

Arbitrating Disputes in the Futures Industry

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Background

Futures contracts for agricultural commodities have been traded in the U.S. for more than 150 years and have been under Federal regulation since the 1920s. In recent years, trading in futures contracts has expanded rapidly beyond traditional physical and agricultural commodities into a vast array of financial instruments, including foreign currencies, U.S. and foreign government securities, and U.S. and foreign stock indices. More than one billion futures and options contracts are traded on U.S. futures exchanges.²

The futures industry is regulated by the Commodity Futures Trading Commission (“CFTC”). The Commodity Exchange Act (“CEA”) and the CFTC regulations promulgated thereunder form the main body of federal law governing the futures industry. Congress amended the CEA in December 2000 when it passed the Commodity Futures Modernization Act of 2000 (“CFMA”). The CFMA is particularly significant because it made clear, after much litigation, that the CFTC has jurisdiction over retail foreign currency trading.

Futures contracts are traded on contract markets, also called designated contract markets (“DCMs”).³ There are fourteen DCMs throughout the United States over which the CFTC has jurisdiction.⁴ Each contract market is required to adopt and administer its own procedural by-laws and rules which must be followed by its members. Each contract market must also adopt rules governing the arbitration of disputes arising out of the business conducted on the contract market.⁵

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² See <http://www.cftc.gov/cftc/cftcabout.htm?from=home&page=aboutcftcleft> (last visited November 17, 2008).

³ See <http://www.cftc.gov/industryoversight/tradingorganizations/designatedcontractmarkets/index.htm> (last visited November 17, 2008).

⁴ See <http://services.cftc.gov/SIRT/SIRT.aspx?Topic=TradingOrganizations&implicit=true&type=DCM&CustomColumnDisplay=TTTTTTTT> (last visited November 17, 2008).

⁵ See §5A of the CEA.

Arbitration in the futures industry has become the preferred method to resolve commercial disputes arising from transactions in futures contracts.⁶ Resolving disputes through the arbitration process in the futures industry in many respects is similar to arbitration in the securities industry. There is, however, one main difference. All claims based on violations of the CEA seeking damages for trading abuses must be commenced within two years of the time the cause of action accrued or should have been discovered.⁷ This time frame is substantially shorter than the present six year eligibility period permitted for commencing arbitration claims brought before the New York Stock Exchange (“NYSE”) and Financial Industry Regulatory Authority (“FINRA”) for securities law abuses.

All participants in the futures industry must be registered to do business with the public.⁸ The categories of registration include:

- Futures Commission Merchants (“FCMs”) – brokers and clearing brokers who are permitted to carry customer money;
- Introducing Brokers (“IBs”) – registrants who are licensed to introduce customer accounts to FCMs;
- Commodity Trading Advisors (“CTAs”) – registrants entitled to advise customers with respect to their trading;
- Commodity Pool Operators (“CPOs”) – registrants licensed to trade pooled money or a fund of money;
- Associated Persons (“APs”) – individuals who are employed by and solicit customers for FCMs, IBs, CTAs or CPOs;
- Floor Brokers (“FBs”) – individuals who are members of contract markets and are authorized by the contract market to execute orders for customers on the trading floor of the contract market;
- Floor Traders (“FTs”) – individuals who purchase or sell any commodity futures or options contract on any contract market for such individual’s own account;
- Agricultural Trade-Option Merchants (“ATMs”) – individuals or organizations which are in the business of soliciting and offering trade options for sale. Trade options are off-exchange options offered to a commercial producer or user of the commodity; and

⁶ There is a reparations process administered by the CFTC where claimants may initiate claims against industry registrants. Reparations claims are heard by either a hearing officer or an administrative law judge. For more information on the CFTC’s reparations program see <http://www.cftc.gov/customerprotection/redressandrepairs/reparationsprogram/index.htm> . A customer may also elect to file an arbitration claim with the exchange where the trade(s) at issue was executed.

⁷ See § 14(a)(1) of the CEA, NFA Code of Arbitration Procedure § 5 and NFA Member Arbitration Rule § 4.

⁸ As part of the reauthorization of the CFTC in May 2008, Congress amended the CEA to require forex solicitors, account managers, and pool operators to register with the CFTC as Introducing Brokers, Commodity Trading Advisors, or Commodity Pool Operators and become Members of the NFA. For more information on the NFA’s forex registration requirements see http://www.nfa.futures.org/compliance/forex_registration_overview.asp. See also NFA Compliance Rule 2-39. Additionally except as provided in NFA Bylaw 306(b), Members of NFA are Forex Dealer Members (“FDMs”) if they are the counterparty or offer to be the counterparty to forex transactions. See NFA Bylaws 306(a) and 1507(b).

- Leverage Transaction Merchants (“LTMs”) – individuals, associations, partnerships, corporations, trusts or other persons that are engaged in the business of offering to enter into, entering into or confirming the execution of leverage contracts, or soliciting or accepting orders for leverage contracts, and who accepts leverage customer funds (or extends credit in lieu thereof) in connection therewith.

Members of contract markets are regulated by the CFTC and the contract market of which they are a member – known as the Self-Designated Regulatory Organization (“SDRO”). Non-members of contract markets who are registered as FCMs, IBs, CPOs and CTAs must become members of the National Futures Association (“NFA”), which is the futures industry equivalent to the FINRA. The NFA is the SDRO of non-contract market member futures industry registrants.

