UNITED STATES OF AMERICA
Before the
COMMODITY FUTURES TRADING COMMISSION

MARY ADAMS v. BLACK DIAMOND FUTURES & TRADING, INC. and LAWRENCE BARRELL HUNDLEY, III	CFTC Docket No. 04-R052 OPINION AND ORDER

Mary Adams ("Adams") appeals the dismissal of her reparations complaint against Black Diamond Futures & Trading, Inc. ("Black Diamond"), an introducing broker, and Lawrence Barrell Hundley, III ("Hundley"), Black Diamond's sole registered principal and associated person. During part of the time relevant to this matter, Black Diamond was guaranteed by Peregrine Financial Corporation ("Peregrine"), a futures commission merchant, which is no longer a party to this action.[1] Neither Black Diamond nor Hundley filed an answering brief.

In his initial decision, the Judgment Officer found that Hundley violated the Commodity Exchange Act ("Act") by making unauthorized trades for Adams's account, but that Adams ratified the unauthorized trades and therefore was barred from recovery. *Adams v. Black Diamond Futures and Trading, Inc., and Lawrence Barrell Hundley,* CFTC Docket No. 04-R52, 2006 WL 1675950 (C.F.T.C. June 16, 2006) ("I.D."). Because the Judgment Officer's findings of fact do not support his legal conclusion of ratification, we reverse that holding. We affirm the Judgment Officer's finding of unauthorized trading and award damages to Adams.

[1] Black Diamond operated as an independent introducing broker after October 21, 2002.

BACKGROUND[2]

Adams opened an account with Hundley and Black Diamond, carried by Peregrine, in October 2001. Although Adams's account was nondiscretionary, at her request, Hundley placed trades without consulting her. He did not ask her to sign a discretionary trading authorization and did not inform her that one was required. Adams received confirmation statements when Hundley placed trades for her account, but paid these scant attention, focusing instead on the end of the month liquidation value reported in her monthly account statements.

Trading, which began in January 2002 with an initial deposit of $10,000, initially was profitable. The liquidation value of Adams's account was $12,417 at the end of February. The account experienced losses and ended April with a liquidation value of $400. The account's fortunes reversed and it enjoyed several months of increasing profits, ending July with a liquidation value of $14,627. Adams deposited $5,560 to her account in August, which was another profitable trading month. On September 23, 2002, she transferred $4,800 from her account to open an account for her son, with herself as custodian. Adams made a final $6,000 deposit to her account on October 11, 2002.

The account remained profitable through September, but began incurring losses in October. At year-end, its liquidation value had sunk to $3,735. The account rebounded, ending January 2003 valued at $7,253. Losses resumed thereafter, leaving the account valued at $3,590 at the end of April and $368 at the end of May. On July 31, 2003, Peregrine returned to Adams her remaining $142 account balance.

Adams subsequently filed two pro se reparations complaints against Black Diamond, Hundley and Peregrine, claiming damages in connection with her account and her son's account on grounds including fraud, misrepresentation and unauthorized trading. Adams withdrew both

[2] The background narrative relies on the undisputed findings of fact contained in the I.D.

complaints against Peregrine pursuant to a settlement agreement under which Peregrine compensated her for all losses in her son's account. Since she was made whole in that case, she withdrew the complaint regarding her son's account against the other respondents as well. This case proceeded to a telephonic hearing at which Adams and Hundley appeared and testified. The case concluded with the Judgment Officer's dismissal of the complaint.

The Judgment Officer made the following findings. Contention between Adams and Hundley arose in October 2002 as a result of losses on several S&P e-mini futures trades after several months of profits. While Hundley did not guarantee profits or promise to reimburse Adams for her S&P e-mini losses, he expressed confidence in his ability to recoup the losses. About the time that Adams closed the account in mid-2003, she sent a letter to Hundley complaining that he had not fulfilled his undertakings of "the last nine months" to make her whole for the "e-mini errors in October 2002." I.D. at *6.

