (2) of the Act and Regulation 1.38

Section 4c(a)(1) and (2) of the Act generally prohibits noncompetitive trades including, among other things fictitious sales and the reporting of non-bona fide prices. "By enacting Section 4c(a), Congress sought to 'ensure that all trades are focused in the centralized marketplace to participate in the competitive determination of the price of the futures contracts.'"

² Specifically, FCStone Merchants knowingly entered into and FCStone Financial reported the EFPs at issue with the intent to negate the counterparty's Canadian Dollar /U.S. Dollar currency risk. This currency risk arose from the counterparty's canola futures trades placed on ICE Futures Canada (priced in Canadian Dollars), and its CAD futures trades placed on the CME (priced in U.S. Dollars) in a quantity that corresponded to the value of the underlying physical canola seed exchanged.

In re Thomas Collins, CFTC No. 94-13, 1997 WL 761927, at *6 (Dec. 10, 1997) (quoting S. Rep. No. 93-1131, at 5857 (1974)). Although the term “fictitious sales” is not specifically defined in the Act, “the central characteristic of the general category of fictitious sales, is the use of trading techniques that give the appearance of submitting trades to the open market while negating the risk or price competition incident to such a market.” *In re Harold Collins*, CFTC No. 77-15, 1986 WL 66165, at *7 (Apr. 4, 1986), *rev’d on other grounds sub nom. Stoller v. Commodity Futures Trading Comm’n*, 834 F.2d 262 (2d Cir. 1987). “[P]rice competition or market risk is negated when it is reduced to a level that has no practical impact on the transaction at issue.” *In re Gimbel*, CFTC No. 84-20, 1988 WL 232267, at *1 n. 7 (Apr. 14, 1988). If a person attempts to evade the risks and price competition of the open market, such trading schemes are generally prohibited as fictitious sales pursuant to Section 4c(a) of the Act. *See Merrill Lynch Futures Inc. v. Kelly*, 585 F. Supp. 1245, 1251 n.3 (S.D.N.Y. 1984) (Section 4c(a)(A) of the Act was “intended generally to prevent collusive trades conducted away from the trading pits.”).

Specifically, Section 4c(a)(1) and (2) of the Act makes it unlawful for any person to enter into or confirm the execution of a transaction that is a fictitious sale and to cause any price to be reported, registered, or recorded that is not a true and bona fide price. When the transaction is non-bona fide, the prices reported for such transactions are also non-bona fide. *See In re Gilchrist*, CFTC No. 83-58, 1991 WL 83518, at *9 (Jan. 25, 1991) (finding violations of Section 4c(a)(B) of the Act and Regulation 1.38 when non-bona fide prices were reported to CME). In fact, the prices reported on unlawfully executed noncompetitive trades are non-bona fide even if they accurately reflect the prices agreed upon by the parties and the current price for similar contracts traded on exchange. *Id.* Thus, Section 4c(a)(1) and (2) of the Act broadly prohibits trades intended to avoid the risks and price competition of the open market.³

Similarly, Regulation 1.38(a) requires that all purchases and sales of futures be executed “openly and competitively.” “The purpose of this requirement is to ensure that all trades are executed at competitive prices and that all trades are directed into a centralized marketplace to participate in the competitive determination of the price of futures contracts.” *In re Absa Bank, Ltd.*, CFTC No. 14-30, 2014 WL 4793544, at *3 (Sept. 25, 2014). However, this general requirement “shall not apply to transactions which are executed noncompetitively in accordance with written rules of the contract market . . . specifically providing for the noncompetitive execution of such transactions.” *See* 17 C.F.R. § 1.38(a). In addition, Regulation 1.38(b) recognizes that such transactions allowed by exchanges may include the exchange of futures for cash commodities or in connection with cash commodity transactions, but requires such transactions and all orders, records, and memoranda pertaining thereto to be designated as such.

Yet even when noncompetitive trading is allowed by exchange rules, failure to follow those rules results in such trading being fictitious and in violation of Section 4c(a)(1) and (2) of the Act. *See In re JSC VTB Bank*, CFTC No. 16-27, 2016 WL 5224443, at *4 (Sept. 19, 2016)

³ In order to establish a violation of Section 4c(a) of the Act, the Commission also must demonstrate that a person knowingly participated in transactions initiated with intent to avoid a bona fide market position. *See Harold Collins*, 1986 WL 66165, at *3-4. However, “knowledge cannot be eliminated by willfully or carelessly induced ignorance.” *Commodity Futures Trading Comm’n v. Savage*, 611 F.2d 270, 284 (9th Cir. 1979).

