

NOTES

COMMODITY FUTURES LITIGATION: A BY-PRODUCT OF INVESTOR ROULETTE

The commodity futures market is a fascinating, exciting and challenging arena. Its activity is reactive to every major social, political and meteorological event throughout the continents. It is an industry that pits the investor against the unknown. Its roots based in antiquity, the market today is luring, daring and even defying investors of all walks of life to come and play with the big boys—the high rollers. In essence, it's a win or lose proposition where its beauty and seductiveness lie in its risk. Indeed, the wrath of commodity futures can be swift and unyielding or swift and rewarding for this mistress of a market, can with the touch of her hand, make a prince into a pauper.

This Note is not addressed to those who win or to those who lose rightfully, regardless of the amount. As the old phrase goes—if you want to dance, you have to pay the piper. However, this Note is addressed to those who lose wrongfully as a result of the unethical practices of various brokerage houses throughout the continental United States.

I. CAUSES OF ACTION

One of the most exciting and challenging areas of the law today is commodity futures litigation. Born as a result of the separate evolution of the commodity futures industry as a viable alternative to the investing public, commodity futures litigation has survived its adolescence and has now come of age. This "coming of age" has brought with it a new body of law, so that today, a commodity futures litigant is armed with a virtual arsenal of rules and regulations to utilize against unscrupulous brokerage houses. An exhaustive discussion of this "barrage of weapons" would be beyond the scope and intent of this Note. Typically, however, current commodity futures disputes involve allegations of churning, violations of section 4b of the Commodity Exchange Act,¹ margin rule violations, unauthorized trading and/or breaches of fiduciary duties.² The following materials address these various

1. 7 U.S.C. § 6b (1976).

2. However, causes of action could conceivably be predicated, *inter alia*, on common law fraud, negligence, breach of contract (oral or written), failure to supervise, and/or section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j (1976) (applicable only if actions involving discretionary accounts are available in that circuit).

allegations.

A. Churning

One of the most overused and least understood terms in the vernacular of commodity futures is that of "churning." In essence an account has been churned when a broker who has control over an account trades it excessively without regard to the customer's needs and objectives.³ Consequently, because a commission is charged for each transaction, the end result of churning is the generation of handsome commissions for the broker, at the customer's expense. Two crucial factors are implicit in the definition of churning: Control⁴ and excessive trading.⁵

1. Control

Proof that the broker exercised control over the customer's account is vital to substantiate an allegation of churning. In most cases this is often easier said than done.⁶ Recently, the Commodity Futures Trading Commission in *Smith v. Siegel Trading Co.*,⁷ enumerated tangible factors to be considered in determining the often-elusive element of control. In its decision the Commission stated that:

[A]mong the factors which tend to demonstrate control are 1) a lack of customer sophistication 2) a lack of price commodity trading experience on the part of the customer and a minimum of time devoted by him to his account 3) a high degree of trust and confidence reposed in the associated person⁸ by the customer 4) a large percentage of transactions entered into by the customer based on 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.⁹

3. *Deems v. Citadel Trading Co.*, No. R 78-464-79-144, slip op. at 3-4 (Comm. Fut. Trading Comm'n April 22, 1980). See also *Fey v. Walston*, 493 F.2d 1036, 1040 n.1, 1050-51 (7th Cir. 1974); *Moscarelli v. Stamm*, 288 F. Supp. 453, 457 (E.D.N.Y. 1968).

4. *E.g.*, *Deems v. Citadel Trading Co.*, No. R 78-464-79-144, slip op. at 3 (Comm. Fut. Trading Comm'n April 22, 1980).

5. See, *e.g.*, *id.*, slip op. at 5.

6. See, *e.g.*, *id.*, slip op. at 4-5.

7. [1980] 2 COMM. FUT. L. REP. (CCH) ¶ 21,105, at 24,450 (Comm. Fut. Trading Comm'n).

8. An associated person is defined as "any person who . . . is associated with any futures commission merchant or with any agent of a futures commission merchant as a partner, officer, or employee . . . in any capacity which involves (1) the solicitation or acceptance of customers' orders . . . or (2) the supervision of any person or persons so engaged." General Regulations Under The Commodity Exchange Act, 17 C.F.R. § 1.3(aa) (1980).

9. *Smith v. Siegel Trading Co.*, [1980] 2 COMM. FUT. L. REP. (CCH) ¶ 21,105, at 24,454 (Comm. Fut. Trading Comm'n) (footnote added). Accord, *Carras v. Burns*, 516 F.2d 251 (4th Cir. 1975); *Hecht v. Harris, Upham & Co.*, 430 F.2d 1202 (9th Cir. 1970); *Norris & Hirschberg*,

In addition, it has been held that where a discretionary account is not involved, the burden is on the customer to demonstrate that the broker exercised de facto control over the *volume and frequency* of trading in the customer's account.¹⁰ Moreover, substantial reliance upon a broker's advice does not, in and of itself, establish the requisite control necessary to substantiate an allegation of churning.¹¹

A positive aspect from the complainant's perspective, however, is that the vesting of formal discretion in the broker is *not* a requirement to substantiate control.¹² In other words, control can be established despite the fact that the broker has not been given the authority to trade as he sees fit in the best interests of the customer.

