Customer Rights Under the Commodity Exchange Act

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Customer Rights Under the
Commodity Exchange Act

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I. Introduction

Congress substantially amended the Commodity Exchange Act (the CEA)\(^1\) in 1974\(^2\) to provide additional protection to persons trading in commodity futures contracts, commodity options, and "leverage" transactions\(^3\) and to place such transactions within the exclusive jurisdiction of the Commodity Futures Trading Commission (CFTC).\(^4\) As the result, however, of continued abuses in commodity options and increased public trading\(^5\) in exotic, new financial futures such as stock index\(^6\) and Government National Mortgage Association (GNMA) futures contracts,\(^7\) Congress twice recently has significantly amended the CEA to broaden those protections.\(^8\) This Article reviews customer rights and remedies now available under the CEA. Specifically, part II of this Article explores the scope of transactions covered by the CEA,\(^9\) part III addresses the antifraud provisions of the CEA,\(^10\) and part IV discusses the standard of intent required to prove that fraud has been

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5. In 1972, 18.3 million commodity futures contracts were traded in the United States. By 1982 that volume had increased to 112.4 million contracts. 9 Futures Industry Association Report 6 (Feb. 1973); see Comptroller General, Report to the Congress, Commodity Futures Regulation—Current Status and Unresolved Problems 1 (July 15, 1982). "Last year, trading volume in financial futures soared to 42 million contracts from 29 million just a year earlier and 3.9 million five years before." N. Y. Times, Apr. 24, 1983, at 3, col. 1. In 1982 approximately 30 million financial futures contracts and 45 million agricultural commodity futures contracts (e.g., soybeans and pork bellies) were traded, a decline in the latter from some 60 million contracts in 1980 and an increase in the former in that same year from some 15 million contracts. Id.
6. A stock index futures contract is a theoretical agreement to purchase a portfolio of stocks based on an index such as Value Line or the Dow Jones Industrial Average. Unlike an ordinary futures contract, actual delivery is not permitted with a stock index future contract. Markham & Gilberg, Washington Watch: Stock Index Futures, 6 Corp. L. Rev. 59, 61 (1983).
7. U. S. Treasury Department, Treasury/Federal Reserve Study of Treasury Futures Markets (May 1979). For an examination of the SEC’s authority to regulate trading in GNMA certificates, see Board of Trade v. SEC, 677 F.2d 1137 (7th Cir.) (prohibiting trading of GNMA's pending action by the CFTC denying the authority of the SEC to regulate such trading), vacated as moot, 459 U.S. 1026 (1982).
9. See infra notes 16-41 and accompanying text.
10. See infra notes 42-178 and accompanying text.
committed under CEA provisions. Part V of this Article examines the secondary liability of brokerage firms and others for the fraudulent acts of its employees, part VI discusses fiduciary liability under the CEA, and part VII enumerates the various forums available for customer remedies. This Article concludes in part VIII with suggestions for improving dispute resolution in the commodity industry.

II. TRANSACTIONS SUBJECT TO THE CEA

A. Commodity Futures Transactions

A commodity futures contract is a legally binding commitment to purchase or sell a specified quantity of a commodity with delivery effected at a specified time in the future. The terms of a futures contract are standardized, with the exception of the price, which is determined by market forces. Commodity futures contracts are traded on margin, which allows substantial leverage that may compound gains or losses as the price of the commodity changes. If such fluctuations are adverse to the customer's positions, the customer will be required to post additional "variation" or "maintenance" margin payments at least roughly equal to the amount of loss caused to the investor by the adverse market move. Margin calls must be met promptly, and if they are not so

11. See infra notes 179-204 and accompanying text.
12. See infra notes 205-19 and accompanying text.
13. See infra notes 220-36 and accompanying text.
14. See infra notes 237-54 and accompanying text.
15. See infra part VIII.
16. See, e.g., Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Curran, 456 U.S. 353, 357-58 (1982). For example, a futures contract on silver traded on the Commodity Exchange, Inc. (COMEX) provides for delivery of 5000 ounces of silver at a stated time in the future and at a price negotiated by the parties upon execution of the contract. The seller of the futures contract undertakes an obligation to deliver 5000 ounces of silver, and is therefore said to have taken a "short" position (i.e., he is "short" the silver). The purchaser of the contract, required to accept delivery of the silver, is referred to as taking a "long" position. COMMODITY FUTURES TRADING COMMISSION, REPORT TO THE CONGRESS IN RESPONSE TO SECTION 21 OF THE COMMODITY EXCHANGE ACT, Pub. L. No. 96-276, ch. II, at 6, 96th Cong., 2d Sess. § 7, 94 Stat. 542 (1980) [hereinafter cited as CFTC SILVER REPORT.

17. The margin on a commodity futures account, unlike its counterpart in the securities industry, does not represent an extension of credit, but is a "performance bond" or "earnest money" which serves as an assurance of the customer's good faith performance under the terms of the futures contract. Both the purchaser and seller of the futures contract are required to post margin payments. The amount of margin required is fixed as that amount deemed necessary to assure performance. The initial margin requirement generally represents a small percentage of the total value of the futures contract. CFTC SILVER REPORT, supra note 16, ch. II, at 8.

met, the broker has the right, and may be required by exchange rules, to liquidate the customer’s account. The risks of commodity futures trading are thus accentuated by the potential necessity for the customer to raise and commit sizable amounts of additional liquid funds, often in a very short period of time.

Trading risks are exacerbated further through imposition of “price limits” by contract markets, which restrict the extent to which the price of a particular commodity may drop (“limit down”) or increase (“limit up”) in the course of a trading day. Designed to maintain orderly trading in the market, these price limits may force an investor to maintain a loss position.

Investors may engage in commodity futures trading solely for speculative purposes. A speculator taking a “long” position in a particular commodity anticipates an increase in the price of that commodity prior to the delivery date. If the price rises he is able to sell the commodity at a market price higher than his purchase price and profit from the transaction. Conversely, if the price falls he will be obligated to sell the commodity at a price below the purchase price and will suffer a loss. Accordingly, the trader is speculating against the future price of the commodity.

Trading commodity futures contracts also may be used to “hedge” business risks. For example, an institution with a widely based stock portfolio or that is anticipating an overall drop in stock market values for a short term may, instead of selling the portfolio, hedge that market risk by entering into a stock index futures contract. This futures contract would reflect the overall drop in market prices and allow the institution to receive profits from the transaction that would offset, at least to some extent, losses in the institution’s portfolio.

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19. See, e.g., Margin Rule H of the COMEX.
20. See, e.g., Silver Trading Rule 5 of the COMEX. If a maximum price limit is reached (i.e., a “limit up” or “limit down” market), a futures trader might be unable to liquidate a position (except possibly under a complicated “switching” arrangement), because maximum losses are “locked in” at the prevailing cash price for the commodity. The existence of a “locked limit” market may, therefore, force the trader to maintain a loss position and, if price limits continue over a number of days or become even more restrictive, increase the trader’s losses.
21. A “long” position is the posture taken by the purchaser of the futures contract. See supra note 16.
23. P. JOHNSON, supra note 18, § 1.12.
24. Markham & Gilberg, supra note 6, at 61. Only a very small percentage of all futures contracts result in the actual delivery of a physical commodity. Id. at 60 & n.5. In-
B. Commodity Options Transactions

A commodity option contract is a right for a limited period of time to purchase or sell a specified amount of a commodity or a commodity futures contract at a specified exercise or “striking” price.25 The option right expires unless exercised by the purchaser. The writer of the option right pays a premium to the seller for the right. The option to buy is referred to as a call option, while the right to sell is commonly referred to as a put option.26 Unlike commodity futures contracts, options offer the advantage of limiting the holder’s liability to the amount of the premium paid while offering the opportunity to profit through a leveraged investment. The writer of an option, however, is liable to the full extent of any price changes. Therefore, the risk to the seller of a call option is comparable to that of a futures contract, although the option writer’s losses are offset by the amount of the premium paid.27

Various forms of commodity options exist including “dealer” options which are backed by an inventory of the commodity, “naked” options which are not backed by anything other than the credit of the writer of the option, “London” options which are traded on the London markets, and, today, options traded on United States contract markets.28 Commodity options trading historically has been a matter of concern under the CEA because of the many abuses that have arisen in connection with these instruments.29 Those abuses were a precipitating factor in the enactment of the CEA and the creation of the CFTC in 1974,30 when the CFTC was granted exclusive jurisdiction over commodity options.31 The CFTC, however, was unable to stem a flood of “boiler room” operations, including one scandal concerning an escaped

26. Id.
27. See generally Markham & Gilberg, Stock and Commodity Options—Two Regulatory Approaches and Their Conflicts, 47 ALB. L. REV. 741, 756-59 (1983) (the authors discuss, inter alia, the mechanics of commodity option trading).
28. Id. at 757-59.
29. For a discussion of the nature and history of commodity options and their abuses, see P. JOHNSON, supra note 18, § 1.07; Lower, The Regulation of Commodity Options, 1978 DUKE L.J. 1095, 1098-99; Markham & Gilberg, supra note 27, at 747-56.
felon who operated a commodity firm on a nationwide basis. As a result of those scandals, the CFTC and later Congress imposed a moratorium on all commodity options sales with the exception of certain “dealer” and commercial options and, more recently on a limited basis, commodity options traded on United States exchanges.