The NFA is the most frequently used forum regarding arbitrations for the futures industry.⁹ In many instances professional traders elect the NFA as a forum because the NFA does not have a direct affiliation to a contract market. Also, NFA draws from a pool of futures industry professionals to participate as arbitration panelists.

This article primarily addresses the NFA’s arbitration processes and procedures for resolving futures industry disputes.

I. Subject Matter of Arbitration Proceedings in Futures

In general, arbitration disputes may be initiated by customers for a wide variety of claims. While there is no suitability claim per se, allegations of high pressure sales tactics, misrepresentations about the risk involved in trading futures or the failure to disclose the risk inherent in trading futures, churning, excessive commission rates, order execution negligence, unauthorized trading, improper liquidation/margin claims, breach of fiduciary duty, RICO and failure to supervise can be asserted. Under certain circumstances punitive damages may be recoverable if liability is established. In certain instances FCMs may be liable for the acts of others. General allegations are discussed below.

No Suitability Rule Per Se

There is no definition of suitability in the CEA or the regulations thereunder. However, the NFA has adopted a “know your customer” rule that requires an FCM, IB, CTA or CPO and their associated persons to obtain certain information from the customer prior to the opening of an account. NFA Compliance Rule 2-30. This information includes the:

- Customer’s name and address and principal occupation or business;

⁹ The NFA Code of Arbitration has been amended to require FDMs, other Members who do business with them, and their Associates and employees to submit to arbitration at the request of a retail forex customer. See http://www.nfa.futures.org/compliance/forex_registration_overview.asp and NFA Arbitration Code § 1(o)(6).

- Customer's current estimated annual income and net worth;
- Customer's approximate age; and
- Indication of customer's previous investment and futures trading experience.¹⁰

High Pressure Sales

The use of high pressure sales tactics may be a violation of the anti-fraud provisions of the CEA. The law with respect to high pressure sales in futures trading is similar to the parallel concept under securities law. The case law defines high pressure sales tactics as being an offer to a customer of securities of certain issuers in large volume by means of an intensive selling campaign by telephone or direct mail, without regard to the customer's experience, investment objectives or needs, in such a manner as to induce a hasty decision to buy the instruments being offered without disclosure of the materials facts.¹¹

Misrepresentations About and Failure to Disclose Risk

CFTC and NFA regulations require that brokers disclose the true nature and risks of trading in futures contracts and options on futures contracts. The anti-fraud provisions of the CEA prohibit misrepresentation, non-disclosure and the downplaying of risks involved in futures and options transactions. All regulated futures firms are required to present each customer with a risk disclosure document which includes all of the basic disclosures regarding the risks in trading futures and options.¹²

¹⁰ See *Patch v. Concorde Trading Group, Inc.*, [1994-1996 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,253 (CFTC 1994); *Taylor v. Rand Financial Services, Inc.*, [1994-1996 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,748 (CFTC 1996); *Hauptland v. ContiCommodity Services, Inc.*, [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,217 (CFTC 1986); *Wilkinson v. Rosenthal & Co.*, [1987-1990 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,328 (E.D. Pa. 1994); *Phacelli v. ContiCommodity Services*, [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,250 (CFTC 1986); *Jensen v. Shearson Hayden Stone*, [1980-1982 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,324 (CFTC 1981); *Merrill Lynch, Pierce, Fenner & Smith v. Goldman*, 593 F.2d 129 (8th Cir. 1979), *cert. denied*, 444 U.S. 838 (1979).

¹¹ See *Monnier v. Lind-Waldock & Company*, [1994-1996 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,644 (CFTC 1996); *CFTC v. Crown Colony Commodity Options, Ltd.*, 436 F. Supp. 911, 918 (S.D.N.Y. 1977). See also *Markstein v. First National Trading Corp.*, [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,973 (CFTC 1990); *Magill v. Int'l Trading Group, Ltd.*, [1987-1990 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,095 (CFTC 1988); *In re Apache Trading Corporation*, [1987-1990 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,413 (CFTC 1989); NFA Compliance Rule 2-29.

¹² See *Modlin v. Cane*, [1996-1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,392 (CFTC 1998); *In the Matter of Competitive Strategies*, [1996-1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,215 (CFTC 1998); *Jacobsen v. Commonwealth Financial Group, Inc.*, [1996-1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,094 (CFTC 1997); *Scheufler v. Gerald, Inc.*, [1996-1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,926 (CFTC 1996); *Ricci v. Commonwealth Financial Group, Inc.*, [1994-1996 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,545 (CFTC 1995); *Krey v. Silvers*, [1992-1994 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,127 (CFTC 1994); *In the Matter of Sutton Ross & Associates, Inc.*, [1982-1984 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,813 (CFTC 1983); *Miller v. Kirch*, [1980-1982 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,488 (CFTC 1982); *Gordon v. Shearson Hayden Stone, Inc.*, [1980-1982 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,016 (CFTC 1980); CFTC Regulations §§ 1.55, 4.21, 4.31 and 33.7 (17 C.F.R. §§ 1.55, 4.21, 4.31 and 33.7). See also NFA Compliance Rule 2-30.

Churning

Churning involves the excessive trading of a customer account for the purpose of generating commissions for the broker and is a violation of the anti-fraud provisions of the CEA. Case law has defined churning as a volume or frequency of trading that in light of the nature of the account and the needs and objectives of the customer indicates a purpose of the broker to generate commissions for his or her own interest rather than to protect the customer's interests.