In addition, it is apparent that the trading sophistication of the complainant can be, and often is, a major factor in the disposition of churning allegations.¹³ One note of caution, however; courts generally consider both *securities* and *commodities* trading experience when determining a customer's trading sophistication. This practice is a result of the inherent similarities that exist in the trading of commodities and securities.¹⁴

2. Excessive Trading

As previously stated, in addition to establishing the requisite element of control, it must also be demonstrated that the account was traded excessively.¹⁵ Although this sounds simple in theory, practical application is often deceptive, for courts have long held "that no single quantitative indicator"¹⁶ can establish excessive trading. Consequently, "[a]n overall, impressionistic view must be taken of the transactions in the account to conclude whether, in light of the particular needs and objectives of the customer, trading has indicated an objective of the broker to generate commissions in disregard of that customer's interest."¹⁷ In this regard, the ratio of commissions to the

Inc. v. SEC, 177 F.2d 228 (D.C. Cir. 1949); *Newburger, Loeb & Co. v. Gross*, 365 F. Supp. 1364 (S.D.N.Y. 1973). In *Smith*, however, the Commodity Futures Trading Commission cautioned that the enumerated factors were not intended to be exhaustive and that each individual factor need not be present to substantiate control. See *Smith v. Siegel Trading Co.*, [1980] 2 COMM. FUT. L. REP. (CCH) ¶ 21,105, at 24,454 n.6.

10. *Franklin v. Dean Witter Reynolds, Inc.*, No. R 79-98-79-322, slip op. at 4-5 (Comm. Fut. Trading Comm'n April 14, 1980).

11. *Id.*

12. See *Smith v. Siegel Trading Co.*, [1980] 2 COMM. FUT. L. REP. (CCH) ¶ 21,105, at 24,454 (Comm. Fut. Trading Comm'n 1977).

13. See, e.g., *Hyman v. Maduff & Sons, Inc.*, [1980] 2 COMM. FUT. L. REP. (CCH) ¶ 21,006, at 23,924 (Comm. Fut. Trading Comm'n).

14. See *McGaughey v. Hogan-Orr, Inc.*, No. R 78-527-79-152, slip op. at 8 (Comm. Fut. Trading Comm'n July 31, 1980).

15. See text accompanying note 5 *supra*.

16. *McGaughey v. Hogan-Orr, Inc.*, No. R 78-527-79-152, slip op. at 8 (Comm. Fut. Trading Comm'n July 31, 1980).

17. *Deems v. Citadel Trading Co.*, No. R 78-464-79-144, slip op. at 5 (Comm. Fut. Trading

amount of the customer's investment has been held to be a significant factor regarding substantiation of excessive trading.¹⁸ Similarly, the Commission, while noting that major differences do exist between securities and commodities,¹⁹ has nonetheless held that various indicators of excessive securities trading are also applicable in discerning the existence or nonexistence of excessive commodities trading.²⁰

One such factor is the "turnover rate" of the customer's account.²¹ Basically, the turnover rate is computed by dividing the cost of purchases by the average net equity in the account, discounted by the amount of initial investment.²² While in securities, "an annual turnover rate of six reflects excessive trading,"²³ such is not the case in commodity futures because of the lack of underlying equity interest characteristic of commodity futures accounts.²⁴ Moreover, because futures contracts are "margin accounts,"²⁵ the leveraged aspect of the typical account encourages frequent trading in order to capitalize on minimal price fluctuations in the commodity being traded.²⁶

In addition to the turnover rate of an account, courts generally regard the ratio of broker's commissions charged to the average net equity in an account as a significant factor to be contemplated regarding an allegation of churning.²⁷ In this regard "short term in-and-out trading"²⁸ is suspect be-

Comm'n April 22, 1980). *Accord*, *Hecht v. Harris, Upham & Co.*, 430 F.2d 1202 (9th Cir. 1970). See also Note, *Churning By Securities Dealers*, 80 HARV. L. REV. 869 (1967). Because of the differences that do exist between commodities and securities, this Note has questionable application to the analysis of the churning of commodities.

18. *E.g.*, *Hecht v. Harris, Upham & Co.*, 283 F. Supp. 417, 436 (N.D. Cal. 1968), *modified*, 430 F.2d 1202 (9th Cir. 1970).

19. See *McGaughey v. Hogan-Orr, Inc.*, No. R 78-527-79-152, slip op. at 8 & n.3. (Comm. Fut. Trading Comm'n July 31, 1980). For a discussion of the major differences between commodities and securities see 1 A. BROMBERG, *SECURITIES LAW* § 4.6, at 82.422 (1977).

20. *McGaughey v. Hogan-Orr, Inc.*, No. R 78-527-79-152, slip op. at 8 (Comm. Fut. Trading Comm'n July 31, 1980).

21. *Id.* slip op. at 10.

22. *Id.*, slip op. at 10 n.4.

23. *Mihara v. Dean Witter & Co.*, 619 F.2d 814, 821 (9th Cir. 1980). *But cf.* *McGaughey v. Hogan-Orr, Inc.*, No. R 78-527-79-152, slip op. at 10 (Comm. Fut. Trading Comm'n July 31, 1980) (reparations decision holding that an annual turnover rate in excess of two is indicative of churning).

24. *McGaughey v. Hogan-Orr, Inc.*, No. R 78-527-79-152, slip op. at 10 (Comm. Fut. Trading Comm'n July 31, 1980). In *McGaughey*, a turnover rate of 11.4 times was found not to be dispositive of churning.

25. Margin is defined as "an amount of money deposited by both buyers and sellers of futures contracts to insure performance against the contract." Board of Trade of the City of Chicago, *Commodity Trading Manual* 277 (1973).

26. One author has advocated the position that only extremely high turnover rates should be indicative of churning when analyzing commodities. See Hudson, *Consumer Protection in the Commodity Futures Market*, 58 B.Y. L. REV. 1, 22 (1978).

27. See, *e.g.*, *Deems v. Citadel Trading Co.*, No. R 78-464-79-144, slip op. at 7 (Comm. Fut. Trading Comm'n April 22, 1980).