C. Leverage Transactions

The CFTC also is given exclusive jurisdiction over so-called “leverage” transactions. Leverage transactions generally contain a standardized agreement to purchase a specified quantity of a commodity such as gold or silver. The purchaser pays a portion of the purchase price at the outset and agrees to buy the commodity at a specified price with a delivery date at a specified time in the future. In addition to the initial payment, purchasers must pay a sales commission or markup along with maintenance, interest, and other finance charges connected with the seller’s theoretical obligation to carry the commodity for the purchaser during the term of the contract. Actually, leverage merchants may not own the commodity but instead protect themselves through offsetting futures contracts or other means.

The CFTC has imposed a moratorium on the expansion of trading in leverage contracts with one exception. A grandfather provision was adopted that allowed firms already engaged in leverage contract trading to continue. The CFTC also, at one point, determined to regulate leverage contracts as futures contracts, which effectively would have banned their sale. The CFTC later


34. 7 U.S.C. § 6c (1982).
39. Leverage contracts are not traded on futures contract markets. Congress authorized the CFTC, by amendment to the CEA in 1974, to determine whether leverage transactions should be regulated in the same manner as futures contracts, which are required to be traded on exchanges. See S. REP. No. 1131, 83d Cong., 2d Sess. 41 (1974). That determination was made by the CFTC in 1979. See Regulation of Leverage Transactions as Contracts
postponed the implementation of that decision,\textsuperscript{40} however, and more recently Congress amended the CEA to require the CFTC to adopt a comprehensive regulatory scheme for such transactions, to remove the grandfather restriction, and to prevent the treatment of such transactions as futures contracts.\textsuperscript{41}

\section*{III. Customer Right to Protection from Fraud Under the CEA}

A principal protection for customers under the CEA is its antifraud prohibitions. One such provision, section 6b,\textsuperscript{42} makes it unlawful for any person, in connection with the purchase or sale of futures contracts, "to cheat or defraud or attempt to cheat or defraud" any other person, to make or cause to be made any false statement or misrepresentation, or to "bucket"\textsuperscript{43} a customer's order by failing to execute such order on a contract market. In addition, the CEA contains an express antifraud prohibition governing the activities of commodity pool operators and commodity trading advisors.\textsuperscript{44} The CFTC also has adopted antifraud rules for futures contracts traded on foreign exchanges,\textsuperscript{45} commodity options transactions,\textsuperscript{46} and leverage transactions.\textsuperscript{47} The following discussion outlines various fraud claims that have been made under the CEA and the corresponding CFTC attempts to develop those theories.

\subsection*{A. Suitability}

The concept of "suitability" is traceable to securities exchange rules that required brokers to "know your customer"; a broker

\begin{itemize}
\item \textsuperscript{40} See Regulation of Leverage Transactions as Contracts for Future Delivery; Postponement of Effective Date, 44 Fed. Reg. 44,177 (1979); see also In re First Nat'l Monetary Corp., [1982-1984 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 21,707 (C.F.T.C. Apr. 29, 1983).
\item \textsuperscript{41} See Regulation of Leverage Transactions as Contracts for Future Delivery; Postponement of Effective Date, 44 Fed. Reg. 69,304 (1979).
\item \textsuperscript{42} 7 U.S.C. § 6b (1982).
\item \textsuperscript{43} Id.; see infra notes 176-77 and accompanying text.
\item \textsuperscript{44} 7 U.S.C. § 60 (1982).
\item \textsuperscript{45} 17 C.F.R. § 30.02 (1984).
\item \textsuperscript{46} Id. § 32.9.
\item \textsuperscript{47} Id. § 31.3; see Mitchell v. Premex, Inc., [1982-1984 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 21,678 (C.F.T.C. Feb. 10, 1983).
\end{itemize}
must assure itself that its customers are able to meet their obligations.\textsuperscript{48} This duty was later expanded to impose an obligation on securities brokers to refrain from making recommendations to customers that were not suitable in light of the customers' finances, needs, and objectives.\textsuperscript{49} This expansion, however, of the "know your customer" rule has not been broadly applied. Its use is most frequently confined to "boiler room" operations that utilize high pressure telephone sales campaigns for speculative low price securities.\textsuperscript{50}

At an early stage of its existence, the CFTC was faced with numerous "boiler room" sales operations. These operations generally involved the offer and sale of commodity options without any consideration of the suitability of those transactions for individual customers.\textsuperscript{51} For example, in \textit{CFTC v. Crown Colony Commodity Options, Ltd.},\textsuperscript{52} the district court held that the defendant had engaged in fraud by operating "a 'boiler room' operation calculated to sell as large a volume of options as possible to customers throughout the United States \textit{without regard to the suitability of the investment for customers . . . .} \textsuperscript{53} The court noted that the defendants were "crass and callous" in their indifference to the needs of their customers.\textsuperscript{54} Similarly, in \textit{Kelley v. Carr},\textsuperscript{55} defendants also participated in a "boiler room" operation. The district court concluded that the defendants had made no attempt to counsel clients or to consider their financial position to determine whether customers could realistically afford to purchase the commodity options being offered.\textsuperscript{56}

As a result of these types of abuses, the CFTC proposed a rule that would prohibit persons registered with the CFTC from recom-

\begin{footnotesize}
\begin{enumerate}
\item See, e.g., New York Stock Exchange Rule 405.
\item See N. Wolfson, R. Phillips & T. Russo, supra note 49, ¶ 2.08, at 2-36.
\item \textit{Id.} at 918 (emphasis added).
\item \textit{Id.} at 919.
\item \textit{Id.} For a discussion of these and other "boiler room" cases, see Schief & Markham, The Nation's "Commodity Cops" — Efforts by the Commodity Futures Trading Commission to Enforce the Commodity Exchange Act, 34 Bus. Law. 19, 21-26 (1978).
\end{enumerate}
\end{footnotesize}
mending a commodity transaction to a customer unless that customer was determined to be suitable for the transaction. The CFTC subsequently concluded, however, that the adoption of such a rule merely would codify principles already implicit in the Act and unintentionally narrow the scope of existing standards. Notwithstanding the CFTC's failure to adopt a suitability rule, various CFTC administrative law judges thereafter held that the CEA contemplated suitability violations. The CFTC subsequently stated, however, that it rejected an administrative law judge's suggestion that there was a suitability requirement implicit in the CEA. In another decision, the CFTC expressly disavowed the decision of another administrative law judge who had stated that suitability is a basis for recovery under the CEA. In addition, the Eighth Cir-

57. The proposed rule stated that a registrant could not recommend a trade unless:
(1) . . . the professional obtained from the customer, before the recommendation or trade, the essential facts about the customer's financial condition and trading objectives . . . ; and (2) . . . the professional had reason to believe, at the time of the recommendation or trade, that the position would be 'suitable' for the customer based on the information known to the professional. The suitability of a position would depend on whether the risk of loss involved was (a) one that the customer could safely assume in light of his financial condition and (b) consistent with the customer's trading objectives.


62. Id. at 24,286. Subsequent decisions of CFTC administrative law judges have accordingly declined to find a right of action for suitability. See, e.g., Kats v. Merrill Lynch Commodities, Inc., [1982-1984 Transfer Binder] COMM. Fut. L. Rep. (CCH) ¶ 21,998
cuit held in *Myron v. Hauser*\(^63\) that because the CFTC had not developed any suitability standard, the court could not find a violation of the CEA on the basis of a claim of suitability.\(^64\) More recently a district court relying on *Myron* and the CFTC's earlier decisions,\(^65\) held that no suitability requirement exists under the CEA.\(^66\) Similarly, another district court held that there was no suitability standard under the CEA because of the difficulty that the CFTC had encountered in formulating meaningful standards of universal application.\(^67\)

These decisions should not be construed, however, as a CFTC determination that customer suitability protection is not warranted. Rather, the CFTC has substituted specific disclosure requirements that advise the customers in simple boldface language of the risks they face in commodities trading. Thus, the CFTC imposes upon the customer, rather than the broker, the duty to assess trading risks in determining whether to accept a broker's recommendation.\(^68\) For example, the CFTC recently approved a pilot program for exchanges that trade in commodity options. The specified disclosures that the program requires commodity brokers to make to customers contain a provision which states that commodity option trading is not suitable for everyone, and investors should consider their own situations to determine whether such trading is suitable for them.\(^69\)

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\(^{63}\) 673 F.2d 994 (8th Cir. 1982).