(finding block trades conducted in violation of exchange rules were unlawful noncompetitive trades); *see also In re Vojtek*, CEA No. 99, 22 Agric. Dec. 778, 785-86 (1963) (determining futures contracts traded off-exchange that did not meet specific rules of the contract market exceptions constituted fictitious sales).

In addition, Regulation 38.500(b) permits an exchange to authorize certain EFRPs, including EFPs, that are executed noncompetitively. *See* 17 C.F.R. § 38.500(b) (2017). To that end, CME Rule 538 authorizes EFRPs so long as particular requirements are met. Pursuant to CME Rule 538, an EFP is defined as a privately negotiated, off-exchange transaction that involves the “the simultaneous execution of an Exchange futures contract and a corresponding physical transaction or a forward contract on a physical transaction.”

As its name suggests, the futures contract and the physical commodity exchanged in an EFRP must be related. *See* CME Rule 538. Specifically, CME Rule 538.C states that “[t]he related positions component of an EFRP must be the cash commodity underlying the Exchange contract or a by-product, a related product or an OTC derivative instrument of such commodity that has a reasonable degree of price correlation to the commodity underlying the Exchange contract. . . .” Moreover, the Commission has found that Section 4c(a) and Regulation 1.38 are violated when noncompetitive futures trades are reported to an exchange as EFRPs when in fact the trades lacked the corresponding and related cash or OTC derivative positions. *See In re Morgan Stanley & Co., LLC*, CFTC No. 12-22, 2012 WL 3262462, at *5 (June 5, 2012) (finding EFRPs lacking related positions violated exchange rules and were fictitious sales).

Under CME Rule 538.C, CAD futures and physical canola seed are not “corresponding and related” positions. Therefore, the EFPs at issue were invalid EFRPs, and thus fictitious sales. By knowingly entering into and improperly designating the EFPs as valid EFRPs, Respondents caused non-bona fide CAD futures prices to be reported to the CME. Accordingly, Respondents violated Section 4c(a)(1) and (2) of the Act and Regulation 1.38.

B. Respondents Are Liable for Their Respective Employees’ Acts and Omissions

The foregoing acts, omissions, and failures of Respondents’ employees occurred within the scope of their employment, office, or agency with either FCStone Financial or FCStone Merchant; therefore, pursuant to Section 2(a)(1)(B) of the Act, 7 U.S.C. § 2(a) (2012) and Regulation 1.2, 17 C.F.R. § 1.2 (2017), Respondents are liable for those acts, omissions, and failures in violation of Section 4c(a)(1) and (2) of the Act and Regulation 1.38.

C. FCStone Financial’s Supervision Failures

Regulation 166.3 requires each registered FCM to diligently supervise the handling by its partners, officers, employees, and agents of all commodity interests carried and other activities relating to the business as a Commission registrant. A violation of Regulation 166.3 is demonstrated by showing either that: (1) the registrant’s supervisory system was generally inadequate; or (2) the registrant failed to perform its supervisory duties diligently. *See In re GNP Commodities, Inc.*, CFTC No. 89-1, 1992 WL 201158, at *18-19 (Aug. 11, 1992) (providing that, even if an adequate supervisory system is in place, Regulation 166.3 can still be violated if the supervisory system is not diligently administered); *In re Paragon Futures Assoc.*, CFTC No. 88-18, 1992 WL 74261, at *14 (Apr. 1, 1992) (“...[T]he focus of any proceeding to determine

whether Rule 166.3 has been violated will be on whether [a] review [has] occurred and, if it did, whether it was diligent.”) (internal quotation omitted); *Sansom Refining Co. v. Drexel Burnham Lambert, Inc.*, CFTC No. 82-R448, 1990 WL 282783, at *11 (Feb. 16, 1990) (noting that, under Regulation 166.3, an FCM has a “duty to develop procedures for the detection and deterrence of possible wrongdoing by its agents.”) (internal quotation omitted). Evidence of violations that “should be detected by a diligent system of supervision, either because of the nature of the violations or because the violations have occurred repeatedly,” is probative of a failure to supervise. *Paragon Futures*, 1992 WL 74261, at *14. Moreover, the Commission has found violations of Regulation 166.3 where an FCM improperly documented EFRPs and failed to confirm that the trades designated as EFRPs were executed simultaneously with a cash or OTC derivative position before reporting the trades to the exchange. *See Morgan Stanley & Co.*, 2012 WL 3262462, at *7.