28. One indicator of short term in-and-out trading is the number of "day trades" that are

cause such a pattern usually results in minimal gains or losses for the customer, while generating a steady, and often hefty, flow of commissions for the broker.²⁹

3. *Defenses to Churning Allegations*

The question arises in futures litigation as to whether an affirmative defense exists to defeat a substantiated allegation of churning. A recent decision seems to indicate that there is such a defense.³⁰ In *Jensen v. Shearson Hayden Stone, Inc.*,³¹ the complainant's account was being traded pursuant to "the so-called Donchian System,"³² a system that monitors price fluctuations in select commodities in five and twenty day periods.³³ In finding that the complainant "exhibited unusual familiarity with the Donchian technique and terminology,"³⁴ the judge attached substantial significance to the fact that the complainant was system trading and therefore there existed a "bona fide rationale for each investment."³⁵ Consequently, the allegation of churning was dismissed.³⁶ It is apparent that when transactions are executed under the guise of a defined system, and an investor is apprised of the mechanics of that system, a churning allegation will not be sustained.

B. *Violations of the Commodity Exchange Act*

In addition to a cause of action founded on churning, numerous causes of action are to be found in the rubric of the Commodity Exchange Act.³⁷ It would be beyond the scope of this Note to exhaust all possible allegations that may be brought under the rules and regulations of the Commodity Exchange Act.³⁸ However, the majority of litigation today is premised upon section 4b of the Commodity Exchange Act.³⁹ In its entirety, section 4b provides that:

It shall be unlawful (1) for any member of a contract market, or for any correspondent, agent, or employee of any member, in or in connec-

transacted in an account. A "day trade," a term of art in the futures vernacular, results when a position (purchase or sale) is established and then liquidated by an offsetting purchase in a single trading day.

29. *McGaughey v. Hogan-Orr, Inc.*, No. R 78-527-79-152 (Comm. Fut. Trading Comm'n July 31, 1980).

30. *Jensen v. Shearson Hayden Stone, Inc.*, No. R 78-140-78-195 (Comm. Fut. Trading Comm'n July 28, 1980).

31. *Id.*

32. *Id.* slip op. at 3-4.

33. *Id.* slip op. at 4.

34. *Id.*

35. *Id.* slip op. at 14.

36. *Id.*

37. 7 U.S.C. §§ 1-24 (1976 & Supp. III 1979).

38. *Id.*

39. 7 U.S.C. § 6b (1976).

tion with any order to make, or the making of, any contract of sale of any commodity in interstate commerce, made, or to be made, on or subject to the rules of any contract market, for or on behalf of any other person, or (2) for any person, in or in connection with any order to make, or the making of, any contract of sale of any commodity for future delivery, made, or to be made, on or subject to the rules of any contract market, for or on behalf of any other person if such contract for future delivery is or may be used for (a) hedging any transaction in interstate commerce in such commodity or the products or by-products thereof, or (b) determining the price basis of any transaction in interstate commerce in such commodity, or (c) delivering any such commodity sold, shipped, or received in interstate commerce for the fulfillment thereof —

(A) to cheat or defraud or attempt to cheat or defraud such other person;

(B) willfully to make or cause to be made to such other person any false report or statement thereof, or willfully to enter or cause to be entered for such person any false record thereof;

(C) willfully to deceive or attempt to deceive such other person by any means whatsoever in regard to any such order or contract or the disposition or execution of any such order or contract, or in regard to any act of agency performed with respect to such order or contract for such person; or

(D) to bucket such order, or to fill such order by offset against the order or orders of any other person, or willfully and knowingly and without the prior consent of such person to become the buyer in respect to any setting order of such person, or become the seller in respect to any buying order of such person.

Nothing in this section or any other section of this chapter shall be construed to prevent a futures commission merchant or floor broker who shall have in hand, simultaneously, buying and selling orders at the market for different principals for a like quantity of a commodity for future delivery in the same month, from executing such buying and selling orders at the market price: *Provided*, That any such execution shall take place on the floor of the exchange where such orders are to be executed at public outcry across the ring and shall be duly reported, recorded, and cleared in the same manner as other orders executed on such exchange: *And provided further*, That such transactions shall be made in accordance with such rules and regulations as the Commission may promulgate regarding the manner of the execution of such transactions.⁴⁰

There is some dispute as to the standard of care that is imposed upon a commodity professional under section 4b(A).⁴¹ Recently, in *Gordon v. Shearson Hayden Stone, Inc.*,⁴² the Commodity Futures Trading Commission concluded that "a breach of a fiduciary duty, even if committed negli-

40. *Id.*

41. *Id.*

42. [1980] 2 COMM. FUT. L. REP. (CCH) ¶ 21,016, at 23,973 (Comm. Fut. Trading Comm'n).

gently, constitutes fraud as proscribed by Section 4b(A) of the Act."⁴³ Immediately the floodgates of litigation opened as a result of this novel negligence standard which dispensed with any scienter requirement. Conversely, in the older reparation case of *Avis v. Shearson Hayden Stone, Inc.*,⁴⁴ it was held that "although the negligent failure to exercise appropriate care or skill may expose the fiduciary to a negligence or contract action, this alone is not actionable in a suit for damages under a fraud claim."⁴⁵ Although the *Gordon* and *Avis* cases are in direct conflict with one another, it appears (absent any holding to the contrary) that the *Gordon* negligence standard is currently the proper standard of care to be imposed on the commodity professional.

By far, the most litigated and controversial aspect of section 4b still remains the question of whether or not a private cause of action is inherent in the statute.⁴⁶ In other words, the question is whether a plaintiff can seek redress in a court of law, or whether he is left exclusively to administrative relief in the form of reparations. Even though the jury is still out on this issue, a verdict is expected soon in the case of *Curran v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*⁴⁷

In *Curran*, the plaintiffs suffered a substantial loss of money in speculative futures trading while customers of the defendants and accordingly filed suit in federal district court.⁴⁸ One of the issues on appeal was whether an implied cause of action existed under the Commodity Exchange Act.⁴⁹ The

43. *Id.* at 23,981.

44. [1977-1980 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 20,738, at 23,056 (Comm. Fut. Trading Comm'n 1979).

