UNITED STATES OF AMERICA
Before the
COMMODITY FUTURES TRADING COMMISSION

In the Matter of	)	**CFTC DOCKET NO.** 10-19
	)	
Alaron Trading Corporation,	)	**ORDER INSTITUTING PROCEEDINGS PURUSUANT TO SECTIONS 6(c) AND 6(d) OF THE COMMODITY EXCHANGE ACT, MAKING FINDINGS AND IMPOSING REMEDIAL SANCTIONS**
Respondent.	)	

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I.

The Commodity Futures Trading Commission ("Commission" or "CFTC") has reason to believe that Alaron Trading Corporation ("Alaron") has violated Commission Regulation ("Regulation") 166.3, 17 C.F.R. § 166.3 (2010). Therefore, the Commission deems it appropriate and in the public interest that public administrative proceedings be, and hereby are, instituted to determine whether Alaron has engaged in a violation of Regulation 166.3 and to determine whether any order should be issued imposing remedial sanctions.

II.

In anticipation of the institution of an administrative proceeding, Alaron has submitted an Offer of Settlement ("Offer"), which the Commission has determined to accept. Alaron acknowledges receipt of this Order Instituting Proceedings Pursuant to Sections 6(c) and 6(d) of the Act, Making Findings and Imposing Remedial Sanctions ("Order"). Alaron, without admitting or denying the findings of fact or conclusions of law herein, consents to the use of the findings contained in this Order in this proceeding and in any other proceeding brought by the Commission or to which the Commission is a party.[1]

[1] Alaron does not consent to the use of the Offer or this Order, or the findings consented to in the Offer or this Order, as the sole basis for any other proceeding brought by the Commission other than a proceeding in bankruptcy or to enforce the terms of this Order. Nor does Alaron consent to the use of the Offer or this Order, or the findings consented to in the Offer or this Order, by any other party in any other proceeding.

III.

The Commission finds the following:

A. SUMMARY

From at least January 2008 to at least October 2008 (the "relevant period"), Alaron, a registered futures commission merchant ("FCM"), failed to supervise diligently Alaron's employees' handling of commodity interest accounts carried by Alaron and other activities of Alaron's employees relating to its business as a Commission registrant, in violation of Regulation 166.3, 17 C.F.R. § 166.3 (2010). Among other things, Alaron had inadequate procedures for managing risks associated with customer accounts trading via "give-up agreements."[2]

Alaron's procedures for managing risks associated with accounts trading via give-up agreements were inadequate in several respects. Alaron failed to monitor overnight trading activity that occurred by means of give-up agreements. Additionally, Alaron failed to establish and implement procedures to put accounts incurring large debits on liquidation status. As a consequence, Alaron's inadequate or non-existent procedures failed to protect the firm's ability to meet its capital and segregation requirements and therefore protect the firm's continued viability. In fact, these failures permitted an Alaron customer ("Customer") to trade his account in a manner that allowed him to incur an approximate $4 million debit in July 2008 that caused Alaron to become undersegregated and fall below its net capital requirements.

B. RESPONDENT

Alaron Trading Corporation is located at 822 W. Washington, Chicago IL 60607. Alaron has been registered with the Commission in various capacities since July 1989. From July 1989 to March 1994, Alaron was registered as an introducing broker, at which point the firm became registered as an FCM. Since February 2, 1990, Alaron also has been registered as a commodity trading advisor. Alaron was a clearing member of the Chicago Mercantile Exchange, Inc. ("CME") from 2002 to September 2008. During that time, the CME was also its designated self-regulatory organization ("DSRO"). During the relevant period, Steven Greenberg ("Greenberg") was the chief executive officer and a principal of Alaron. In October 2008, Alaron transferred its clearing customers to Penson GHCO, an FCM. Alaron sold its assets to PFGBest, an FCM, in May 2009 and no longer carries any customer accounts.

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[2] It is an established practice in the futures industry that FCMs engage in transactions through give-up arrangements, whereby an FCM, acting as an executing broker, executes an order on an exchange for a customer, which in accordance with applicable exchange rules is then given-up to a clearing broker. Pursuant to a give-up arrangement, which may be formalized by a written agreement, an executing broker will execute a trade on order of the customer and then direct it to the account that the customer has established with its clearing broker. The trade thereafter is subject to acceptance by the clearing broker. *See, e.g., In re Szach*, [2000-2002 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 28,451 (CFTC Jan. 8, 2001).

C. FACTS

1. Alaron's Disciplinary Background

Since Alaron became a Commission registrant in 1989, Alaron has been subject to 15 exchange disciplinary actions, two National Futures Association disciplinary actions, and one CFTC enforcement action involving financial requirements, trade practice, record keeping, and failure to supervise violations.[3]

In its capacity as Alaron's DSRO from 2002 to 2008, the CME conducted several financial examinations and audits of Alaron's policies and procedures. After each audit, the CME sent a list of audit failures and concerns to Alaron. For example, after the CME's Clearing House Risk Sub-Committee performed an audit of Alaron in 2003, the CME instructed Alaron that it needed to hire additional experienced risk management personnel. The CME reiterated this directive in connection with another audit in April 2004, and again in connection with the CME's November 2006 financial and compliance examination of Alaron. Notwithstanding these repeated warnings and directives, Alaron did not hire experienced risk management staff until October 2007, when it hired a Chief Operating Officer ("COO") to change and implement new policies and procedures. The COO did not immediately address the give-up process even though it was one of the identified areas of concern.