Churning is established if:

- The person who allegedly churned the account controlled the level and frequency of trading in the account;
- The overall volume of trading was excessive in light of the customer's trading objectives; and
- The trading must have been done with, at the least, reckless disregard for the customer's interest.

The following factors are usually looked at in considering the needs and objectives of the customer:

- Commission to equity ratio;
- Percentage of day trades;
- Departure from a previously agreed upon strategy;
- Whether the account was traded while it was under-margined; and
- Reestablishment of previously liquidated positions in the same or related contracts.¹³

Excessive Commission Rates

The CEA does not contain a provision regarding the regulation of commission rates. Charging high commissions does not, in and of itself, violate the anti-fraud provisions of the CEA. As long as the terms and fees are made known to the customer and the customer is willing to pay the fees, the level of fees by itself will not constitute a fraud per se. However, it is a violation of the anti-fraud provisions of the CEA to misrepresent, intentionally withhold or not disclose information regarding the effect of high commission rates on the potential profitability of futures

¹³ See *Hinch v. Commonwealth Financial Group, Inc.*, [1996-1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,056 (CFTC 1997); *Scheufler v. Gerald, Inc.*, [1996-1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,926 (CFTC 1996); *Symon v. Fullet*, [1994-1996 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,728 (CFTC 1996); *Sherwood v. Madda Trading Co.*, [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,401 (CFTC 1977); *Booth v. Peavey Co. Commodity Services*, 430 F.2d 132 (8th Cir. 1970); *Smith v. Siegel Trading Co.*, [1980-1982 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,105 (CFTC 1980); *In re Lincolnwood Commodities, Inc. of California*, [1982-1984 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,986 (CFTC 1984); *Gilbert v. Refco, Inc.*, CFTC, No. 87-R223 (1991). See also CEA § 4(b).

and options transactions. While charging high commission rates may not be a violation of the CEA, such conduct may help prove other violations such as churning.¹⁴

Order Execution

As in securities transactions, a commodities broker is obligated to get a customer the best execution possible given the existing market conditions. A liability may arise when a customer places an order when the market is at a certain price and then receives an execution which is a substantial amount away from that price.¹⁵

Unauthorized Trading

A commodities broker must get specific authorization from a customer to engage in trading. Each broker, FCM, IB, CTA, CPO or AP must be expressly instructed by the customer with respect to each trade or be authorized in writing through a written power of attorney to make trades in the account without the customer's specific authorization.¹⁶

Improper Liquidation

All futures contracts are traded on margin. This concept is different in futures trading than margin in securities trading. While margin trading in securities constitutes an extension of a loan by a broker dealer that is secured by the securities of the customer, margin for commodity futures is a good faith deposit of money that is designed to assure performance of the contract by the parties.

¹⁴ See *Rice v. Futures Trading Group, Inc.*, [1996-1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,048 (CFTC 1997); *Braycewski v. Neuberger Securities Corp.*, [1980-1982 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,141 (CFTC 1981); *Aronson v. Cayman Associates, Ltd.*, [1980-1982 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,268 (CFTC 1981); *Sundet v. First Commodity Corporation of Boston*, [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,287 (CFTC 1984); *Schreider v. Rouse Woodstock, Inc.*, [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,683 (CFTC 1984); *Marvin v. First National Monetary Corporation*, [1987-1990 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,190 (CFTC 1987). See also CEA § 4(b) and NFA Compliance Rule 2-30.

¹⁵ See *Symon v. Fullet*, [1994-1996 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,728 (CFTC 1996). See also CEA §§ 4a-c (7 U.S.C. §§ 6a-c) and CFTC Regulations 155.2-155.4 (17 C.F.R. §§ 155.2-155.4).

¹⁶ *Scheufler v. Gerald, Inc.*, [1996-1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,926 (CFTC 1996); See *Symon v. Fullet*, [1994-1996 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,728 (CFTC 1996); *Theodoros Kotsikas Foundation v. Drexel Burnham Lambert, Inc.*, [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 25,014 (CFTC 1991); *Comtrade, Inc. v. Cargill Investor Services, Inc.*, [1994-1996 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,734 (CFTC 1996); *Anderhold v. Rosenthal & Co.*, [1980-1982 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,218 (CFTC 1981); *Koski v. Rosenthal & Co.*, [1980-1982 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,207 (CFTC 1981); *Baker v. Edward E. Jones & Co.*, [1975-1977 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,241 (CFTC 1976), *rev'd* [1980-1982 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,167 (CFTC 1981); *In re John S. Morris*, 34 Agric. Dec. 316 (1975); *In re Douglas Steen*, Agric. Dec. 1076 (1962).

Margin deposited in a futures contract account is designed to protect the FCM and the clearing system from insolvency losses which could arise from a failure of customers to meet their contractual obligations. Case law generally gives an FCM wide latitude in liquidating a customer's account in the event it becomes undermargined. FCMs may, but are not required to, liquidate a customer's account immediately upon a customer's failure to post margin.¹⁷

Breach of Fiduciary Duty

A breach of fiduciary duty by a futures professional to a customer is a violation of the anti-fraud provisions of the CEA if it involves knowledge or recklessness, *i.e.* scienter. A fiduciary relationship however does not arise merely because a commodity professional offers advice and counsel upon which the customer has a right to place trust and confidence. Rather, where discretionary authorization exists between a customer and a broker, a fiduciary duty exists in a broad sense and the commodity professional must:

- Manage the customer's account in a manner consistent with the customer's stated needs, objectives and instructions or the needs and objectives apparent from the customer's investment and trading strategy;
- Keep informed regarding changes in the market which affect the customer's interests and act responsibly to protect those interests;
- Keep the customer informed as to each completed transaction; and
- Explain completely, openly and honestly the practical impact and potential risks of the trading strategy and the positions the commodity professional is engaged in on behalf of the customer.¹⁸

RICO

An individual claimant who proves he or she has been injured as a result of a violation of the Racketeering Influenced and Corrupt Organizations Act (18 U.S.C. §§ 1961-1968) ("RICO") can recover treble damages and reasonable attorney's fees. Proof of a RICO violation requires that the person show that he or she was injured by a person associated with an "enterprise" that has

¹⁷ See *Preston v. Refco, Inc.*, [1996-1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,233 (CFTC 1997); *Nacht v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, [1994-1996 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,366 (CFTC 1995); *Kraft v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,262 (CFTC 1984); *Olmos v. Golding*, [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,893 (N.D. Ill. 1989); *Street v. J.C. Bradford & Co.*, 856 F.2d 1472 (6th Cir. 1989); *Comex Clearing Association, Inc. v. Flo-Arb Partners*, 711 F. Supp. 1169 (S.D.N.Y. 1989).

¹⁸ *Scheufler v. Gerald, Inc.*, [1996-1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,926 (CFTC 1996); *Knight v. First Commercial Financial Group, Inc.*, [1994-1996 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,515 (CFTC 1995); *Keyser v. Green*, [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,320 (CFTC 1984); *Myhre v. First Commodity Corp. of Boston*, [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,001 (CFTC 1986); *Refco, Inc. v. Troika Investment Limited*, 702 F. Supp. 684 (N.D. Ill. 1988); *Hammond v. Smith Barney Harris Upham & Company, Inc.*, [1987-1990 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,617 (CFTC 1990); *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Boeck*, 377 N.W.2d 605 (N.D. Wis. 1985).

been engaged in a “pattern of racketeering” which consists of at least two “predicate acts” during a ten year period. The list of “predicate acts” set forth in the statute includes mail fraud and wire fraud. However, the list does not include commodities fraud. Nevertheless, in certain instances conduct involving futures transactions may constitute mail fraud or wire fraud. Proving a RICO violation is a very complicated process and the applicable requirements vary from circuit to circuit. In practice, RICO claims are rarely asserted in arbitration proceedings.¹⁹

Punitive Damages

Claims for punitive damages may be arbitrated under the Federal Arbitration Act, 9 U.S.C. § 1 *et seq.*, (“FAA”), and NFA arbitration panels may consider claims for and award punitive damages. In certain cases, however, the FAA is not controlling on this point because certain states prohibit an award of punitive damages as a matter of public or legal policy.

Where punitive damages are available, they generally are assessed for the specific purpose of punishing a respondent and sending a message to the community to deter others from similar wrongdoing. To subject a party to liability for punitive damages arbitrators must find that the party acted with malice, ill will or conscious disregard of the consequences of his or her acts to others. The size of punitive damage awards must be reasonable given the circumstances of the case.

In evaluating claims for punitive damages arbitrators generally will consider:

- The degree of reprehensibility of the respondent’s conduct, the duration of the conduct, the respondent’s awareness of the conduct, whether there was any concealment and the existence and frequency of similar conduct;
- What is a reasonable relationship between the punitive damage award and the harm likely to result from the respondent’s conduct as well as the harm that actually occurred;
- The profitability of the wrongful conduct and the desirability of removing such profit and of having the respondent also sustain a loss;
- The financial position of the respondent;
- All costs of the litigation; and

¹⁹ See *Tatum v. Smith*, [1994-1996 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,474 (CFTC 1995); *Stephens, Inc. v. Geldermann, Inc.*, [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 25,279 (8th Cir. 1992); *McGee v. Gerstenberg & Co., Inc.*, [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,100 (N.D. Ill. 1986); *H.J. Inc. v. Northwestern Bell Telephone Co.*, 492 U.S. 229 (1989); *Shearson Lehman/American Express v. McMahon*, 482 U.S. 220 (1987); *Sedima, S.P.R.L. v. Imrex Co., Inc.*, 473 U.S. 479 (1985); *Minpeco, S.A. v. Hunt*, 718 F. Supp. 168 (S.D.N.Y. 1984).

- Whether there are any mitigating factors, *e.g.* whether criminal sanctions have been imposed on the respondent for its conduct.²⁰

See infra p. 9 for a discussion of FCM liability for floor orders and punitive damages.

Failure to Supervise

CFTC Regulation 166.3 requires all futures professionals to properly supervise persons under their direction and control. This requirement is fulfilled if:

- Procedures have been established which would be reasonably expected to prevent or detect the wrongful conduct;
- The person has reasonably discharged the duties and obligations imposed upon him or her by the procedures; and
- The person does not know and does not have reason to know about the wrongful conduct.

Failure to follow the above procedures can result in violations of the CEA and regulations thereunder and NFA rules.²¹

FCM Responsibility for Introducing Brokers

Section 2(a)(1)(B) of the CEA provides *respondeat superior* and general principal-agent standards for imposing liability on employers and principals for acts of their employees or agents. Whether one party is acting as an agent for another turns on an overall assessment of all of the circumstances. If it can be shown that an IB is a de facto branch office of an FCM, the FCM may be deemed to be primarily liable for the failure to supervise the IB and vicariously liable for the acts of the IB.