45. *Id.* at 23,060. *Accord*, *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976). *See also* *Plywood Wholesalers, Inc. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, [1980] 2 COMM. FUT. L. REP. (CCH) ¶ 21,004 at 23,920 (Comm. Fut. Trading Comm'n). In this case Administrative Law Judge Hunt adopted the proof of fraud provisions enunciated in *Santa Fe Industries v. Green*, 430 U.S. 462 (1977).

46. Currently an implied cause of action exists in the following jurisdictions: *Deaktor v. L. D. Schreiber & Co.*, 479 F.2d 529 (7th Cir. 1973), *rev'd on other grounds sub nom.* *Chicago Mercantile Exch. v. Deaktor*, 414 U.S. 113 (1973) (*per curiam*); *Booth v. Peavey Co. Commodity Servs.*, 430 F.2d 132 (8th Cir. 1970); *Seligson v. New York Produce Exch.*, 378 F. Supp. 1076 (S.D.N.Y. 1974), *aff'd sub nom.* *Miller v. New York Produce Exch.*, 550 F.2d 762 (2d Cir. 1977), *cert. denied*, 434 U.S. 823 (1977); *Arnold v. Bache & Co.*, 377 F. Supp. 61 (M.D. Pa. 1973); *Johnson v. Arthur Espey, Shearson, Hammill & Co.*, 341 F. Supp. 764 (S.D.N.Y. 1972); *United Egg Producers v. Bauer Int'l Corp.*, 311 F. Supp. 1375 (S.D.N.Y. 1970); *Anderson v. Francis I. duPont & Co.*, 291 F. Supp. 705 (D. Minn. 1968); *Hecht v. Harris, Upham & Co.*, 283 F. Supp. 417 (N.D. Cal. 1968), *modified on other grounds*, 430 F.2d 1202 (9th Cir. 1970). *Goodman v. H. Hentz & Co.*, 265 F. Supp. 440 (N.D. Ill. 1967).

47. [1980] 2 COMM. FUT. L. REP. (CCH) ¶ 21,030, at 24,054 (6th Cir.), *petition for cert. filed*, 49 U.S.L.W. 3053 (U.S. Aug. 9, 1980) (No. 80-203).

48. [1975-1977 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 20,276, at 21,504 (E.D. Mich. 1976).

49. *Curran v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, [1980] 2 COMM. FUT. L. REP. (CCH) ¶ 21,030, at 24,063-68 (6th Cir.), *petition for cert. filed*, 49 U.S.L.W. 3053 (U.S. Aug. 9, 1980) (No. 80-203).

Sixth Circuit reversed the district court in part and held that a private cause of action is implied under the Act.⁵⁰ Currently, the commodity world is waiting to see if the United States Supreme Court will grant certiorari in *Curran*. Needless to say, the disposition of this case will be the most significant case decided concerning commodity futures litigation.

Regardless of the existence of a private cause of action, the doctrine of suitability, implicit in section 4b(A) of the Commodity Exchange Act, should not be overlooked. The doctrine of suitability provides that a broker is under a duty to "recommend only investments suited to the needs and objectives of the investor."⁵¹ Consequently, if it is found that a commodity professional recommended and executed a transaction on behalf of a customer "whom he [knew] or [had] reason to believe, [was] financially unable or mentally incompetent to assume the risks therein,"⁵² then the professional "will be presumed to have violated Section 4(b)A of the Act."⁵³

C. Margin Rule Violations

An often overlooked, or discounted cause of action lies in a broker's failure to comport with exchange margin rules. Recently this cause of action came into the limelight in *Iowa Grain v. Farmers Grain & Feed Co.*,⁵⁴ an Iowa Supreme Court case. The plaintiff, a grain brokerage company, brought an action against a customer to collect an alleged deficit balance in the customer's account.⁵⁵ Subsequently, the customer counterclaimed asserting that plaintiff's alleged failure to follow a Chicago Board of Trade Rule prohibiting undermargined accounts,⁵⁶ constituted breach of contract.⁵⁷ In other words, defendant's contention was based upon the fact that had the

50. *Id.* at 24,067.

51. *Tomasian v. Smith Barney, Harris Upham & Co.*, [1977-1980 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 20,433, at 21,757 (Comm. Fut. Trading Comm'n 1977). *See also* *Dwyer v. Murlas Bros. Commodities, Inc.*, [1977-1980 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 20,520, at 22,143 (Comm. Fut. Trading Comm'n 1977) (holding that brokers have a duty to investigate and determine a customer's needs to insure that an adequate basis exists for their recommended transactions). In fact, in September 1977, the Commodity Futures Trading Commission proposed a suitability rule. *See*, 42 Fed. Reg. 44,750 (1977). However this rule was never adopted for fear of narrowing the scope of the suitability rule implicit in section 4b of the Commodity Exchange Act. *See* 43 Fed. Reg. 31,889 (1978).

52. *Jensen v. Shearson Hayden Stone, Inc.*, [1980] 2 COMM. FUT. L. REP. (CCH) ¶ 21,062, at 24,284 (Comm. Fut. Trading Comm'n).

53. *Id.* at 24,284-85.

54. 293 N.W.2d 22 (Iowa 1980).

55. *Id.* at 23.

56. Rule 210 of the Chicago Board of Trade provided that an account could not be carried by a member without proper and adequate margin. *See id.* at 24.