Here, FCStone Financial lacked an adequate system to supervise the execution, handling, and processing of EFRPs and thus violated Regulation 166.3. Specifically, FCStone Financial failed to verify that the EFRPs at issue had the necessary corresponding and related cash or OTC derivatives positions required for EFRPs before they were reported to the CME. In addition, FCStone Financial lacked adequate procedures and surveillance systems to monitor EFRPs and identify trades incorrectly or improperly designated as EFRPs. Finally, FCStone Financial failed to ensure that its employees involved in EFRPs received adequate training regarding the requirements for executing, processing, and handling valid EFRPs. Accordingly, FCStone Financial failed to exercise diligent supervision in violation of Regulation 166.3.

V.

FINDINGS OF VIOLATION

Based on the foregoing, the Commission finds that, during the Relevant Period, Respondents violated Section 4c(a)(1) and (2) of the Act and Regulation 1.38, and FCStone Financial violated Regulation 166.3.

VI.

OFFER OF SETTLEMENT

Respondents have submitted the Offer in which they, without admitting or denying the findings and conclusions herein:

- A. Acknowledge receipt of service of this Order;
- B. Admit the jurisdiction of the Commission with respect to all matters set forth in this Order and for any action or proceeding brought or authorized by the Commission based on violation of or enforcement of this Order;
- C. Waive:
 1. The filing and service of a complaint and notice of hearing;

2. A hearing;
 3. All post-hearing procedures;
 4. Judicial review by any court;
 5. Any and all objections to the participation by any member of the Commission's staff in the Commission's consideration of the Offer;
 6. Any and all claims that they may possess under the Equal Access to Justice Act, 5 U.S.C. § 504 (2012) and 28 U.S.C. § 2412 (2012), and/or the rules promulgated by the Commission in conformity therewith, Part 148 of the Regulations, 17 C.F.R. §§ 148.1-30 (2017), relating to, or arising from, this proceeding;
 7. Any and all claims that they may possess under the Small Business Regulatory Enforcement Fairness Act of 1996, Pub. L. No. 104-121, §§ 201-253, 110 Stat. 847, 857-868 (1996), as amended by Pub. L. No. 110-28, § 8302, 121 Stat. 112, 204-205 (2007), relating to, or arising from, this proceeding; and
 8. Any claims of Double Jeopardy based on the institution of this proceeding or the entry in this proceeding of any order imposing a civil monetary penalty or any other relief;
- D. Stipulate that the record basis on which this Order is entered shall consist solely of the findings contained in this Order to which Respondents have consented in the Offer;
- E. Consent, solely on the basis of the Offer, to the Commission's entry of this Order that:
1. Makes findings by the Commission that Respondents violated Section 4c(a)(1) and (2) of the Act and Regulation 1.38;
 2. Makes findings by the Commission that FCStone Financial violated Regulation 166.3;
 3. Orders Respondents to cease and desist from violating Section 4c(a)(1) and (2) of the Act and Regulation 1.38;
 4. Orders FCStone Financial to cease and desist from violating Regulation 166.3;
 5. Orders Respondents to pay, jointly and severally, a civil monetary penalty in the amount of two-hundred eighty thousand Dollars (\$280,000), plus post-judgment interest within ten (10) days of the date of entry of this Order; and
 6. Orders Respondents to comply with the conditions and undertakings consented to in the Offer and as set forth in Part VII of this Order.

Upon consideration, the Commission has determined to accept the Offer.

VII.

ORDER

Accordingly, IT IS HEREBY ORDERED THAT:

- A. Respondents shall cease and desist from violating Section 4c(a)(1) and (2) of the Act and Regulation 1.38.
- B. FCStone Financial shall cease and desist from violating Regulation 166.3.
- C. Respondents shall pay, jointly and severally, a civil monetary penalty in the amount of two hundred-eighty thousand Dollars (\$280,000) (“CMP Obligation”), plus post-judgment interest, within ten (10) days of the date of the entry of this Order. If the CMP Obligation is not paid in full within ten (10) days of the date of entry of this Order, then post-judgment interest shall accrue on the CMP Obligation beginning on the date of entry of this Order and shall be determined by using the Treasury Bill rate prevailing on the date of entry of this Order pursuant to 28 U.S.C. § 1961 (2012).