\(^{65}\) See supra notes 60 & 63 and accompanying text.


\(^{69}\) This disclosure requirement states in part that:

because of the volatile nature of the commodities markets the purchase and granting of commodity options involve a high degree of risk. Commodity option
CUSTOMER RIGHTS

The suitability issue also remains unresolved by the CFTC and in the courts. In a recent decision by the District of Columbia Court of Appeals, the court stated that the Commission had not actually rejected a suitability right of action in the Jensen and Avis cases. The CFTC, rather, had simply "reserved the question whether a suitability requirement is implicit in the Act." Following the lead of the District of Columbia Court of Appeals, a CFTC administrative law judge concluded that there is a suitability right of action under the Act, rejecting the decisions in Myron and Hoetger and concluding that the Jensen and Avis cases did not undercut a right of suitability.

B. Misrepresentations

The prohibitions against misleading and deceptive statements contained in section 4b and other provisions of the CEA provide the principal CEA customer protection from high pressure "boiler room" commodity option solicitations. For example, in CFTC v. J.S. Love & Associates Options Ltd., the district court concluded that the promotional literature and the New York Times advertisement of an option firm was misleading because, while these materials promised large profits and limited risk, the advertisements failed to state that many of the firm's salespersons were inexperienced, the firm's charges for options were exorbitant, profitability claims were unsubstantiated in the advertisement, and commodity options trading "is often highly speculative and is usually engaged in by sophisticated investors." Similarly, in CFTC v. Crown Colony Commodity Options, Ltd., the court held that the commodity options sales presentations at issue were fraudulent be-

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74. Id. at 655-56.
cause they “conveyed the distinct impression that extraordinary short-term profits were all but certain to be realized by investors” and because the mechanics of commodity options trading were misrepresented. Numerous other commodity options cases found fraud in promoters’ failure to disclose the absence of a secondary market in commodity options, commissions and other charges, the fundamentals of options trading, the lack of registration and experience of commodity options salespersons, and pertinent risks.

76. Id. at 916-17.


The CFTC also has warned that unwarranted profit predictions in connection with commodity options transactions are "inherently fraudulent" whether expressed in terms of opinion or fact. The CFTC's Office of General Counsel similarly has stated that section 4b of the CEA prohibits any suggestion or claim of profit potential that does not fairly represent the possibility of loss and has proscribed any predictions or recommendations that are not explicitly labeled or do not have a reasonable basis in fact. CFTC administrative law judges have concluded that section 4b is violated when a customer is promised that losses will be limited.


83. CFTC Interpretative Letter No. 77-16 [1977-1980 Transfer Binder] COMM. Fut. L. Rep. (CCH) ¶ 20,498 (Oct. 18, 1977). This letter from the general counsel also stated:

A purported compilation of a record of past performance, which is disseminated by any means, would also violate Section 4b(2) unless it is based upon actual trades executed in the market place and fairly represents results achieved for comparable periods as well as for the period specifically set forth. Proscribed as well are the use of unwarranted superlatives or inflammatory statements, which tend to encourage trading on an emotional, rather than a reasoned basis.

Id. at 22,065.

material information or the mechanics of futures trading are not disclosed, claims of large profit and limited risk are made, inducements are promised that give undue expectations of profit,


or simulated trading records are used improperly.88 Imprudent investment decisions, however, do not give rise to liability under the CEA,89 nor is it a violation for a broker to dissuade a customer from making a trade that would have been profitable or to make reasonable price predictions.90

As a means of countering misrepresentations and assuring that customers are informed of the risks of trading, the CFTC has required a “Risk Disclosure Statement” be supplied to customers before they trade. This document sets forth, in boldface type, the specific types of risk that may be incurred in commodities trading. For example, brokerage firms, referred to in the commodity futures industry as “futures commission merchants,” are required to provide a statement to customers containing the following language:

The risk of loss in trading commodity futures contracts can be substantial. You should therefore carefully consider whether such trading is suitable for you in light of your financial condition. In considering whether to trade,

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you should be aware of the following:

(1) You may sustain a total loss of the initial margin funds and any additional funds that you deposit with your broker to establish or maintain a position in the commodity futures market. If the market moves against your position, you may be called upon by your broker to deposit a substantial amount of additional marginal funds, on short notice, in order to maintain your position.

(5) The high degree of leverage that is often obtainable in futures trading because of the small margin requirements can work against you as well as for you. The use of leverage can lead to large losses as well as gains.91

Since the adoption of this provision, CFTC administrative law judges have been reluctant to find that risks of trading have been misrepresented to customers when the customer received a disclosure document before trading. In *Tapper v. Rosenthal & Co.*,92 a CFTC hearing officer stated: "The disclosure statement made it abundantly clear, in bold-face type, that [complainant] could lose her entire investment. I reject [her] testimony that she was never told she could lose her investment."93 Similarly, in *Thompson v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*,94 the administrative law judge noted that the "[c]omplainant signed a risk disclosure statement prior to any trades being made on the account, and that statement informed him that losses may be substantial." Consequently, complainant’s contention that he would never have consented to trades recommended by his account executive had he realized the loss potential was rejected.95 The CFTC also has concluded that when a required risk disclosure statement is not supplied, customers may not recover their trading losses if they are otherwise informed of the risks.96 In a proceeding prior to the ef-

93. Id. at 25,915.
95. Id. at 4. In *Margolin v. First Commodity Corp.*, [1980-1982 Transfer Binder] COMM. Fut. L. REP. (CCH) ¶ 21,432 (C.F.T.C. June 10, 1982), a CFTC hearing officer held that the CFTC had "sought to alert individuals to [the] danger [of trading commodity futures contracts] by establishing formal disclosure requirements which are designed to 'enlighten the prudent' and 'to discourage the foolhardy';" therefore, the broker's "uninhibited optimism should have been offset in the complainant's mind by the clear warning to prospective customers set forth in the formal statement." Id. at 26,076 (footnotes omitted). The CFTC, however, subsequently found the hearing officer's opinion in *Margolin* to be unpersuasive. Id.; see also *Rasheed v. Heinold Commodities, Inc.*, [1982-1984 Transfer Binder] COMM. Fut. L. REP. (CCH) ¶ 21,337 (C.F.T.C. Aug. 19, 1983).
flective date of the CFTC’s risk disclosure statement requirements, a CFTC hearing officer held that no misrepresentation would be found, even though the broker had made assurances of “tremendous profits and very limited risk,“97 because the broker had spe-


cifically warned the complainant in writing before the account was opened that there was a high risk of loss trading commodity futures. Similarly, another CFTC decision indicates that any broker misrepresentations are cured through delivery of the disclosure statement. In other decisions the CFTC has stated, however, that written disclosure statements will not provide immunity where oral misrepresentations are made that overcome the written disclosure.


Schwarz v. Drexel Burnham Lambert, Inc., No. 82-239 (C.F.T.C. Feb. 14, 1983) (any misrepresentation was cured by furnishing risk disclosure documents).


C. Churning

Churning\textsuperscript{100} is a form of cheating and defrauding and thus is a violation of section 4b(A) of the CEA.\textsuperscript{101} Whether the volume of trading in a commodities account constitutes churning is dependent upon a consideration of the facts surrounding the transactions in that account.\textsuperscript{102} Churning as a violation of the securities laws has been well documented in case law.\textsuperscript{103} Two major elements must be present to establish churning in a securities account: (1) broker control over trading in the customer's account, and (2) trading that is excessive both in frequency and in volume in light of the customer's trading objective.\textsuperscript{104}

Recognizing that motive and opportunity for churning in both commodities and securities are similar,\textsuperscript{105} the CFTC, nonetheless,
has distinguished churning in a commodities account from churning in a securities account. Particularly, the Commission has rejected the use of the "turnover rate" as a statistical gauge for determining whether churning has occurred in the securities area. The CFTC stated that the "turnover rate", as applied in securities cases, is "inherently inappropriate for determining whether excessive trading has been established in futures churning cases." A basic premise of securities trading is that once a securities professional acquires securities for a controlled account, the acquisition normally is followed by a holding period so the professional may determine whether his assessment of the securities’ growth potential was accurate. Commodities futures contracts, however, are short term instruments that have a faster inherent "turnover rate" because of short expiration dates and the volatility of commodity prices. The CFTC concluded, therefore, that the length of time a futures contract is held is not "particularly revealing in determining whether a commodities account has been traded excessively." Furthermore, the CFTC noted that the turnover rate’s focus on the total cost of securities purchased over a period of time is inapplicable in commodities cases because a futures contract is executory in nature and the overwhelming majority of commodity customers trade futures contracts without any intention of making or taking delivery of the underlying commodity. Given this situation, the CFTC concluded that it would be inaccurate to consider the total dollar value of the commodity futures contracts purchased in the same manner as the "turnover rate" is considered in a securities account.