57. The parties' commodity account agreement provided in part that "[a]ll transactions shall be subject to the rules and customs of the exchange and clearing house or market where executed." *Id.* at 23. Furthermore, the account agreement vested authority in the plaintiff to liquidate the defendant's account whenever margin became insufficient. *Id.*

brokerage company liquidated its account as soon as a margin call had not been met, defendant's account would have had a credit, not a debit, balance.⁵⁸

In opposition, the brokerage company rested on the laurels of decisions that held that violations of exchange rules do not give rise to private causes of action absent fraudulent conduct.⁵⁹ However, the Supreme Court of Iowa, in a landmark decision, held for the customer.⁶⁰ The majority stated that "[a] broker's covenant with its customer that it will follow exchange rules and customs establishes a contractual duty to the customer."⁶¹ Therefore, the customer's claim was "not dependant on the existence of a private cause of action for breach of margin rules. Rather, [his claim was] based on [the brokerage company's] alleged breach of contract."⁶²

One note of caution, however. The *Iowa Grain* decision did not address the issue of exchange rules that vest discretionary authority in the broker regarding liquidation of an undermargined account. In the event that the exchange rules apply a discretionary standard of liquidation, arguably, the *Iowa Grain* case could be distinguished.

D. Unauthorized Trading

In addition to margin rule violations, another cause of action manifests itself in the form of unauthorized trading. The wrath of unauthorized trading lies in its detection, for frequently it can proceed unnoticed. For example: A discretionary account wherein a trader is vested with the authority to trade as he sees fit with due regard to the investors needs and objectives.⁶³ One of the most obvious forms of unauthorized trading however, emerges where the investor is trading without authorization from his corporation, but yet, "conveniently" uses corporate funds or assets. A classic illustration would involve a grain elevator manager taking it upon himself, without the board of directors authorization or knowledge, to invest assets (typically stored grain of the corporation) to speculate in commodity futures. Perhaps the manager loses a substantial amount of money the first day, however, due to the possibility of large gains in a single day, the manager invests the next day hoping to recoup the previous day's losses. Maybe he does recoup, typically he does not, and as each day goes on the "domino effect" perpetuates itself until finally it is detected, usually thousands of dollars later. What can

58. *Id.* at 23-24.

59. *Id.* at 24.

60. *Id.* at 25.

61. *Id.*

62. *Id.* at 24.

63. See, e.g., *In re Robert Haltmier*, [1975-1977 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 20,160, at 20,974 (Comm. Fut. Trading Comm'n 1976), *aff'd sub nom. Haltmier v. Commodity Futures Trading Comm'n*, [1977-1980 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 20,414, at 21,653 (2d Cir. 1977).

be done? The answer can be found in the regulations promulgated by the Commodity Futures Trading Commission. Lurking in the midst of numerous rules and regulations is regulation 166.2, Authorization to Trade,⁶⁴ which provides:

No futures commission merchant or associated person 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 or associated person 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.

(b) Authorized in writing the futures commission merchant or associated person to effect transaction in commodity interests for the account without the customer's specific authorization.⁶⁵

Although regulation 166.2 is a relatively new regulation, cases dealing with this exact problem date back to days of old. Consider the case of *Farmers' Cooperative Association Shipping v. George A. Adams Grain Co.*⁶⁶ The facts, like a late-night mystery, illustrate the classic situation of an employee who, with company assets and without authorization, speculates on the futures market, and eventually incurs substantial losses.⁶⁷ Consequently, being unable to recoup the incurred losses by subsequent trading, he vanishes to places unknown.⁶⁸ Upon discovering the unauthorized trading, the company files suit against the broker for the losses incurred.⁶⁹ In affirming a judgment for the plaintiff,⁷⁰ the Supreme Court of Nebraska found that the estranged grain manager had no apparent authority to speculate on the board of trade, nor was the plaintiff estopped to deny such authority.⁷¹

Years later, a similar case arose in Iowa.⁷² Here, the plaintiff's grain elevator manager was merely given authority to purchase and sell grain at a profit of two cents per bushel.⁷³ He was not given authority to speculate in futures on the board of trade.⁷⁴ Nevertheless, the manager, despite instruc-

64. Customer Protection Rules, 17 C.F.R. § 166.2 (1980).

65. *Id.*

66. 84 Neb. 752, 122 N.W. 55 (1909).

67. *Id.* at 753-55, 122 N.W. at 56.

68. *Id.* at 756, 122 N.W. at 57.

69. *Id.* at 753, 122 N.W. at 56.

70. *Id.* at 759, 122 N.W. at 58.

71. *Id.* at 757-58, 122 N.W. at 57-58.

72. *Watkins Grain Co. v. Fraser Smith Co.*, 221 Iowa 1164, 267 N.W. 115 (1936).

73. *Id.* at 1167, 267 N.W. at 116.

74. *Id.*

tions to the contrary, proceeded in speculative transactions.⁷⁵ Eventually, the manager's transactions and losses were discovered. Fortunately for the plaintiff, the Milwaukee Board of Trade had promulgated a rule requiring advance written authorization from corporations to the effect that an officer or manager was vested with the authority to trade.⁷⁶ Since no authorization had been given, the court found for the plaintiff.⁷⁷

One of the most exhaustive discussions of unauthorized trading is contained in the case of *Sherwood v. Madda Trading Co.*,⁷⁸ a reparations suit before the Commodity Futures Trading Commission. In clarifying the Commission's position on unauthorized transactions, the Commission held that an investor has an "absolute right not to incur liability for any trade not authorized by him. In other words, if a transaction is executed without proper customer authorization, the position [the purchase or sale] belongs to the futures commission merchant, not the customer."⁷⁹ Moreover, the Commission noted the trader "also must either inform the customer, or be demonstrably certain that the customer otherwise understands, that the customer is under a duty to make a complaint at the first reasonable opportunity should he discover unauthorized trading."⁸⁰

Accordingly, it is imperative to note the potential for assertion of laches, equitable estoppel⁸¹ and ratification defenses⁸² in the event that the customer fails to make an unequivocal and timely complaint. However, should the customer discharge his duty of complaint in good faith and should the trader choose to ignore it, the customer "may recover as damages in a reparation proceeding all subsequent, albeit aggravated, market losses sustained while the unauthorized positions are being liquidated by him in a

75. *Id.*

76. *Id.* at 1165-66, 267 N.W. at 116.