Respondents shall pay the CMP Obligation by electronic funds transfer, U.S. postal money order, certified check, bank cashier’s check, or bank money order. If payment is to be made other than by electronic funds transfer, then the payment shall be made payable to the Commodity Futures Trading Commission and sent to the address below:

Commodity Futures Trading Commission
Division of Enforcement
ATTN: Accounts Receivables
DOT/FAA/MMAC/AMZ-341
CFTC/CPSC/SEC
6500 S. MacArthur Blvd.
Oklahoma City, OK 73169
(405) 954-7262 office
(405) 954-1620 fax
nikki.gibson@faa.gov

If payment is to be made by electronic funds transfer, Respondents shall contact Nikki Gibson or her successor at the above address to receive payment instructions and shall fully comply with those instructions. Respondents shall accompany payment of the CMP Obligation with a cover letter that identifies the paying Respondents and the name and docket number of this proceeding. The paying Respondents shall simultaneously transmit copies of the cover letter and the form of payment to the Chief Financial Officer, Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street, NW, Washington, D.C. 20581.

- D. Respondents and their successors and assigns shall comply with the following conditions and undertakings set forth in the Offer:

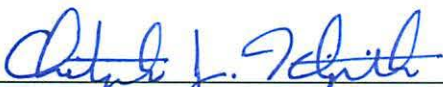
1. Public Statements: Respondents agree that neither they nor any of their successors and assigns, agents, or employees under their authority or control shall take any action or make any public statement denying, directly or indirectly, any findings or conclusions in this Order or creating, or tending to create, the impression that this Order is without a factual basis; provided, however, that nothing in this provision shall affect Respondents: (i) testimonial obligations; or (ii) right to take legal positions in other proceedings to which the Commission is not a party. Respondents and their successors and assigns shall undertake all steps necessary to ensure that all of their agents and/or employees under their authority or control understand and comply with this agreement.
2. Cooperation with the Commission: Respondents shall cooperate fully and expeditiously with the Commission, including the Commission's Division of Enforcement, and any other governmental agency in this action, and in any investigation, civil litigation, or administrative matter related to the subject matter of this action or any current or future Commission investigation related thereto.
3. Partial Satisfaction: Respondents understand and agree that any acceptance by the Commission of any partial payment of Respondents' CMP Obligation shall not be deemed a waiver of their obligation to make further payments pursuant to this Order, or a waiver of the Commission's right to seek to compel payment of any remaining balance.
4. Change of Address/Phone: Until such time as Respondents satisfy in full their CMP Obligation as set forth in this Order, Respondents shall provide written notice to the Commission by certified mail of any change to their telephone numbers and mailing addresses within ten (10) calendar days of the change.
5. Additional Undertakings:
 - a. FCStone Financial internally reviewed its general EFRP practices and retained two third party consultants to review its EFRP practices and policies. FCStone Financial will continue to consult with its retained consultants to further identify deficiencies in its processes and controls with the following objectives:
 1. To develop stronger and additional internal controls and processes to detect and deter the noncompetitive execution of futures trades and improper designation and reporting of trades as EFRPs to the CME, including, but not limited to, requiring new documentation and procedures for exercising due diligence as to the bona fide nature of the EFRP transactions it submits to the CME; and
 2. To enhance its compliance manuals and (i) issue compliance-related memoranda, notices, and bulletins to document the respective updates; (ii) strengthen procedures for handling EFRPs;

and (iii) otherwise remind, educate, and warn their employees that all futures transactions must be executed through an exchange, unless subject to certain limited exceptions, and detailing the requirements of bona fide EFRPs.

- b. FCStone Merchants agrees to:
 - 1. Develop stronger and additional internal controls and processes to detect and deter the noncompetitive execution of futures trades and the improper designation and reporting of trades as EFRPs to the CME via its clearing firm, including, but not limited to, (i) requiring new documentation and procedures for confirming trades that are designated as EFRPs, including FCStone Merchants' listing all component parts to such trades, submitting such documentation to FCStone Financial; and (ii) requiring operations employees to immediately report the absence of such documentation to their supervisors or other personnel as needed; and
 - 2. Enhance its supervisory procedures and protocols relating to its practices pertaining to EFRPs and the documentation of EFRPs submitted for clearing, and will remind, educate and warn their employees that all futures transactions must be executed through an exchange, unless subject to certain limited exceptions, and detailing the requirements of bona fide EFRPs.
- c. Respondents have and will further develop, implement, and provide enhanced futures training for all personnel and operations employees that execute, handle, and process EFRPs.

The provisions of this Order shall be effective as of this date.

By the Commission.



Christopher J. Kirkpatrick
Secretary of the Commission
Commodity Futures Trading Commission

Dated: November 14, 2017