In 1977 the CFTC proposed a regulation outlining the standards of conduct for commodity trading professionals. The proposed standards contained a provision that expressly prohibited
the churning of commodities accounts.\textsuperscript{112} The CFTC emphasized that this provision only made explicit what was implicitly required of commodity trading professionals under the various antifraud provisions of the Commodity Exchange Act and the CFTC's rules: that the churning of a customer's commodity futures account is a clear violation of section 4b of the CEA.\textsuperscript{113}

The CFTC has noted that, although no precise guidelines can be drawn as to when churning occurs and each situation must be judged on its own facts,\textsuperscript{114} the principal elements of the churning offense are: control of the account by the professional and excessive trading.\textsuperscript{115} Control of an account is defined as the express authorization to the professional by the customer to trade or exercise "control in fact" over the account even though no grant of discretion has been made.\textsuperscript{116} The CFTC outlined control in fact as

\begin{itemize}
  \item[(i)] The \textit{turn-over rate}. This is the ratio of the total cost of purchases made for the account during a given period of time to the average month-end net equity in the account during the period. The amount of permissible turn-over will depend upon such factors as market conditions, the commodity interest [sic].
  \item[(ii)] The \textit{nature of the account}. As indicated in (i) above, the stated objective of the customer is an important factor. A turn-over rate that is acceptable in the account of an individual who wishes to trade especially actively may be unacceptable in the account of an average trader.
  \item[(iii)] \textit{"In-and-out" trading}. Since the establishment of market positions for periods of less than a day (such trades are commonly known as "day trades" or "in-and-out trades") can generate substantial commission revenues, this type of trading—although clearly not inherently improper—could be a factor in determining whether an account has been churned.
  \item[(iv)] \textit{Ration [sic] of commissions to net equity}. The ration [sic] of the commissions generated by the account during a particular period to the average, month-end net equity in the account during the period is also a significant factor, particularly when it can be compared to the commission-equity ratio in other similar accounts maintained with the commodity professional.
\end{itemize}

\textit{Id. at 44,745}. As noted supra notes 82-88 and accompanying text, the CFTC subsequently rejected the use of turnover rates in commodity futures churning analyses. \textit{See In re Lincolnwood Commodities, Inc., [1982-1984 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 21,986 (C.F.T.C. Jan. 31, 1984).}

\textsuperscript{115} Proposed Standards of Conduct, supra note 57, at 44,745 (footnote omitted).

\textsuperscript{116} Hecht v. Harris, Upham & Co., 283 F. Supp. 417, 433 (N.D. Cal. 1968). If a broker
existing:

[W]here the professional—by reason of the trust and confidence placed in him by the customer, the customer's lack of sophistication in commodity trading, or some combination of these factors—significantly influences the trading in the account. The mere fact that the customer occasionally initiates his own trades or rejects the professional's advice would not preclude the existence of factual control, nor would the customer's sophistication in commodity trading."

In 1978 the CFTC decided not to adopt the proposed churning rule on the basis of two factors. First, the CFTC believed the churning rule would merely codify principles that are implicit in the antifraud provisions of the CEA. Second, the Commission believed that "the benefits to be gained from codification [were] outweighed by the risk of unintentionally narrowing the scope of these provisions."

As noted, an essential element in a churning claim is "broker control" over the commodities account. It is not necessary, however, for the account to be discretionary before churning can be found. Courts have found "broker control" in both discretionary and nondiscretionary accounts. In the leading pronouncement of the CFTC on broker control, Smith v. Siegel Trading Co., the CFTC enunciated six factors that, although not exhaustive, were typified as "well recognized factors . . . probative of control and which at a minimum should be considered by the trier of fact" in determining whether churning has taken place:

1) a lack of customer sophistication
2) a lack of prior commodity trading experience on the part of the customer
3) a high degree of trust and confidence reposed in the associated person by the customer

overtrades a commodities account without having express or implied control over trading decisions, he is trading without customer authorization, not churning the account. See Hudson, supra note 104, at 20; supra notes 114-15 and accompanying text; infra notes 117-30.

117. Proposed Standards of Conduct, supra note 57, at 44,745 (footnote omitted).


119. As one court noted:
Although control by the representative over the account is essential to a finding of churning, such control need not amount to a formal vesting of discretion in that representative. A degree of control sufficient to warrant protection may be inferred from evidence that the customer invariably relied on the dealer's recommendations, especially when the customer is relatively naive and unsophisticated.


4) a large percentage of transactions entered into by the customer based upon
the recommendations of the associated person
5) the absence of prior customer approval for transactions entered into on his
behalf
6) customer approval of recommended transactions where the approval is not
based upon full, truthful and accurate information supplied by the associated
person.\textsuperscript{121}

Churning cases concerning nondiscretionary commodities accounts
have hinged on a determination of whether the plaintiff had the
capacity to determine his overall position or the total amount of
real profit or loss occurring in his account.\textsuperscript{122} The Ninth Circuit
Court of Appeals recently held that "[t]he touchstone [for deter-
mining broker control] is whether or not the customer has suffi-
cient intelligence and understanding to evaluate the broker's rec-
ommendations and to reject one when he thinks it unsuitable" and
"[a]s long as the customer has the capacity to exercise the final
right to say 'yes' or 'no', [sic] the customer controls the
account."\textsuperscript{123}

The judiciary and the CFTC have been loathe to adopt a pre-
cise empirical formula to determine when churning occurs in a
commodities account. A court, however, invariably will review the
length of the time period during which trading occurred, the
amount lost by the customer, and the commissions earned by the

\textsuperscript{121} Id. at 24,454 & n.6; see also Friedman v. Dean Witter & Co., [1980-1982 Transfer
Binder] COMM. FUT. L. REP. (CCH) ¶ 21,307 (C.F.T.C. Nov. 13, 1981); In re Luizzi, [1982-

\textsuperscript{122} In Hecht v. Harris Upham & Co., 283 F. Supp. 417 (N.D. Cal. 1968), the court
stated that a customer must be "sufficiently skilled" to be able to supervise his account. Id.
at 434. The court held that "plaintiff's comprehension of the securities market was defi-
nitely limited, her comprehension of the commodities market was virtually nil and her com-
prehension of both was most superficial." Id. at 433.

\textsuperscript{123} Follansbee v. Davis, Skaggs & Co., 681 F.2d 673, 677 (9th Cir. 1982).
broker. For example, churning was found when a broker engaged in over 500 transactions and generated $23,522.87 in commissions in a period of approximately eighteen months.\textsuperscript{124} Churning also was found when the commissions of a broker equaled seventy-two percent of the amount deposited for a commodities account during a nine-week period in which the account was depleted from $2500 to $2.\textsuperscript{125} A CFTC hearing officer has emphasized that "[a] very important factor in determining churning is the ratio of the size of the professional's profit in relation to the size of the customer's initial investment."\textsuperscript{126} A 67.1% commission equity ratio and a 57% commission trading ratio were found to compel a finding of churning.\textsuperscript{127} One administrative law judge has even stated "the entry of a single trade that is not for the benefit of the customer shall always be considered as churning."\textsuperscript{128}
The CFTC, relying on *Siegel Trading,*\(^{129}\) rejected an administrative law judge's conclusion that, as a general rule, churning may be found whenever trading in a controlled account generates commissions of fifty percent of a customer's investment over a period of six months or less.\(^{130}\) The CFTC stated that the determination that trading was excessive can be made only after analyzing the specific objectives of the account.\(^{131}\) The CFTC affirmed its belief that a finding of churning includes several factors, and the interrelationship between these factors should be carefully considered by the trier of fact in the context of each case.\(^{132}\)

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129. *See supra* notes 120-21 and accompanying text.


131. *Id.*

132. *Id.* For decisions concerning the appropriate measure of damages in churning.
D. Unauthorized Trading

A trade in a nondiscretionary account without the customer's consent constitutes unauthorized trading. Unauthorized trading is a violation of section 4b of the CEA and CFTC Regulation 166.2. This rule, prompted by frequent customer complaints of unauthorized trading by futures commission merchants, prohibits future commission merchants, or associates from effecting transactions in nondiscretionary accounts unless the customer specifically authorizes the transaction and identifies the particular commodity and exact amount eligible for purchase or sale. Upon adoption of the rule, the CFTC announced that because unauthorized trading had been held a violation of section 4b of the CEA, adopting the specific rule would have no substantive effect on existing law.