²⁰ *See Mulder v. Donaldson, Lufkin & Jenrette*, 224 A.D.2d 125, 648 N.Y.S.2d 535 (1996); *Mastrobuono v. Shearson Lehman Hutton, Inc.*, 513 U.S. 921 (1995); *Meber, N.V. v. Hindes*, [1987-1990 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,233 (S.D.N.Y. 1988); *Steller v. Shearson Loeb Rhoades, Inc.*, [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,663 (CFTC 1985); *Pacific Mutual Insurance Co. v. Haslip*, 499 U.S. 1 (1991); *Lee v. Chica*, 983 F.2d 883 (8th Cir. 1993); *Barbier v. Shearson Lehman Hutton, Inc.*, 948 F.2d 117 (2nd Cir. 1991); *Todd Shipyards Corporation v. Cunard Lines, Ltd.*, 943 F.2d 1056 (9th Cir. 1991); *Fahnstock & Co., Inc. v. Waltman*, 935 F.2d 512 (2nd Cir. 1991); *Raytheon Company v. Automated Business Systems, Inc.*, 882 F.2d 6 (1st Cir. 1989); *Willoughby Roofing & Supply Co. v. Kajima International, Inc.*, 598 F. Supp. 353 (N.D. Ala. 1989), *aff'd* 776 F.2d 269 (11th Cir. 1989); *Garrity v. Lyle Stuart, Inc.*, 353 N.E.2d 793 (1976).

²¹ *See Preston v. Refco*, [1996-1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,233 (CFTC 1997); *In the Matter of Mayer*, [1994-1996 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,736 (CFTC 1996); *Yetman v. Smith Barney, Harris, Upham & Co., Inc.*, [1982-1984 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,087 (CFTC 1984); *In the Matter of First Commodity Corp. of Boston*, [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 25,250 (CFTC 1992); *CFTC v. Commodities Fluctuations Systems*, 583 F. Supp. 1382 (S.D.N.Y. 1984); *In the Matter of GNP Commodities, Inc.*, [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 25,360 (CFTC 1992); *In the Matter of Interstate Securities Corporation*, [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 25,295 (CFTC 1992); *Riddick v. Shearson Lehman/American Express, Inc.*, [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,478 (CFTC 1985); *Bennett v. E.F. Hutton Co.*, 597 F. Supp. 1557 (N.D. Ohio 1984). *See also* NFA Compliance Rule 2-29.

There are two types of IBs:

- Independent IBs who maintain adjusted net capital equal to or greater than \$30,000; and
- Guaranteed IBs who operate pursuant to a guarantee agreement with an FCM.

The fact that an IB is independent does not automatically mean that an FCM cannot be held responsible for the IB as its agent. Responsibility turns on a factual determination. An agency relationship may be determined if the FCM prepared all pre-printed account opening documents, if the FCM provides research and trading information which are passed on to the customer, if representations that the IB is “part of” the FCM are made and if the IB does all its business through the FCM. An agency relationship is not established if an IB and an FCM work as independent business entities where the only services provided by the FCM are clearing back office services, such as calculating margin and net equity, collecting margin and sending confirmations of purchases and sales and monthly statements to customers introduced by the IB to the FCM.

In the case of guaranteed IBs the written agreement between the IB and FCM will usually provide that the FCM is jointly and severally liable to the customers of the IB for the IB’s violations of the CEA or CFTC regulations. In establishing responsibility of the FCM for the IB’s conduct, it must be determined that the guaranteed IB’s conduct involved an obligation of the IB under the CEA or CFTC regulations and that the conduct occurred while the guarantee agreement was in effect. If a customer can prove these elements, the FCM providing the guarantee is responsible for the conduct of the IB.²²

FCM Liability for Floor Orders

An FCM is liable for the negligent acts that its floor brokers commit within the scope of their employment or agency with the FCM. The FCM is also liable for actual damages for a floor broker’s violations of the CEA and the rules of the exchange of which the floor broker is a member.

The FCM is liable for the acts of its own employees as well as independent floor brokers if a customer proves:

- The FCM selected the floor broker;
- The floor broker was an employee or agent of the FCM;

²² See *Clemons v. McCabe*, [1996-1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,284 (CFTC 1998); *Cunningham v. Waters Tan & Company*, [1994-1996 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,488 (CFTC 1995); *Concor Financial Services, Inc. v. Assured Futures, Inc.*, [1987-1990 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,409 (CFTC 1988); *Reed v. Sage Group, Inc.*, [1987-1990 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,943 (CFTC 1987); *Bogard v. Amraham-Rietz & Co.*, [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,273 (CFTC 1984); *Theodoros Kotsikas Foundation v. Drexel Burnham Lambert, Inc.*, [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 25,014 (CFTC 1991).

- The floor broker executed or failed to execute the customer's order which proximately caused the customer damage; and
- The floor broker was acting within the scope of his employee or agency.

A customer does not have to attempt to collect from the floor broker before pursuing the FCM for damages. Moreover, a customer can decide to only bring an action against an FCM and not the floor broker.

Punitive damages, up to twice the amount of the actual damages, can be awarded against the FCM if the customer can prove that the FCM willfully and intentionally selected the floor broker with the intent to assist in or facilitate the floor broker's violation.²³

II. Arbitration Procedure

Basis for Arbitration and Forum

The rights and obligations of parties to proceed in arbitration usually arise out of a written agreement. Members of contract markets are required, pursuant to exchange rules, to submit their disputes to arbitration before their contract market. Non-contract market members, futures industry employees and customers may submit their disputes to arbitration at the NFA. Customers of industry registrants may elect either arbitration or reparations under the CEA as a method for resolving disputes which arise out of the relationship between the customer and an industry registrant.