77. *Id.* at 1174, 267 N.W. at 120.

78. [1977-1980 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 20,728, at 23,014 (Comm. Fut. Trading Comm'n 1979).

79. *Id.* at 23,018.

80. *Id.* Should the trader fail to notify the customer of this right, the trader assumes "absolute liability" for all unauthorized trades. *Id.*

81. The Commission held that:

Four elements must be present to establish the defense of equitable estoppel: (1) The party to be estopped must know the facts; (2) he must intend that his conduct shall be acted on or must so act that the party asserting the estoppel has a right to believe it is so intended; (3) the latter must be ignorant of the true facts; and (4) he must rely on the former's conduct to his injury.

Id. at 23,021.

82. In *Sherwood*, the Commission went on to hold that ratification will only be applied "where it is clear from all circumstances presented that the intent of the customer was to adopt as his own and for all time the trades executed for his account without authorization." *Id.* at 23,020. See, e.g., *Kurachek v. ContiCommodity Serv., Inc.*, [1980] 2 COMM. FUT. L. REP. (CCH) ¶ 21,043, at 24,126 (Comm. Fut. Trading Comm'n).

At least one decision has held that the respondent has the burden of proof of ratification. *McCurnin v. Kohlmeyer & Co.*, 477 F.2d 113, 115 (5th Cir. 1973).

reasonable fashion."⁸³

One related aspect of unauthorized trading is the duty of a commodity professional to disclose the high degree of risk inherent in commodity futures trading. One of the most important regulations promulgated by the Commodity Futures Trading Commission is regulation 1.55 dealing with the distribution of a Risk Disclosure Statement.⁸⁴ The importance of this document cannot be overemphasized.⁸⁵ The reader should note, this regulation

83. *Sherwood v. Mada Trading Co.*, [1977-1980 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 20,728, at 23,022 (Comm. Fut. Trading Comm'n 1979).

84. General Regulations Under the Commodity Exchange Act, 17 C.F.R. § 1.55 (1980).

85. Regulation 1.55 provides that:

(a) No futures commission merchant may open a commodity futures account for a customer unless the futures commission merchant first (1) furnishes the customer with a separate written disclosure document containing only the language set forth in paragraph (b) of this section (except for nonsubstantive additions, e.g., captions) and (2) receives from the customer an acknowledgement signed and dated by the customer that he received and understood the disclosure document.

(b) The language set forth in the written disclosure document required by paragraph (a) of this section shall be as follows:

RISK DISCLOSURE STATEMENT

This statement is furnished to you because rule 1.55 of the Commodity Futures Trading Commission requires it.

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, 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 margin funds, on short notice, in order to maintain your position. If you do not provide the required funds within the prescribed time, your position may be liquidated at a loss, and you will be liable for any resulting deficit in your account.

(2) Under certain market conditions, you may find it difficult or impossible to liquidate a position. This can occur, for example, when the market makes a "limit move."

(3) Placing contingent orders, such as a "stop-loss" or "stop-limit" order, will not necessarily limit your losses to the intended amounts, since market conditions may make it impossible to execute such orders.

(4) A "spread" position may not be less risky than a simple "long" or "short" 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.

This brief statement cannot, of course, disclose all the risks and other significant aspects of the commodity markets. You should therefore carefully study futures trading before you trade.

(c) The acknowledgement required by paragraph (a) of this section must be retained by the futures commission merchant in accordance with § 1.31.

Id.

goes so far as to prescribe the mandatory language that is required to insure compliance under the Commodity Exchange Act. Even if a Risk Disclosure Statement has been provided, it is imperative upon counsel to peruse the language of such a disclosure statement to ascertain whether the statement sets forth verbatim the requisite language mandated by regulation 1.55. If a discrepancy exists, a violation of the regulation has occurred.

E. Breaches of Fiduciary Duty

Another cause of action that may exist against a commodity professional is that of breach of a fiduciary duty. As early as 1939 it was recognized "that . . . on commodity exchanges, the broker and his customer stand to each other as principal and agent. This relation[ship], contemplating as it does the holding by the broker of a customer's money and other property, is primarily fiduciary in nature."⁸⁶ Similarly, note the prominent use of the phrase "for or on behalf of any other person" in section 4b of the Commodity Exchange Act,⁸⁷ which implies the existence of a fiduciary relationship.

In the recent case of *Gordon v. Shearson Hayden Stone, Inc.*, the Commodity Futures Trading Commission took an aggressive and definitive position regarding breaches of fiduciary duties and the requisite culpability required to substantiate such allegations.⁸⁸ For example, it held that a commodity professional giving advice "has a duty to know all material market facts which are reasonably ascertainable in connection with a customer's trading decision."⁸⁹ Moreover, a duty to disclose these material facts to the customer was imposed on the advisor.⁹⁰ In addressing the fiduciary obligation incumbent upon the broker, the commission noted that "[t]he specific duties and degree of care imposed upon a particular agent — fiduciary — which give rise to potential liabilities under Section 4b(A) — relate directly to the nature of his relationship with his customers."⁹¹ Accordingly, it is apparent that due to the differing relationships that can exist between a commodity professional and his customer, fiduciary obligations can, and do arise in a variety of contexts.

Undoubtedly, the single most important aspect in the *Gordon* decision was that the Commission took a definitive stand and held that intent to

86. *In re Rosenbaum Grain Corp.*, 103 F.2d 656, 660 (7th Cir. 1939).

87. See text accompanying note 40 *supra*.

88. [1980] 2 COMM. FUT. L. REP. (CCH) ¶ 21,016 (Comm. Fut. Trading Comm'n).

89. *Gordon v. Shearson Hayden Stone, Inc.*, [1980] 2 COMM. FUT. L. REP. (CCH) ¶ 21,016, at 23,981 (Comm. Fut. Trading Comm'n).