Id. at 44,742. CFTC Regulation 166.2 “Authorization to Trade” states:

No futures commission merchant, introducing broker or any of their associated persons may directly or indirectly effect a transaction in a commodity interest for the account of any customer unless before the transaction the customer, or person designated by the customer to control the account:

(a) Specifically authorized the futures commission merchant, introducing broker or any of their associated persons to effect the transaction (a transaction is “specifically authorized” if the customer or person designated by the customer to control the account specifies (1) the precise commodity interest to be purchased or sold and (2) the exact amount of the commodity interest to be purchased or sold); or

(b) Authorized in writing the futures commission merchant, introducing broker or any of their associated persons to effect transactions in commodity interests for the account without the customer’s specific authorization.

whether the customer ratified the unauthorized transaction.\textsuperscript{138}


For example, in Kats v. Cayman Assocs., [1980-1982 Transfer Binder] COMM. Fut. L. Rep. (CCH) \# 21,205 (C.F.T.C. Apr. 10, 1981), the CFTC hearing officer found unauthorized trading to be present in an account of Kats, an Iowa farmer who demonstrated that his commodities trading account with Cayman Associates, Ltd. was solely for the purpose of hedging in connection with his feeder cattle business and no authorization had been given for speculative trades in pork bellies. When Kats received a confirmation that indicated trades had been placed in pork bellies, he called his broker to object and followed up the telephone call with a written complaint in accordance with the customer agreement that he had signed. The hearing officer awarded Kats the amount of the net loss on the unauthorized trades and the amount of commission charges plus interest.


whether the transaction fell within the scope of the authorization,\(^{140}\) whether the transaction was the result of a mistake,\(^{141}\) and whether the failure to disclose risk precludes a holding of true authorization.\(^{142}\) The preeminent case concerning ratification of unauthorized transactions is \(\text{Sherwood v. Madda Trading Co.}\),\(^{143}\) in

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which the CFTC clarified the interrelated rights and duties that arise when a customer believes that unauthorized trades have been made in his account. \(^{144}\) The complicated set of facts presented in Sherwood concerned several unauthorized trades in the plaintiff's commodity account made by a broker in the defendant's firm. The CFTC emphasized that a customer has an absolute right not to be liable for any trade not authorized by him. If an unauthorized trade occurs, the liability attaches to the futures commission merchant, not the customer. \(^{146}\) The CFTC also emphasized that a futures commission merchant has a duty to inform the customer that he must complain about unauthorized trades. \(^{146}\) The defendant's customer information statement contained the following notice: "Note: Please Report Any Differences Immediately." \(^ {147}\) The CFTC found that this "meager" statement imposed a duty upon the plaintiff to notify his original broker or the defendant brokerage firm of the errors, but advised that a more comprehensive statement would have been appropriate. \(^ {148}\) The CFTC found that the plaintiff had partially satisfied this duty through his daily at-

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\(^{144}\) Id. at 23,017.

\(^{145}\) Id. at 23,018.

\(^{146}\) The CFTC stated:

[T]he futures commission merchant also must either inform the customer, or be demonstrably certain that the customer otherwise understands, that the customer's under a duty to make a complaint at the first reasonable opportunity should he discover unauthorized trading in his account. Any notification should be clear and unequivocal, assuring that the customer understands the import of his action or inaction. If the futures commission merchant fails to insure that its customer is on notice of this duty, the futures commission merchant must necessarily assume absolute liability for all trades ultimately found to have been executed without authorization. This notification in turn triggers the duty of the customer to complain or attempt to complain to his futures commission merchant immediately upon discovery of unauthorized trading. Should a customer, who has been informed that he must make a timely complaint of unauthorized trades, fail to notify or to attempt to notify the futures commission merchant of unauthorized transactions, the customer will have breached his duty to the futures commission merchant and thus must absorb himself any aggravated losses resulting from subsequent liquidation of the unauthorized positions . . . .

\(^{147}\) Id. at 23,018-19 (footnotes omitted).

\(^{148}\) The CFTC stated:

It would have been better had Sherwood also been informed of his right to have unauthorized trades removed from his account upon timely and substantial complaint. This would have assured Sherwood's understanding of the consequence of his failure to object to the unauthorized trades. We wish to emphasize that a clear explanation to the customer of his rights and duties inures to the benefit of both the customer and the futures commission merchant.

\(^{148}\) Id. at 23,019 n.16.
tempts\textsuperscript{149} to contact his original broker. The CFTC also held that the defendant's statement was "sufficiently ambiguous" so that the plaintiff should not have been expected to know that his failure to complain in timely fashion constituted permanent adoption of the unauthorized trades and, therefore, was insufficient to demonstrate ratification by the plaintiff.\textsuperscript{150} The CFTC recognized that notifications indicating a customer duty to inform the responsible officer or agent of the futures commission merchant that an error has occurred, such as those found in customer agreements, trade confirmations and account statements, raise a presumption of understanding on the part of a customer. However, this presumption can be dispelled or rebutted if a customer can demonstrate that his broker's subsequent conduct obscured the customer's understanding of his rights and duties.\textsuperscript{151}

The CFTC in \textit{Sherwood} discussed the timing of notice of error stating that "instant repudiation by the customer is not absolutely necessary in order to dispel claims of ratification."\textsuperscript{152} The CFTC further stated that:

The fact that a customer and account executive either by explicit or implicit agreement await short-term market action which might cure any loss occurring as the result of unauthorized activity prior to actually fixing financial responsibility for the transaction in question does not, by itself, constitute ratification or affirmative adoption of a trade. Rather, it is more of a cooperative attempt to mitigate — and hopefully, eliminate — losses incurred in hopes that the ultimate question of responsibility might never need to be reached. However, absent some understanding between the parties, the customer risks being estopped from recovering a full measure of damages should his delay in protesting result in aggravated losses. . . . Indeed, should the delay be of an unreasonable length, a factfinder might be free to conclude, in conjunction with other circumstances, that the customer did actually intend by his silence to adopt unauthorized trades as his own, regardless of subsequent market actions.\textsuperscript{153}

In cases decided after \textit{Sherwood}, the CFTC continued to opt for the more "\textit{ad hoc} and flexible principles of equitable estoppel"\textsuperscript{154} when approaching a ratification question arising from unau-

\textsuperscript{149} The original broker instructed the plaintiff to call him person-to-person collect whenever the plaintiff wished to contact him. After refusing the call, plaintiff would return the call via the firm's WATS line. \textit{Id.} at 23,017 n.8. The plaintiff called the broker daily upon discovery of the unauthorized trades. The broker returned only one telephone call, which the plaintiff was not available to answer. \textit{Id.} at 23,019.

\textsuperscript{150} \textit{Id.} at 23,020.

\textsuperscript{151} \textit{Id.} at 23,018 n.14.

\textsuperscript{152} \textit{Id.} at 23,020 n.20.

\textsuperscript{153} \textit{Id.}.

\textsuperscript{154} \textit{Id.} at 23,022.

The CFTC stated:
Authorized trading. 155

E. Other Customer Claims Under the CEA

Customer claims may be brought under sections of the CEA other than section 4b. For example, section 4 of the CEA 156 prohibits commodity futures contracts from being sold unless through a member of a contract market registered with the CFTC and such transactions must be effected on that exchange. The CFTC has brought numerous actions charging that various forms of "off-exchange" contracts were actually futures contracts and were re-

We will not permit a commission merchant to assert that a customer has ratified a trade made without customer authorization, such trade being patently fraudulent and illegal, absent a clear and unequivocal adoption of such a trade by the customer. However, neither will we permit recovery of damages where unfair conduct by a customer harms the financial interests of the broker. In sum, we wish to assure that all receive fair treatment in the marketplace.

155. In Anderholt v. Rosenthal & Co., [1980-1982 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 21,218 (C.F.T.C. June 26, 1981), a CFTC administrative law judge found that certain unauthorized trades were ratified and certain others were not. The determining consideration in Anderholt was whether the broker obscured the customer's understanding as to the nature of commodities trades. The administrative law judge found that the customers ratified certain unauthorized trades because they should have understood the text of the confirmations that were sent to them and objected to the unauthorized trades. The Anderholt judge stated:

I find complainant's testimony believable . . . . However, under [Sherwood v. Madda Trading Co.] they are nevertheless bound by the statements, and must themselves "absorb" the losses resulting from the discrepancies. [Complainants] were not experienced commodity or stock traders, but they obviously are above average in business sophistication and capable of reading such statements. There is no claim that respondent obscured their understanding of the statements or misled them as to their meaning. It is, therefore, found that the unauthorized purchases of March options were ratified by complainants.