Based on Hundley's admission, the Judgment Officer found that Hundley traded Adams's account without obtaining written discretionary trading authorization or obtaining her specific authority before most individual trades. He concluded that Hundley's conduct was a *per se* violation of Commission Rule 166.2 and Section 4b of the Act.[3] The Judgment Officer thus

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[3] Commission Rule 166.2 provides, in pertinent part:

> No . . . introducing broker, or any [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 . . .—
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> > (a) Specifically authorized the . . . [associated person] to effect the transaction (a transaction is "specifically authorized" if the customer . . . specifies (1) the precise commodity interest to be purchased or sold and (2) the exact amount of commodity interest to be bought or sold); or
> >
> > (b) Authorized in writing the . . . [associated person] to effect transactions in commodity interests for the account without the customer's specific authorization.

Section 4b of the Act prohibits fraud in connection with futures transactions. Unauthorized trading violates this prohibition. *Cange v. Stotler*, 826 F.2d 581, 589 (7th Cir. 1987); *Severance v. First Options of Chicago*, [Current

determined that Hundley was liable for Adams's losses from the unauthorized trades, unless he could show that she was estopped or that she ratified the trades.

The Judgment Officer stated that "[i]n order to establish a successful estoppel defense Hundley must show that Adams was aware of material information that was not available to Hundley and that Adams's failure to share that information with Hundley exacerbated her financial injury." I.D. at *6. He concluded that Hundley's estoppel defense failed because Adams was unaware until after she closed her account that Hundley needed either her permission in writing for discretionary trading authority or specific authorization for individual trades.

The Judgment Officer nonetheless held that Hundley "has successfully established that Adams ratified all of the trades" because Adams (1) "received a confirmation for each trade;" (2) "never objected to, or attempted to repudiate, any trade;" (3) "deposited additional funds and opened a second account for her son;" and also because (4) "Hundley never misled Adams by telling her that she was obligated to accept the trades." *Id.* at *7. He concluded that "[i]n these circumstances, it is reasonable to infer that Adams intentionally adopted the trades and was properly charged for the losses incurred."[4] *Id.* (citation omitted).

On appeal, Adams asks the Commission to reweigh the evidence in her favor and argues that the Judgment Officer displayed bias against her evidenced by adverse discovery rulings, negative comments, and prolonged questioning during the telephonic hearing.

Transfer Binder] Comm. Fut. L. Rep (CCH) ¶ 30,132, at 57,516-17 (CFTC Sept. 7,. 2005); *Slone v. Dean Witter Reynolds, Inc.*, [1994-96 Transfer Binder] Comm. Fut. L. Rep (CCH) ¶ 26,283, at 42,433 (CFTC Dec. 6, 1994).

[4] The Judgment Officer found that both parties' testimony was self-serving and suffered from "a notable lack of convincing factual description." I.D. at *2. He dismissed all of Adams's claims except her allegations of unauthorized trading, finding that she failed to establish them by a preponderance of the evidence.

DISCUSSION

As the Judgment Officer found, Hundley's acknowledged failure either to obtain a written discretionary trading authorization or to obtain Adams's specific authority for the majority of trades he executed for her constituted *per se* unauthorized trading. We previously summarized our case law on unauthorized trading as follows:

> A liability analysis under Commission Rule 166.2 focuses on two issues: (1) whether there was a written power of attorney in effect at the time of the transaction at issue and, if not, (2) whether the transaction was specifically authorized by the customer in advance of its execution. *See Wolken v. Refco, Inc.*, [1987-1990 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,509 at 36,188 (CFTC July 18, 1989). Under Rule 166.2, a customer's oral grant of general discretion to an account executive is irrelevant to the analysis of liability, because the rule renders such oral agreements void. *Id.* The customer's post-transaction conduct is equally irrelevant to an analysis of liability, because a transaction cannot be specifically authorized unless the customer selects the type of transaction (purchase or sale), the commodity interest, and the exact amount of the commodity interest, in advance of the transaction. . . . Similarly, in *In re Paragon Futures Association*, [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 25,266 at 38,850 (CFTC Apr. 1, 1992), the Commission noted that "oral authorization which is not specific does not satisfy the requirements of Commission Rule 166.2."