90. *Id.* The standard of materiality used in *Gordon* was whether "a reasonable person would be likely to attach significance . . . in deciding whether to enter the commodity futures markets." *Id.* at 23,981-82.

91. *Id.* at 23,981. Accord, *White v. Abrams*, 495 F.2d 724 (9th Cir. 1974); *Lieb v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 461 F. Supp. 951 (E.D. Mich. 1978).

defraud is not an element in section 4b(A).⁹² Thus, "a breach of fiduciary duty, even if committed negligently, constitutes fraud as proscribed by Section 4b(A) of the Act. Accordingly, in order to establish a violation of Section 4b(A) it must be shown that a fiduciary relationship existed and that a fiduciary duty was breached."⁹³

II. CHOICE OF FORUM

Assuming a cause of action can be established, the most crucial decision in commodity futures litigation can be, and often is, the plaintiff's choice of forum. Unlike most civil actions, litigation involving commodity futures may avail itself of the benefits of a number of forums. Typically, relief may be sought in federal court, state court, reparation proceedings or in arbitration,⁹⁴ depending on the state of the law in a particular jurisdiction. Consequently, because of the choice confronting the potential litigant, it behooves counsel to undertake a detailed analysis of the benefits and the pitfalls that accompany each choice of forum. The old vaudeville opening that "a funny thing happened on the way to the forum today" can be a reality in commodity futures litigation if this critical step is taken lightly. Accordingly, a brief synopsis of the available forums is appropriate at this point.

A. Federal Court

As previously stated,⁹⁵ the availability of a federal forum is dependent upon whether the particular jurisdiction recognizes an implied, private cause of action under the Commodity Exchange Act.⁹⁶ In essence, counsel must discern whether, in the event that the case was appealed on jurisdictional grounds, the particular circuit would uphold a private cause of action.⁹⁷ This dilemma revolves around the interpretation of the "exclusive jurisdiction" language in section two of the Commodity Exchange Act. Section two provides "that the Commission shall have exclusive jurisdiction with respect to accounts."⁹⁸ Yet, the language of section two continues and states that "[n]othing in this section shall supersede or limit the jurisdiction conferred on courts of the United States or any State."⁹⁹ As the quoted language dem-

92. *Gordon v. Shearson Hayden Stone, Inc.*, [1980] 2 COMM. FUT. L. REP. (CCH) ¶ 21,016, at 23,975-77 (Comm. Fut. Trading Comm'n).

93. *Id.* at 23,981. However, the Commission added that the requisite harm to the customer must be substantiated in order to recover monetary damages. *Id.* at 29,981 n.35.

94. One author has advocated that in addition to these forums, a remedy also available, and often overlooked is settlement with the broker himself. See Nastro, *Remedies and Redress in Commodity Disputes: Recourse in the Courts*, 35 BUS. LAW. 765, 765 (1980).

95. See text accompanying notes 46-50 *supra*.

96. 7 U.S.C. §§ 1-24 (1976 & Supp. III 1979).

97. See note 46 *supra*.

98. 7 U.S.C. § 2 (1976 & Supp. III 1979) (emphasis added).

99. *Id.*

onstrates, the definition of jurisdiction is confusing to say the least. It is no wonder that such discrepancy exists among the circuits involving the interpretation of this section. Accordingly, the importance of *Curran v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*,¹⁰⁰ cannot be overstated. Until such time as the Supreme Court ultimately decides the issue, all potential litigants must carefully peruse the case law of their jurisdictions to decide whether the doors of the federal courthouse are open to them. In the event that the doors are locked, the litigant will be forced into a reparations proceeding to exhaust all available administrative remedies.¹⁰¹

B. State Court

One of the main benefits of seeking redress in state court, assuming the tests of in personam jurisdiction are met,¹⁰² is that virtually all common law causes of action can be adjudicated in state court.¹⁰³ The problem, however, revolves around a state court's ability or willingness to adjudicate causes of action under the Commodity Exchange Act. State courts confronted with this issue have generally deemed it best to yield jurisdiction to their administrative counterpart, the Commodity Futures Trading Commission. For example, in *State v. Monex International, Ltd.*,¹⁰⁴ which involved a suit to restrain the sale of silver on the ground that the defendant allegedly had not complied with requisite registration requirements under a state security act,¹⁰⁵ the court held that the Commodity Futures Trading Commission had exclusive jurisdiction to regulate margin sales.¹⁰⁶ Similarly, the Supreme Court of Arkansas in *International Trading, Ltd., v. Bell*,¹⁰⁷ held that a state securities law could not be enforced against a commodity options dealer as jurisdiction was lacking.¹⁰⁸

Accordingly, it is apparent that should a cause of action be premised solely upon common law rights, state courts are the usual alternative for the potential litigant. Again, this can only be discerned upon careful analysis by

100. [1980] 2 COMM. FUT. L. REP. (CCH) ¶ 21,030, at 24,054 (6th Cir.), petition for cert. filed, 49 U.S.L.W. 3053 (U.S. Aug. 9, 1980) (No. 80-203).

101. See Nastro, *Remedies and Redress in Commodity Disputes: Recourse in the Courts*, 35 BUS. LAW. 765, 766 (1980).

102. See *World-Wide Volkswagen v. Woodson*, 444 U.S. 286 (1980).

103. See generally *Iowa Grain v. Farmers Grain & Feed Co.*, 293 N.W.2d 22 (Iowa 1980).

104. 527 S.W.2d 804 (Tex. Civ. App. 1975).

105. *Id.* at 805.

106. *Id.* at 806. See generally Commodity Futures Trading Commission Act of 1974, H.R. CON. REP. No. 93-1383, 93rd Cong., 2nd Sess. 35-36, reprinted in [1974] 3 U.S. CODE CONG. & AD. NEWS 5843, 5897.

107. 262 Ark. 276, 556 S.W.2d 420 (1977).