In Brown v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 640 P.2d 453 (Mont. 1982), the court upheld a grant of summary judgment in favor of the defendant brokerage firm following allegations that the firm both improperly had withdrawn funds from plaintiffs' ready asset account to cover margin calls in their commodity account and improperly liquidated certain securities to cover a deficiency balance in another of plaintiffs' accounts. The commodity customer agreement contained the following provisions: (1) any securities or commodities carried in any of the customers' accounts are held as security by the broker for any liability of the customers; (2) the broker had the discretion to liquidate accounts to protect itself; and (3) the broker was authorized to transfer funds of the customers among accounts. The court in Brown found that this agreement was an adequate authorization to permit broker liquidation of a commodities account. Id. at 459; see also Greeley v. Lincolnwood Commodities, Inc., [1982-1984 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 21,834 (C.F.T.C. Aug. 17, 1983); Parver v. Patton, [1980-1982 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 21,454 (C.F.T.C. Aug. 4, 1982).

quired to be traded on a contract market. The CFTC has set forth a detailed description of a futures contract that must be traded on a contract market. Characteristics of such a contract are, inter alia, standardization and the provision for future, rather than present, delivery.

Customers frequently assert that a futures commission merchant either waited too long to liquidate futures contracts after margin calls were not met and thereby failed to mitigate damages, or that a futures commission merchant acted too quickly in liquidating an account for failure to meet margin calls promptly. The CFTC and the courts, however, have concluded that a futures


159. More specifically, these characteristics are: (1) The existence of "standardized contracts for the purchase or sale of commodities which provide for future, as opposed to immediate, delivery"; (2) transactions that are "directly or indirectly offered to the general public"; (3) transactions that are "generally secured by earnest money, or 'margins'"; (4) transactions that are "entered into primarily for the purpose of assuming or shifting the risk of change in value of commodities, rather than for transferring ownership of the actual commodities." In re Stovall, [1977-1980 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 20,941, at 23,777 (C.F.T.C. Dec. 6, 1979).

commission merchant should have broad authority in setting margin requirements for its customers, therefore, and they have generally deferred to the discretion of the broker. This deference is afforded the broker because margin is a fundamental protection of futures commission merchants who themselves are responsible to the exchanges when customers fail to meet margin calls.

A futures commission merchant is required by the CEA to segregate customer funds and can use those funds only for transactions of the customer. The CFTC has held that a futures commission merchant violated such segregation requirements when it used customers' funds to pay for a trading loss in a customer account caused by broker error. This holding is premised on the CFTC's decision that an unauthorized transaction is the position of the futures commission agent, not the customer. Therefore, when a futures commission agent negligently reverses the customer's instructions, resulting in a loss for which the customer's account is debited, the futures commission agent wrongfully charges that customer for the futures commission agent's own transaction.

Other customer claims are more difficult to establish. For example, the CFTC has concluded that violations of exchange rules do not permit an award of damages in reparations proceedings.


164. See supra note 125 and accompanying text.

Courts have reached a similar conclusion holding that no private right of action exists for violations of the internal policies or procedures of a brokerage firm. Similarly, as a result of recent changes in the CEA, the CFTC cannot award reparations against a person who is not registered with it, and, recently a district court held that there was no private right of action for the failure of a broker to register with the CFTC.


Section 4c of the CEA\textsuperscript{170} prohibits "wash trading," "cross trading," "accommodation trading," "fictitious sales," and transactions that cause a false price to be reported.\textsuperscript{171} In \textit{CFTC v. Savage}\textsuperscript{172}, the Ninth Circuit noted that such transactions were viewed by Congress to be "pure, unadulterated fraud."\textsuperscript{173} The court held that although scienter is necessary to establish a violation of section 4c, it cannot be avoided by "willfully or carelessly induced ignorance."\textsuperscript{174}

Another transaction prohibited by section 4b of the CEA is referred to as "bucketing."\textsuperscript{175} Generally, bucketing occurs when a broker does nothing with an order at all, simply betting that the market will move adversely to the customer and allow the broker to profit to the extent of the losses suffered by the customer.\textsuperscript{176}


\begin{itemize}
\item \textit{Id.} at 284 n.13 (quoting Commodity Exchange Authority, Memorandum on Definition of Certain Trade Practices Prohibited by the Commodity Exchange Act (May 25, 1966)).
\item 611 F.2d at 284.
\item 611 F.2d at 284. The court also noted that wash trades were viewed by the Commodity Exchange Authority as including "the \textit{intent} not to make genuine, bona fide trading transactions in stocks or commodities." \textit{Id.} (quoting \textit{In re Jean Goldwurm}, 7 Agric. Dec. 265, 274 (1984)) (emphasis in original); \textit{see supra} note 170 and accompanying text.
\item 7 U.S.C. § 6b (1982).
\end{itemize}
Bucketing (in the form of "cross trading") also occurs when a broker fails to execute a customer's order and instead offsets the order against the matching order of another customer. Bucketing is a particularly pernicious practice because it allows a broker to favor some customers by switching their orders to the detriment of others. In instances where the broker does not execute the order at all, he is simply betting against the customer. This offense is compounded when the broker had advised the customer that the market would move in a given direction and persuaded the customer to enter into the transaction based upon the broker's prediction. The broker bucketing the order, in such instances, is hoping that his own advice is erroneous. Bucketing is dangerous also because the success or failure of the transaction becomes dependent upon the ability and willingness of the broker to pay the customer any realized profits.

Manipulation of commodity futures prices is also prohibited by the CEA.\textsuperscript{177} Claims of manipulation, however, require a complex analysis of the commodity market to determine whether manipulation actually has occurred. In addition, plaintiffs have the difficult burden of showing that the alleged manipulator acted with the intent to manipulate prices.\textsuperscript{178}

IV. SCIENTER REQUIREMENTS UNDER THE CEA

A determination of the standard of intent necessary to prove that fraud has been committed is a recurring concern under the CEA. Portions of section 4b contain an express willfulness requirement. The Seventh Circuit has held that willfulness is present if the defendant acts intentionally, "irrespective of evil motive or reliance on erroneous advice," or if the defendant acts with "careless disregard."\textsuperscript{179} The Second Circuit has taken a similar approach,

\begin{itemize}
  \item \textsuperscript{177} 7 U.S.C. § 13b (1982).
  \item \textsuperscript{179} Goodman v. Benson, 286 F.2d 896, 900 (7th Cir. 1961); accord Silverman v. CFTC, 549 F.2d 28, 31 (7th Cir. 1977); see also In re Williams, [1977-1980 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 20,560 (C.F.T.C. Feb. 13, 1978).
\end{itemize}
holding that a defendant need not have "an evil motive or an affirmative intent to injure his customer" or a subjective intent to cheat or defraud; all that is required is a knowing, intentional act.\(^\text{180}\) Other circuits have demanded at least a recklessness standard before finding scienter. The Ninth Circuit held that scienter to establish a violation of section 4b is present when one acts in "careless disregard of whether his acts amount to cheating, filing false reports, etc."\(^\text{181}\) Similarly, the Tenth Circuit held that conduct must be purposeful or intentionally deceptive to violate section 4b and that mere negligence, mistake or inadvertance is not sufficient to establish liability.\(^\text{182}\) The CFTC, however, has taken a broader view. In *Gordon v. Shearson Hayden Stone, Inc.*,\(^\text{183}\) the CFTC rejected any scienter requirement under section 4b, holding that unintentional or negligent violations of any part of the CEA would be sufficient to establish a violation. Although this decision was later affirmed by the Ninth Circuit in an unpublished opinion, the court affirmed on the basis that scienter was present in that


\(^\text{181}\) CFTC v. Savage, 611 F.2d 270, 283 (9th Cir. 1979). The court also stated that a finding of scienter could not be avoided by "ignorance brought about by willfully or carelessly ignoring the truth." *Id.*


In *Ernst & Ernst v. Hochfelder* the Supreme Court held that scienter was required under section 10(b) of the Securities Exchange Act of 1934 and rule 10b-5. The Supreme Court has stated that these provisions are "similar" to the provisions of section 4b of the CEA. The Supreme Court also held in *Aaron v. SEC* that scienter is required under certain of the antifraud provisions of section 17(a) of the Securities Act of 1933, but, incongruously, concluded that other portions of that statute did not contain such a requirement. Although confusing, the Court's decisions in *Aaron* and *Hochfelder* draw a distinction between those instances in which a statute prohibits fraudulent acts, which require scienter, and those instances in which a statute prohibits the effects of an act. If the effect of the act is to defraud regardless of the intent of the actor, the statute does not require scienter. This rationale leaves judicial interpretation of section 4b uncertain because the language of the statute differs substantially from the provisions addressed by the Court in *Aaron* and *Hochfelder*.