Kacem v. Castle Commodities Corp., [1996-1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,058 at 45,031 (CFTC May 20, 1997). An unauthorized trade nevertheless may be ratified, if the customer adopts the trade with knowledge that it was unauthorized. Ratification is an affirmative defense as to which Hundley bore the burden of proof. To determine whether ratification has been established, we look at a complainant's knowledge and activity after the disputed transaction occurred:

> A customer ratifies unauthorized trading for his account "only where it is clear from all the 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." *Sherwood v. Madda Trading Company*, [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,728 at 23,020 (CFTC Jan. 5, 1979). The customer's adoption of such trading must be "clear and unequivocal." [*Id.*] at 23,022. To determine whether there has been ratification, the Commission looks

> at the complainant's knowledge and activity after the disputed transaction occurs. In this case, complainant was apprised of the unauthorized trading by [respondent's] September 3, 1992 letter. Complainant stated that he was devastated by this information and contacted [respondent] to complain about the trades. (Tr. at 30.) This conduct makes clear that complainant did not intend to adopt these trades as his own, and therefore, no ratification of the trading occurred.
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> Complainant's decision to continue trading with [respondent] in late 1992 does not constitute a ratification of the unauthorized trades.

Id.

The Judgment Officer's finding of ratification does not comport with his factual findings or Commission precedent. A customer ratifies a transaction "only where it is clear from all the 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." *Symon v. Fullet*, [1996-1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,121 at 45,271 (CFTC Aug. 7, 1997), *quoting Sherwood v. Madda Trading Company*, [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,728 at 23,020 (CFTC Jan. 5, 1979). When considering whether ratification has been established, the first step is to examine the customer's knowledge of the agent's wrongdoing and knowledge of the customer's legal right to avoid financial responsibility for unauthorized trades. *Id.*, *quoting Gilbert v. Refco, Inc.*, [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 25,081 at 38,058 (CFTC June 27, 1991).[5] Adams did not know until after her account was closed that Hundley should have obtained written discretionary trading authority or her prior consent to each specific trade.

Neither do the other factual findings upon which the Judgment Officer based his ratification holding meet the foregoing standard of proof. According to the Judgment Officer,

[5] "[Federal courts of appeal] that have confronted the issue have also deemed knowledge of the relevant facts and an intent to approve the unauthorized action after its occurrence to be preconditions to ratification." *Drexel Burnham Lambert, Inc. v. CFTC*, 850 F.2d 742, 750 (D.C. Cir. 1988)(citations omitted).

contention arose as a result of S&P e-mini futures trades placed between October 3 and October 14, 2002 that resulted in an aggregate loss of $5,988. I.D. at *5. Adams admittedly received a confirmation for each trade, reflecting losses as they occurred, but the Judgment Officer found that she paid these scant attention, and focused instead on her monthly account statements. I.D. at *4. Based on this finding, Adams would not be expected to register a protest until early November. The Judgment's Officer's statement that Adams never objected to any trade is at odds with his finding that contention arose between Adams and Hundley as a result of the October losses.

In further support of his finding of ratification, the Judgment Officer noted that Adams opened a custodial account for her son and deposited additional funds to her own account. These events, however, occurred while the account was earning profits. Ratification does not operate prospectively to cover subsequent trades. Finally, the fact that "Hundley never misled Adams by telling her that she was obligated to accept the trades," is outweighed by the fact that he never told her, and she did not know, that most trades he executed for her account violated Commission Rule 166.2.[6] We accordingly find that Hundley's ratification defense fails. We otherwise affirm the findings and conclusions of the Judgment Officer's decision.[7]

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[6] Moreover, the Judgment Officer found that Hundley credibly testified that he expressed confidence in his ability to turn things around on more than one occasion, but that he never guaranteed profits or promised to reimburse Adams for the S&P e-mini losses. According to the I.D., Hundley had recovered losses once before. Thus, there was no reason for Adams to question his ability to do so again. With or without a guarantee, Hundley's expression of confidence may have been very persuasive and may have lulled Adams into keeping her account open. This, too, undermines the clarity of evidence that would lead us to find that Adams intended to ratify the disputed trades.