108. *Id.* at —, 556 S.W.2d at 428. This case concerned alleged fraud in the selling of "London commodity options" which the court assumed, but did not decide, were securities for the purpose of this decision. *Id.* at —, 556 S.W.2d at 422. See also Johnson, *The Commodity Futures Trading Commission Act: Preemption as Public Policy*, 29 VAND. L. REV. 1 (1976).

counsel of applicable state laws.

C. *Reparations*

Reparations is an all encompassing word defined as "[p]ayment for an injury; redress for a wrong done"¹⁰⁹ and is the nomenclature given to the administrative remedy afforded under the Commodity Exchange Act.¹¹⁰ In essence, "[i]t is a dispute over money damages between two private parties, with a customer on one side and a registrant or someone who should be registered on the other."¹¹¹ One of the most unique characteristics of reparations is that in order to utilize this remedy, the plaintiff's claim must be based upon a violation of the Commodity Exchange Act, or the Commission's rules, regulations or orders.¹¹² In other words, causes of action based upon common law rights cannot be adjudicated in reparation proceedings.

In addition to precluding common law causes of action, there are several other disadvantages inherent in reparation proceedings that seriously curtail its consideration as a feasible forum of redress. One of the most significant disadvantages is the delay involved in both obtaining initial review by an administrative law judge and also in obtaining a final decision. One author has stated that "most of the important decisions have been outstanding for three or four years."¹¹³ Note that this three to four year delay is only before the Commission and does not take into account the time involved for an appeal. Conceivably, depending on the backlog of cases in the particular jurisdiction, a total delay of six years or more could be a reality. Another significant disadvantage is the lack of discovery afforded to reparations participants. Parties involved in a reparation proceeding are not allowed to take oral depositions in discovery.¹¹⁴ A third disadvantage lies in the fact that even though many cases have been decided by the Commodity Futures Trading Commission, relatively few have been reported.¹¹⁵ This lack of recorded precedent can, to say the least, result in unpleasant surprises for the unwary litigant and his counsel.

At the present time, the disadvantages of reparations seem to far outweigh any advantages in this administrative remedy. It is hoped that in time, reparations will become a viable alternative to commodity futures liti-

109. BLACK'S LAW DICTIONARY 1167 (5th ed. 1979).

110. 7 U.S.C. § 18(e) (1976 & Supp. III 1979).

111. Graham, *Special "Reparations" Actions*, 35 BUS. LAW. 773, 773 (1980). For a discussion of the process of reparations see *id.*

112. 7 U.S.C. § 18(a) (1976 & Supp. III 1979).

113. Graham, *Special "Reparations" Actions*, 35 BUS. LAW. 773, 785 (1980).

114. See Rules Relating to Reparation Proceedings, 17 C.F.R. § 12.62 (1980). For other rules relating to reparation proceedings see *id.* §§ 12.1-102. See also Nastro, *Remedies and Redress in Commodity Disputes: Recourse in the Courts*, 35 BUS. LAW. 765, 768 (1980) (for a discussion of evidentiary practices in reparations).

115. Graham, *Special "Reparations" Actions*, 35 BUS. LAW. 773, 785-86 (1980).

gants who have lost wrongfully.¹¹⁶

D. Arbitration

Over the years, arbitration seems to have been vested with a less than desirable reputation. However, its utility as an alternative forum should not be discounted for it can often yield a swift resolution to the problem at hand. In 1976, the Commodity Futures Trading Commission adopted regulation 180¹¹⁷ which specifically provided for arbitration. One of the most significant aspects of this regulation is that any agreement between the customer and the broker in consenting to arbitration must be voluntary,¹¹⁸ and must not be a prerequisite to any agreement to trade.¹¹⁹ Note, however, that consent to arbitration may result in a waiver of the customer's ability to seek redress in a court of law.¹²⁰

As in any forum, there are certain inherent disadvantages in arbitration. A potential litigant should be aware that in arbitration there is no discovery.¹²¹ In addition, the absence of recorded and binding precedent, when combined with the fact that no appeal can result from arbitration,¹²² almost precludes arbitration from being considered as a viable forum choice. However, depending on the individual facts of the dispute at issue, arbitration may be the answer.

III. CONCLUSION

Much more could be said about commodity futures litigation and this "mistress of a market"; yet, the question is whether one could ever do them justice. Words are inadequate to describe the market's challenge and vibrance. Indeed, commodity futures remain the epitome of excitement and suspense, and the litigation spawned is nothing less.

Although the volume of litigation is ever increasing, brokerage houses, in general, are to be commended. Their activities usually require split second decisions, in often chaotic situations. Moreover, a wrong move can result in losses exceeding hundreds of thousands of dollars. Nevertheless, the

116. Rules have now been proposed to try to alleviate most of the disadvantages now associated with reparations proceedings. See 45 Fed. Reg. 42,324 (1980) (to be codified in 17 C.F.R. § 12).

117. See Arbitration or Other Dispute Settlement Procedures, 17 C.F.R. § 180 (1980).

118. *Id.* § 180.3.

119. *Id.*

120. *Id.* The customer agreement must state in addition to the mandatory language that "BY SIGNING THIS AGREEMENT, YOU MAY BE WAIVING YOUR RIGHT TO SUE IN A COURT OF LAW." *Id.*

121. Nastro, *Remedies and Redress in Commodity Disputes: Recourse in the Courts*, 35 BUS. LAW. 765, 768 (1980).

122. Frankhauser & Selig, *Private Actions Under the Commodity Exchange Act: Implying Less and Enjoying It More*, 35 BUS. LAW. 847, 861 (1980).

Commodity Exchange Act and its rules and regulations were promulgated for a reason — the protection of all concerned, *especially the investor*. It is precisely for this reason that commodity futures litigation is attaining such a position of significance in the legal array of specialties practiced today.

John E. Orrell Jr.