Since *Aaron*, the CFTC appears to have retreated from its previous position in *Gordon*. Thus, the CFTC has since stated that the antifraud provisions of section 4b "should not be applied to situations . . . where the failure to obey the customer's instructions results not from any fraudulent conduct but rather from a

188. Id. at 27,156 n.5.
191. See supra notes 173-74 and accompanying text.
clerical error — albeit negligent . . . .” CFTC administrative law judges have concluded that a broker does not violate section 4b if he or she exercises due care, and that breaches of contract are not violations of the CEA, but a failure to follow customer instructions may still be held to be fraudulent.

Other antifraud provisions in CFTC rules and the CEA are equally confusing in their scienter standards. For example, the CFTC sought to eliminate any willfulness requirement from its an-

193. Hunter v. Madda Trading Co., [1980-1982 Transfer Binder] COMM. FUT. L. REP. (CH) ¶ 21,242, at 26,204 n.8 (C.F.T.C. Sept. 2, 1981). The CFTC nevertheless found a violation in Hunter of § 4d of the CEA. 7 U.S.C. § 6d (1982). Section 4d requires customer funds to be kept in segregated trust funds and permits brokerage firms to use those funds only for customer obligations. In Hunter the CFTC concluded that the error was not an obligation of the customer, and, therefore, the broker was not authorized to remove the customer's funds from the segregated account to pay for the error. This, of course, allows the CFTC to impose liability in a broad array of situations that would otherwise be the subject of a fraud claim. See Markham, Developments in Commodities Litigation, 14 Rev. Sec. Reg. 843 (Oct. 1981).


tist fraud rule for commodity options, but the courts have divided on whether scienter is required under the rule. Equally confusing is the CFTC antifraud rule concerning the trading of foreign futures contracts in the United States. Although modeled after section 4b of the CEA, this rule does not contain an express willfulness requirement. The First Circuit held that the rule requires a finding of reckless conduct. The CFTC, however, held that the same antifraud rule does not require willful conduct to establish a violation. The Seventh Circuit also concluded that the CFTC antifraud rule for leverage contracts does not include a scienter requirement. Furthermore, the Ninth Circuit held that the CFTC antifraud provision for commodity pools and commodity trading advisors does not require scienter. These provisions contain language similar to that in rule 10b-5 and section 17(a) of the Securities Act of 1933, which raises the question whether Hochfelder or Aaron ultimately will control the application of scienter.

In sum, courts tend to require some element of scienter in establishing a fraud violation under the CEA and its regulations. Nevertheless, careful scrutiny must be given to the specific antifraud provision at issue and alternative provisions of the CEA must be examined to determine if liability may be imposed without a requirement of scienter.

200. See First Commodity Corp. v. CFTC, 676 F.2d 1, 6-7 (1st Cir. 1982).
V. SECONDARY LIABILITY UNDER THE CEA

Section 2(a)(1) of the CEA establishes statutory liability under the doctrine of respondeat superior for persons subject to the Act. The CFTC has sought to apply this standard broadly to impose liability upon brokerage firms and agents. In *In re Big Red Commodity Corp.* a futures commission merchant was held liable by a CFTC administrative law judge for the fraudulent acts of one of its employees, even though the futures commission merchant was unaware of the fraud and did not “knowingly participate” in that fraud.

Subsequent to the decision in *Big Red Commodity*, Congress enacted a “controlling person” provision that precludes imposition of liability upon “any person who directly or indirectly, controls any person who has violated any provision of” the CEA unless it is proven that “the controlling person did not act in good faith or knowingly induced directly or indirectly, the act or acts constituting the violation.” In adopting this provision, Congress made clear its intention that the respondeat superior provision of section 2(a)(1) “not be used as a basis for imputing liability to a controlling person of a firm for acts of an employee or agent of the firm since it does not include the protections that have been care-

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fully articulated in the . . . [controlling person provision] and would make a nullity of that provision." The controlling person provision does not permit imposition of liability for monetary damages; rather it is directed for use in CFTC proceedings. Therefore, the provision appears to preclude damage actions when a controlling person relationship is asserted as the basis for liability.

The CEA also contains a specific statutory provision that imposes liability upon anyone who aids and abets the violations of another. The CFTC has stated that liability for aiding and abetting may be imposed only when there is "proof of a specific unlawful intent to further the underlying violation," and "one must knowingly associate himself with an unlawful venture, participate in it as something that he wishes to bring about and seek by his action to make it succeed." A CFTC hearing officer, however,
imposed a reparations award against a salesman even though he had not been aware of the fraud committed by his firm.213 The hearing officer concluded that the salesman had benefited by receiving commissions and ordered the salesman to repay the amount of his enrichment.214 In 1982 the aiding and abetting provisions of the CEA were amended to allow aiding and abetting liability to be imposed in private actions for damages.215 Previously, the statute had been limited in applicability to CFTC administrative proceedings.

Another form of secondary liability under the CEA is found in a CFTC regulation that requires commodity professionals to supervise their employees.216 In Big Red Commodity,217 a CFTC administrative law judge concluded that a futures commission merchant had failed to supervise properly a salesperson who had carried out a fraud in an unrelated commodity pool in his capacity as president of the pool.218 Declining to enumerate any supervisory failures


216. 17 C.F.R. § 166.3 (1984); Rosen and Shapiro, Regulation 166.3: Actions Under the Diligent Supervision Rule, (Part II) 4 Comm. L. Letter 3 (Nov. 1984).


on which to base liability, the administrative law judge determined that the lack of "reasonable supervisory procedures" itself demonstrated a lack of supervision.210

VI. FIDUCIARY DUTIES UNDER THE CEA

A frequent issue raised in CEA cases is whether brokers owe their customers a fiduciary duty and, if so, what is the extent of that duty. In Robinson v. Merrill Lynch, Pierce, Fenner & Smith, Inc.,220 an action for losses in trading commodity futures contracts, the district court held that "absent an express investment advisory contract there is no fiduciary duty unless the customer is infirm or ignorant of business affairs."221 In Leib v. Merrill Lynch, Pierce, Fenner & Smith, Inc.,222 however, the district court held that a securities broker owed certain duties even to a nondiscretionary account, including: (1) the duty to recommend a stock only after being informed as to its nature, price and financial prognosis; (2) the duty to execute the customer's orders promptly; (3) the duty to inform the customer of the risks involved in purchasing or selling the security; (4) the duty to refrain from self-dealing or failing to disclose any interests of the broker in a recommended security; (5)


221. Id. at 113; see also McGinn v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 736 F.2d 1254 (8th Cir. 1984).

the duty not to misrepresent any material fact; and (6) the duty to execute orders only after receiving prior authorization from the customer.\footnote{223} The Court in \textit{Leib} further stated that when the account is a discretionary one, the broker becomes the fiduciary of the customer in a "broad sense," and is required to: (1) manage the account to comport with the needs and objectives of the customer; (2) keep informed of changes in the market and act responsively to such changes; (3) keep his customer informed as to each completed transaction; and (4) explain the practical impact and potential risks of the course of dealing in which the broker is engaged.\footnote{224}

It is unclear whether the standards in \textit{Leib} will be applied to the commodities area, particularly in light of the rejection by courts of a suitability standard in commodities trading.\footnote{225} The CFTC has concluded that a fiduciary relationship does exist between a broker and customer\footnote{226} and, therefore, even negligent conduct may constitute fraud under section 4b of the CEA.\footnote{227} As pre-

\footnote{223} \textit{Id.} at 953. The court also stated:

Of course the precise manner in which a broker performs these duties will depend to some degree upon the intelligence and personality of his customer. For example, where the customer is uneducated or generally unsophisticated with regard to financial matters, the broker will have to define the potential risks of a particular transaction carefully and cautiously. Conversely, where a customer fully understands the dynamics of the stock market or is personally familiar with a security, the broker's explanation of such risks may be merely perfunctory. \textit{Id.} at 953; \textit{see also} Kenny v. Shearson/American Express, Inc., [1982-1984 Transfer Binder] \textit{COMM. Fut. L. Rep.} (CCH) \textsection 21,924 (C.F.T.C. Nov. 10, 1983).

In Marchese v. Shearson Hayden Stone, Inc., 2 \textit{COMM. Fut. L. Rep.} (CCH) \textsection 22,217 (9th Cir. June 1, 1984), the court held that a broker is in a fiduciary relationship with his customers and has an "affirmative duty of utmost good faith, and full and fair disclosure of all material facts." \textit{Id.} at 29,146 (quoting SEC \textit{v. Capital Gains Research Bureau, Inc.}, 375 U.S. 180, 194 (1963)). In Ray E. Friedman \& Co. \textit{v. Jenkins}, 2 \textit{COMM. Fut. L. Rep.} (CCH) \textsection 22,241 (8th Cir. June 28, 1984), however, the court held that when a nondiscretionary account is controlled by a customer, a fiduciary duty does not attach. \textit{See also} McGinn \textit{v. Merrill Lynch, Pierce, Fenner \& Smith, Inc.}, 2 \textit{COMM. Fut. L. Rep.} (CCH) \textsection 22,242 (8th Cir. June 22, 1984).