[7] Because we are awarding Adams all the relief she seeks and is entitled to in this forum, we need not discuss at length the Judgment Officer's other rulings. Nonetheless, with regard to Adams's allegations of bias, we note that a judge's rulings standing alone "almost never constitute a valid basis for a bias or partiality motion." *Robinson v. Alternative Commodity Traders*, [Current Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 30,155 at 57,603 (CFTC Nov. 4, 2005), *citing Nixon v. Lind Waldock & Co.*, [1996-1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,935 at 44,517 (CFTC Jan. 17, 1997). Bias of a presiding officer is disqualifying only when the record establishes the existence of a personal bias stemming from an extrajudicial source or a deep-seated favoritism or antagonism that makes fair judgment impossible. *In re Nikkhah*, [1994-1996 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶

Under Section 14 of the Act, Adams is entitled to recovery of "actual damages proximately caused" by a violation of the Act or Commission Regulations. *E.g., Severance,* ¶ 30,132 at 57,517. Consequently, Hundley shall reimburse Adams for the entire amount of her out-of-pocket losses incurred in connection with her account, an amount the Judgment Officer found to be $16,618 (less any amount paid by Peregrine for losses in her account).[8]

CONCLUSION

We affirm the Judgment Officer's finding that Hundley engaged in unauthorized trading and that his affirmative defense of estoppel failed. We reverse the Judgment Officer's finding that Adams ratified the unauthorized trades. Hundley shall pay Adams her out-of-pocket losses of $16,618 (less any amount paid by Peregrine for losses in her account) plus interest on this amount at the rate of 4.94 percent, calculated from July 31, 2003 to the time of payment, and her

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26,635 at 43,671 (CFTC Mar. 1, 1996). Adams has presented no evidence to support a finding of extrajudicial bias, and our review of the record reveals no deep-seated antagonism.

[8] Adams requests compensation for lost profits. Reparations proceedings are primarily compensatory in nature and complainants generally are not entitled to more than their out-of-pocket losses. *Stiller v. Shearson, Loeb Rhoades, Inc.*, [1982-1984 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,780 at 27,155 (CFTC July 11, 1983). *Compare Severance*, ¶ 30,132 at 57,517-18 (compensation for lost profits is usually awarded for unauthorized trading in connection with unauthorized liquidation). Adams's requests for reimbursement for the cost of the transcript and for photocopying are denied.

filing fee. Under Section 2a(1)(B) of the Act, Black Diamond, as Hundley's principal, is jointly and severally liable for the award.

IT IS SO ORDERED.[9]

By the Commission (Chairman JEFFERY and Commissioners LUKKEN and DUNN).

Eileen A. Donovan
Acting Secretary of the Commission
Commodity Futures Trading Commission

Dated: April 11, 2007

[9] Under Sections 6(c) and 14(e) of the Act (7 U.S.C. §§ 9 and 18(e) (2000)), a party may appeal a reparation order of the Commission to the United States Court of Appeals for only the circuit in which a hearing was held; if no hearing is held, the appeal may be filed in any circuit in which the appellee is located. The statute states that such an appeal must be filed within 15 days after notice of the Commission order, and that any appeal is not effective unless, within 30 days of the effect of the order, the appealing party files with the clerk of the court a bond equal to double the amount of the reparation award.

A party who receives a reparation award may sue to enforce the award if payment is not made within 15 days of the date the order is served by the Proceedings Clerk. Pursuant to Section 14(d) of the Act, 7 U.S.C. § 18(d) (2000), such an action must be filed in a United States District Court. *See also* 17 C.F.R. § 12.407.

Pursuant to Section 14(f) of the Act, (7 U.S.C. §18(f) (2000)), a party against whom a reparation award has been made must provide to the Commission, within 15 days of the expiration of the period for compliance with the award, satisfactory evidence that (1) an appeal has been taken to the United States Court of Appeals pursuant to Section 6(c) and 14(e) of the Act, or (2) payment has been made of the full amount of the award (or any agreed settlement thereof). If the Commission does not receive satisfactory evidence within the appropriate period, such party shall be automatically prohibited from trading on all contract markets, and its registration under the Act shall be suspended automatically. Such prohibition and suspension shall remain in effect until such party provides the Commission with satisfactory evidence that payment has been made of the full amount of the award plus interest thereon to the date of payment.