National Futures Association

The NFA Code of Arbitration ("NFA Code") provides the most common set of procedures utilized in the futures industry for customer arbitration and dispute resolution. NFA members may also submit their disputes to arbitration under the NFA Member Arbitration Rules. The NFA draws from a pool of arbitrators which has the widest experience within the futures industry.

Events Which Precede a Hearing

The events which precede a customer NFA arbitration hearing are, for the most part, procedural. These events include the filing of a demand for arbitration along with supporting documents, the selection of an arbitration panel, the exchange of documents and information pursuant to the arbitration discovery process, the preparation of a hearing plan which constitutes the "road map" for the hearing and the scheduling of the hearing.

²³ See *Rendita Global Investment A.G. v. Mercabe Clearing, Inc.*, [1994-1996 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,509 (CFTC 1995). See also CEA § 22.

Demand for Arbitration

The arbitration process begins when a demand for arbitration is filed with the NFA or the particular contract market forum. NFA Code § 6(c). Any claim filed with the NFA must allege damages flowing from a violation(s) of the CEA. There are two ways to file an arbitration claim: online using NFA's Web-based claim form or by downloading a claim form and sending it to NFA by e-mail, facsimile or mail. See <https://www.nfa.futures.org/odr/claimCustomer.asp>. A claim to commence arbitration must be made within two years of the event which gives rise to the dispute or when it should have been discovered. NFA Code § 5. If the two year time limit for making a claim is approaching, a complaining party may file a notice of intent to arbitrate with the NFA. This will cause the two year time limit to stop running. This process provides a claimant about 35 days in which to file a formal demand for arbitration. NFA Code § 6(b). The NFA must then receive a completed form from the complainant, including documents in support of the claim. The claim must set forth the amount of damages requested and a basis for the demand which caused the damages. A claim must also set forth whether the claimant desires a member panel or a mixed panel, *i.e.* a panel that includes public arbitrators, whether the complainant will be represented by counsel and whether witnesses will be brought to the hearing. The appropriate filing fee must accompany the complaint. NFA Code § 11(a).

The Answer

Following receipt of the demand for arbitration, the appropriate fees and supporting documents, the NFA transmits the demand to the firm or person against whom the demand has been made. NFA Code § 6(d). Respondents have forty-five days to file an answer with respect to the allegations contained in the demand. The answer must be filed with NFA and a copy transmitted to the claimant. Any allegation contained in the demand which is not denied by the answer is deemed admitted. NFA Code § 6(e).

Any claims respondents assert against other parties must be filed within the proscribed forty-five days. NFA Code § 6(f). These claims can include counterclaims, cross-claims and any third-party claims.

Amended Claims

Once an arbitration panel has been appointed by NFA, no additional pleadings or claims may be filed without the permission of the arbitration panel. NFA Code § 6(k). Amended claims are usually permitted if sound and compelling reasons are given, particularly if a change in factual circumstances occurs. Arbitrators frequently refuse the amendment of claims when such action would unreasonably cause a delay of a hearing or impair the ability of the party to effectively prepare a defense to an amended claim.

Right to Counsel

A party may be represented at any time throughout the arbitration proceeding by an attorney-at-law licensed to practice law in the highest court of any state, by a family member or other person who is representing the party without compensation, or by an officer, partner or employee of the party. NFA Code § 7(a). NFA recently amended this rule to specifically prohibit a person (other than a family member) who has an interest in the outcome of the dispute from acting as an unpaid representative for the party.

Selection of Arbitrators

The selection of arbitrators is supervised by the NFA's arbitration department. NFA Code § 4(c). The requirement of impartiality and disclosure of any conflicts which could exist between the panel member and the parties is a key element in choosing a panel member to serve. NFA Code § 4(b). Panel members must have total confidence that they will be able to render a fair and impartial decision. Likewise, participants utilizing the arbitration forum must have the same confidence.

Any type of relationship which exists or has existed between a potential arbitrator and a party must be disclosed to the forum person responsible for supervising the administration of the arbitration. For example, a participating panel member must disclose his or her relationship with the applicable firm, the broker or any witnesses who potentially could testify before the panel. NFA Code § 4(c).

Once such relationships, if any, are disclosed, panel members are responsible for representing that an impartial decision could be made notwithstanding such relationships. Naturally, all relationships are disclosed to the parties and the parties ultimately have the right to object to the participation of an arbitrator based on bias. *Id.*

Parties may challenge a panelist for cause. An objection to a particular person as an arbitrator must be specific and submitted to the NFA in writing. An objection may be based on bias, financial interests or any past or present relationships with the arbitrator. Any party who fails to disclose the above information is deemed to have waived any objection to the particular arbitrator based on the information. NFA Code § 4(c).

In a case where an arbitrator becomes ineligible or recuses himself, NFA will generally name a replacement arbitrator. NFA Code § 4(e).

Once an arbitration panel has been finalized, *ex parte* communications between parties and the panel are prohibited. NFA Code § 4(f). Only NFA staff members are permitted to communicate with the panel members until the hearing. Panel members are permitted and encouraged to confer with one another prior to the hearing regarding issues, documents, scheduling and procedural matters.

Discovery – The Exchange of Documentation and Written Information

Discovery in arbitration disputes has traditionally been limited to an exchange of existing documents and written information. NFA Code § 8(a)(1). NFA also permits the limited use of interrogatories.