\footnote{224} \textit{Leib v. Merrill Lynch, Pierce, Fenner \& Smith, Inc.}, 461 F. Supp. at 953 (citations omitted).


\footnote{227} The fiduciary duty of brokers is described by the CFTC as follows:
viously discussed, the courts, however, have rejected negligence as a sufficient basis to establish fraud. Nevertheless, the CFTC in a recent decision once again stated that commodity professionals necessarily stand in a fiduciary relationship with their customers. In that decision, the CFTC held that a commodity trading advisor was liable for creating the false expectation that all of a customer's capital would not be at risk in the market.

In *Wattay v. Shearson Hayden Stone, Inc.* the CFTC stated that a brokerage firm employee rendering trading advice to customers had a fiduciary obligation to know all material facts that could affect the customer's trading decision and to disclose the same to the customer. In contrast, in *Rasheed v. Heinold Com-

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For example, although an associated person may act for some customers only as the conduit for orders by transmitting the orders to an exchange floor for execution, for other customers the associated person may act in an advisory capacity. In the latter case, as here, the scope of an associated person's duties to that customer broadens substantially.

As a fiduciary, an associated person giving commodity trading advice has a duty to know all material market facts which are reasonably ascertainable in connection with a customer's trading decision . . . . In addition, such as associated persons [sic] has a fiduciary duty to disclose these material facts to his customers. Id. at 23,981 (footnotes omitted); see also, Notkin v. Paine, Webber, Jackson & Curtis, Inc., [1980-1982 Transfer Binder] COMM. Fut. L. Rep. (CCH) ¶ 21,236 (C.F.T.C. Aug. 25, 1981).

228. See supra notes 179-204 and accompanying text.


modities, Inc.\textsuperscript{232} the CFTC stated that an administrative law judge's finding that a respondent had breached its fiduciary duty by failing to disclose material facts would have been better analyzed as a case of misrepresentation rather than using a breach of fiduciary duty as a basis for liability.\textsuperscript{233} Regardless of the scope of the duty, a broker is not "a human ticker tape machine who must spend every minute of the day reporting the current floor bids to his customers."\textsuperscript{234}

The CFTC recently proposed an amendment to its Risk Disclosure Statements that would require these documents to state that a commodity professional is not relieved of its disclosure responsibilities merely by having a customer sign the Risk Disclosure Statement and that the Risk Disclosure Statement is not the exclusive disclosure requirement under the CEA.\textsuperscript{235} The CFTC based this proposal on its assertion that commodity professionals stand in a fiduciary relationship with their customers and that the Risk Disclosure Statement may not, in all circumstances, meet the professionals' fiduciary obligations of disclosure.\textsuperscript{236} Because of the CFTC's assertion of such a fiduciary duty, this proposal has met with strong industry opposition.

\section{VII. Forums Available for Customer Remedies}

\subsection{A. Reparation Proceedings}

The CEA contains a unique provision that allows the CFTC to award damages to customers in "reparations" proceedings for violations of the CEA by persons registered with the CFTC.\textsuperscript{237} To fulfill this responsibility, the CFTC utilizes administrative law judges

\begin{thebibliography}{9}
\bibitem{233} \textit{Id.} at 27,526 n.4.
\bibitem{234} \textit{Id.} at 27,526 n.4.
\bibitem{237} \textit{Id.} The CFTC release went to great lengths to establish a fiduciary relationship. It also noted that the duties of such a relationship vary substantially depending on the customer. "For example, it seems clear that the scope of . . . disclosure obligations is substantially broader . . . in an advisory capacity for a customer than when simply transmitting a customer's orders to an exchange floor for execution." \textit{Id.} at 26,360; \textit{see also} Gittemeier v. Smith Barney, Harris Upham \& Co., [1982-1984 Transfer Binder] \textit{Comm. Fut. L. Rep.} (CCH) \textsuperscript{\textdagger} 21,929 (C.F.T.C. Nov. 30, 1983).
\bibitem{238} 7 \textit{U.S.C.} § 18(a) (1982).
\end{thebibliography}
to hear evidence and make initial decisions. Governed by extensive CFTC regulations, the CEA makes provision for cases to be heard without the requirement of a costly hearing.

After an administrative law judge renders a decision, an appeal may be made to the CFTC, but the CFTC may determine not to review the administrative law judge’s action. In the event of such review, or refusal to review, a person adversely affected by a reparations decision may seek further review before a court of appeals. When a party refuses to pay a reparation award, a federal district court may enforce the award. Although the CFTC provides for counterclaims by brokers in federal district court proceedings, a recent circuit court decision held that the Act did not permit this.

In the past, CFTC reparations proceedings were plagued by delays because of an unexpectedly large number of claims made by commodity options customers. Recent legislation and the CFTC’s modification of its rules have streamlined these proceedings. No provision exists for a jury trial in reparation proceedings for either a customer or a broker. This disadvantage may be offset by the expedition of proceedings resulting from the expertise of CFTC administrative law judges. Punitive damages have not been awarded in reparations proceedings and discovery rights are limited.

239. See Horwitz & Markham, supra note 41, at 94-95; Rosen, Reparation Proceedings Under the Commodity Exchange Act, 27 EMORY L.J. 1005 (1978); Shipe, Private Litigation Before the Commodity Futures Trading Commission, 33 AD. L. REV. 153 (1981);
245. Futures Trading Act of 1982, Pub. L. No. 97-444, 96 Stat. 2294 (1982). These changes included the elimination of reparations proceedings against persons who are not registered with the CFTC. Congress found that such claims were frequently uncollectible and served only to delay other reparation cases. See S. Rep. No. 384, 97th Cong., 2d Sess. 48 (1982). The CFTC, however, has decided not to apply this change retroactively. Nelson v. Chilcott Commodities Corp., [1982-1984 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 21,934 (C.F.T.C. Dec. 12, 1983).
247. See Markham, supra note 191, at 88.
B. Arbitration

The CEA provides for exchanges to maintain arbitration forums for customer claims. A customer, however, is not required to submit to arbitration; the agreement to do so must be "voluntary." CFTC regulations governing voluntary arbitration require specified language that must be contained in the customer's account agreement and a separate customer signature agreeing to arbitration. Arbitration offers the advantages of speed, lack of publicity, and reduced costs because of the absence of the formal procedures of federal district court litigation or reparations proceedings. Further, rights of appeal are extremely limited and awards are generally final. As with reparations proceedings, no provision for a jury trial exists and discovery, if permitted at all, is generally very limited.

C. Private Rights of Action

In Merrill Lynch, Pierce, Fenner & Smith v. Curran, the Supreme Court held that a private right of action exists for some violations of the CEA. Subsequently, the CEA was amended to reflect this holding and the CEA now allows private damages actions for violations of its provisions. These actions, however, may be brought only by traders, and not by persons indirectly affected. The legislation limits actions against the exchange by requiring that a plaintiff show that the exchange acted in bad faith.

Federal court litigation, of course, may be more expensive and time consuming than arbitration or reparations, but it offers the advantages of full discovery, the right to a jury trial, and the full right of appeal.

VIII. Conclusion

The CFTC has now been in existence for over ten years, and a rapidly developing body of case law has done much to clarify the applicable standards for customer protection under the Commodity Exchange Act. The CFTC has actively sought legislation in ar-

254. Horwitz & Markham, supra note 41, at 97-98.
eas in which it has found customer protection wanting. A number of issues are, however, in need of additional clarification. More definitive standards and guidelines are needed for determining whether the level of trading in a customer's account is so excessive as to constitute churning. Additional standards should be established for unauthorized trading. The overwhelming number of cases arising under the Commodity Exchange Act are claims of unauthorized trading—claims that all too frequently appear to be motivated by the unprofitable nature of the transaction rather than a concern over lack of authority. These abuses could be stemmed, for example, by establishing more exact requirements on the duty to complain—thus reducing the number of claims and greatly alleviating the litigation calendars of the CFTC and the courts.

Finally, the creation of a National Futures Association should permit the development of a nationwide arbitration system that will permit speedy resolutions of customer disputes without prohibitive costs. The development and use of expert arbitrators should preclude the necessity of long explanations of the futures markets or the use of experts to describe those markets. The Arbitration Projects National Futures Association also should hasten the resolution of the many complex issues that arise in the context of commodities markets.