All documents which are material and relevant to a dispute will be required to be exchanged under the NFA's automatic exchange provision. NFA Code § 8(a)(2). Subsequent document production must be made thirty days after a request for documents is served on a party. NFA Code § 8(a)(3). Extensions of time can be granted but are discouraged. Deadlines may be imposed by the panel for the production of documents and information. Panels may issue orders directing parties to deliver information on a timely basis. NFA Code § 8(a)(6).

The NFA Code permits motions to compel. NFA Code § 8(a)(4). A request to compel must include a written certification by the filing party that states that he or she has made a good faith effort to resolve the matters forming the basis for the request through either a telephone conference or in-person meeting with the other party. NFA Code § 8(a)(5). An exchange of letters will not suffice. When a panel orders production of documents as a result of a motion to compel, the failure of a party to comply with the panel's order can result in sanctions against the non-complying party. Among other things, panels may:

- Prohibit a non-responsive party from offering testimony or evidence concerning the subject matter of the requested documents;
- Strike out portions, if not all, of a non-responsive party's pleadings;
- Postpone proceedings until a non-responsive party complies with the request for documents;
- Dismiss the action or proceeding or any part thereof; or
- Render an award by default against a non-responsive party.

NFA Code § 8(d).

Subpoenas

Subpoenas are not generally used in connection with demands for documents and information in NFA arbitration. Members of the NFA, even though not parties to the arbitration case, are required to cooperate with a request for documents and information. However, parties occasionally find that they require documents that can only be obtained from a non-party. Parties are no longer permitted to issue subpoenas on their own. A recent rule change requires that parties submit all subpoena requests to the arbitrators who may issue subpoenas to non-parties. NFA Code § 9(d)(7). The NFA is in a position to take disciplinary action against NFA members who fail to abide by document requests and subpoenas issued by an NFA arbitration panel.

Depositions

Parties can agree to depositions and offer them as evidence at the hearing. Arbitrators are permitted to order evidence depositions for good cause shown. NFA Code § 8(h). NFA believes that evidence depositions are appropriate in limited circumstances such as where a witness cannot attend the hearing because they are too ill, or cannot otherwise be required to attend the hearing.

Motions to Dismiss or for Summary Judgment

Motions to dismiss for failing to state a claim will not be heard by the Panel. Other motions to dismiss must be included in a timely filed answer or reply. Motions for summary judgment may be raised at any time. Motions for directed verdict may be raised at the hearing. NFA Code § 8(e).

NFA has begun to assess motion fees to compensate arbitrators for their time in deciding such motions. For cases involving one arbitrator, a party who files a motion more than 80 days after the last pleading is due must include a \$125 motion fee with the motion. For cases involving three arbitrators, a party who files a motion more than 100 days after the last pleading is due must include a \$425 motion fee with the motion.

Judgment by Default

Although it is possible for a panel to enter a judgment against a party who fails to respond to an arbitration demand, default judgments are rarely issued. In cases where a respondent completely abandons the process, fails to respond to a demand and fails to appear at a hearing, however, defaults are sometimes entered. On the other hand, if a party fails to answer a demand for arbitration but participates in the hearing, there is a reasonable likelihood that a panel, after hearing all evidence, will consider the merits of the evidence presented.

The Hearing Site

Unless a provision exists in the customer agreement establishing a site for a hearing, NFA always endeavors to accommodate the parties' site preferences as indicated in their pleadings but generally abides by forum selection clauses. A recent rule change provides that NFA will only consider a site preference if it is indicated in a *timely-filed* pleading. NFA Code § 9(b). Notice of the location of the arbitration is given to all parties at least 45 days prior to the hearing. *Id.*

Documentary Evidence

At least 10 days before the trial date, the parties must serve on each other and NFA all documents in their possession that they intend to introduce into evidence in support of their direct case. NFA Code § 8(b)(1).

Hearing Plan

The NFA, working with counsel to the parties, drafts a written hearing plan which becomes the road map for the arbitrators. The arbitrators have the authority to impose strict adherence to the hearing plan. The hearing plan generally includes:

- The identity of the parties to the dispute;
- The nature of the case, including a summary of each claim, the answer and the reply;
- The facts to which the parties have agreed or stipulated and do not need to be and should not be allowed to be argued or proven at trial;
- The issues in dispute, meaning the issues that will be argued at the hearing;
- The identity of witnesses who will testify; and
- The exhibits that will be presented.

At least twenty days prior to a hearing the NFA will deliver to the arbitrators the hearing plan and the other documents which will be introduced into evidence during the hearing. NFA Code § 8(c).

Postponement of Hearing Dates

Panels also have the authority to grant postponements of the hearing when the interests of justice so require, but a hearing in progress shall not be adjourned or interrupted except in compelling circumstances. NFA Code § 9(e). A request for a postponement must be accompanied by a fee of \$250 (\$300 in a member-to-member dispute). Additional postponement requests require higher postponement fees -- \$500 for the second request and \$1,000 for each request thereafter. Obviously, the progressive adjournment fee is designed to deter adjournment requests. The ultimate assessment of the fee, however, is for the discretion of the arbitration panel and can be reassessed to the other party in the event it can be demonstrated that the other party caused the request for postponement. NFA Code § 11(c).

Settlement

As in lawsuits, parties to an arbitration may mutually agree to settle their differences prior to the hearing. The parties are encouraged to continue a dialogue in order to reach a settlement prior to a hearing. Arbitrators do not participate in settlement negotiations but should and often do prompt the parties to make an attempt to resolve their differences in order to avoid a hearing. NFA Code § 10(h).

Mediation

Mediation may be facilitated by simply notifying the NFA that mediation is going to be attempted and the parties wish to submit their dispute to a neutral person in order to reach a mutually agreeable settlement. NFA Code § 14. NFA offers a fully-subsidized mediation program which currently involves arbitration claims under \$150,000. If one of the parties does not agree to mediate then mediation will not be compelled. Any statements or offers of settlement made during mediation are confidential and are not admissible in any manner during a hearing. NFA Code § 9(d)(9).

Summary Proceedings

Customer disputes involving claims which do not exceed \$15,000 are resolved solely through written submissions. Customer disputes involving claims which exceed \$15,000 but are not more than \$25,000 will be conducted through written submissions *unless* one of the parties to the proceeding serves a written request for an oral hearing on NFA. While oral hearings may be scheduled by a panel, they are not usually encouraged unless credibility is a central issue in the case. NFA Code § 9(i).

Hearing

The hearing procedure is determined by the panel. NFA Code § 9(d)(10). Each party appears personally before the hearing panel to testify and present evidence. NFA Code § 9(d)(1). The parties are permitted to present opening and closing arguments. They are also given a full opportunity to examine the other party or their witnesses and any evidence that is produced. NFA Code § 9(d)(2).

All testimony at the hearing must be given under oath. NFA Code § 9(d)(5). The panel is not required to abide by the formal rules of evidence and has broad discretion to admit evidence. The panel has the authority to direct NFA members to testify and produce documentary evidence. NFA Code § 9(d)(7). The panel may allow stipulations and other procedures that would expedite the proceedings. NFA Code § 9(d)(6). Arbitrators have the right to ask questions in order to clarify any matters which are relevant.

If a panel permits, parties may testify at arbitration hearing by telephone. NFA Code § 9(a). While testimony by telephone does not offer the best possible way to test a witness' credibility, panels frequently permit testimony by telephone based upon a party's showing of financial hardship and inconvenience for a witness in traveling a far distance to the hearing.

Panel members may accept affidavits if the party can demonstrate that the testimony covered by the affidavit is relevant to a central fact in the case and the person giving the affidavit cannot testify by telephone or in person. NFA Code § 9(d)(6). As a general rule, however, affidavits at hearings are discouraged since there is no ability to cross-examine the testimony contained in the affidavit.

The Award

Awards issued by NFA panels are final. NFA Code § 10(c). The arbitrators must issue a written decision within thirty days of the close of the hearing. NFA Code § 10(a). The award may grant or deny any of the monetary relief requested in a demand for arbitration and, if there is such a grant, it may also include interest and filing fees. NFA Code § 10(b). Under certain provisions, awards may include an assessment of other costs, including attorneys' fees, postponement fees and other matters authorized by statute. NFA Code §§11-12. Awards do not generally state the basis upon which they have been made.

Attorneys' Fees

Attorneys' fees are not automatically awarded to the prevailing party. Attorneys' fees generally may be awarded in three situations:

- The statute under which the party alleged a claim provides for attorneys' fees in event of a meritorious claim;
- NFA Code § 12 provides that if a party files a frivolous or bad faith claim, raises a frivolous or bad faith defense or engaged in willful acts of bad faith during the arbitration, it must pay attorneys' fees; and
- If the parties had a contract which provides for an award of attorneys' fees and the arbitral panel determines that fees were appropriate under the immediate circumstances.

The attorneys' fee that the arbitrators award must be reasonable. In determining reasonableness the panel generally will request a copy of the attorney's billings for the case. NFA Code § 12.

If an attorney is paid by salary and not by the hour the arbitrators will decide what a commercially reasonable rate for work performed is. The panel has discretion to allow parties to submit arguments on what a commercially reasonable rate should be.²⁴

Request for Modification of an Award

Parties may, within twenty days of the date of service of the award, make a request that the award be modified or corrected. Awards may be modified where there was a mathematical error, where arbitrators have made an award upon a matter not submitted before them or where the award is imperfect in matters of form not affecting the merits of the controversy. The NFA staff is responsible for reviewing all requests for modification and determining whether such modification should be transmitted to the panel for its consideration. NFA Code § 10(c).

²⁴ *Gibson v. Best Commodities Services, Inc.*, [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,640 (CFTC 1987); *First National Monetary Corp. v. CFTC*, [1987-1990 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,347 (6th Cir. 1988); *City of Riverside v. Rivera*, 477 U.S. 561 (1986); *Alyeska Pipeline Service Co. v. Wilderness Society*, 421 U.S. 240 (1975).

Review by Courts

NFA awards are final and generally cannot be successfully appealed. NFA Code § 10(d). It is only in rare cases that an NFA award can be set aside and each state has its own requirements for vacating or modifying final arbitration awards. Under New York law, for example, there are a limited number of grounds upon which a court may vacate an award. Such grounds include:

- The award was obtained by corruption, fraud or misconduct;
- An arbitrator was obviously not impartial;
- An arbitrator exceeded his power or so imperfectly executed it that a final and definite award upon the subject matter submitted was not made.

New York Civil Practice Law and Rules § 7511.

Conclusion

The NFA process is designed to reduce the time and costs of resolving disputes. While no dispute resolution process is perfect, NFA has been extremely effective in the futures industry.