2. Alaron's Give-Up Process

During the relevant period, Alaron executed several give-up contracts with various FCMs and executing brokers. All futures contracts that were executed pursuant to give-up arrangements that were "given-in" to Alaron for clearing were required to pass through the "CME Portal" computer screen in real time for clearing. The CME Portal is password protected, and Alaron limited the employees who had access to accept the give-up trades. Only one Alaron employee, called a "balancer," was assigned to review the CME Portal and manually accept the contracts given-in to Alaron. This employee worked Monday through Friday from approximately 8:30 a.m. to 5:00 p.m. and sporadically checked the CME Portal during each work day. Significantly, no one monitored give-up trades during the overnight trading session. Until the trading incident involving the Customer on July 7 and 8, 2008, Alaron had no formal controls in place involving the acceptance of give-up trades.

On or after July 9, 2008, Alaron determined that give-up transactions of 25 or more contracts posed an internal control risk to the firm. The only procedure Alaron implemented to deal with this problem was a limited procedure that required the balancer to obtain the signature approval of the Director of Risk Management in order to accept give-up trades of 25 contracts or more for clearing. Alaron did not implement any other procedures to control the risks inherent in

[3] Beginning in October 2003, the CME required Alaron to maintain higher minimum net capital than that required by Regulation 1.17, 17 C.F.R. § 1.17 (2010), and required the firm to report its net capital and segregation requirements on a daily basis. During July 2008, the CME required Alaron to maintain adjusted net capital of $3 million in excess of CFTC early warning capital requirements.

give-up arrangements during the relevant period, in particular procedures to deal with (1) real-time review of trades being "given up" to Alaron; (2) review of give-up trades during overnight trading; and (3) putting accounts with large deficits on liquidation only status and ensuring that the executing FCM was aware of such status.

Further, even this limited procedure which was implemented was not reasonably designed and did not adequately redress the risks identified by Alaron, in that customers could still accumulate large positions in excess of 25 contracts without the written approval of the director. Specifically, the new procedure placed limitations only on the size of give-up transactions that Alaron would accept, but not the aggregate size of positions that customers could acquire, in that the procedure did not require the balancer to obtain the signature approval of the Risk Manager to address aggregate positions over 25 contracts that a trader might generate through multiple transactions of fewer than 25 contracts.

3. Customer's Trading July 7-8, 2008

The Customer whose trading precipitated Alaron's undersegregation on July 8, 2008 was registered with the Commission as a floor broker and was an exchange member who traded for his own account on the CME as a "local." Customer opened his trading account with Alaron on April 2, 2002. Customer's trading account was subject to a give-up agreement between Alaron and another registered FCM, and from 2007 forward, all of Customer's electronic trading was executed and cleared pursuant to the give-up agreement. As explained below, Alaron permitted Customer to call his trades into an electronic execution group. On July 7 and 8, 2008, Customer incurred an approximate $4 million debit in his Alaron trading account. Customer's trading via give-up agreement at Alaron exposed Alaron's lack of controls.

Customer had a history of using the give-up process to electronically trade during the overnight trading session. Customer's process for trading through the give-up agreement was as follows: (1) Customer called an electronic execution group trading desk to place his orders; (2) the electronic execution group would route the trades through the Order Passing Broker's back office systems; (3) because the Order Passing Broker used the Executing Broker for clearing, the trades would pass through the Executing Broker's back office systems; and (4) the Executing Broker would send the trades to Alaron for clearing through the CME Portal. Under the terms of the agreement, the Executing Broker executed trades on a futures exchange pursuant to orders received from Customer. The Executing Broker gave up Customer's trading positions to Alaron for clearing.

Customer had been a fairly successful commodities trader over the course of several years. However, in February 2008, Customer incurred an aggregate loss of about $987,000 in his trading account, resulting in a margin deficit of approximately $830,000. Customer's father, a trader known to Alaron, paid the loss. Approximately half of Customer's trades in February 2008 were executed electronically utilizing the give-up process. Despite this demonstration of risk posed by Customer's trading and use of give-ups, Alaron did not implement any procedures to guard against a repeat incident.

Customer traded for his own account during the trading day on July 7, 2008. His trading was unprofitable and his losses mounted as the trading day progressed. Most of his trades were executed utilizing the give-up agreement between Alaron and Executing Broker. This required the balancer to manually accept Customer's trades. Alaron did not learn of Customer's loss until approximately 3:00 p.m. on July 7, 2008, when the balancer manually accepted the Customer's give-up trades. By that time, Customer had lost more than $325,000 in his personal trading account and received a margin call.

At approximately 3:00 p.m. on July 7, 2008, Alaron's Director of Risk Management contacted Customer by phone and told him to liquidate his positions. That afternoon, the Director of Risk Management also contacted the COO and informed her of the trading loss incurred by the Customer. Notably, Alaron had no formal policy relating to liquidating a customer's account with a large debit balance. Except for instructing Customer to liquidate his positions, Alaron did nothing to put Customer's account on "liquidation status." For example, Alaron did not identify Customer's account in its system as being on liquidation status, did not put a hold on Customer's trading account, and did not inform the Order Passing Broker of Customer's liquidation status. Alaron staff did not ensure that Customer was liquidating his account during the overnight trading session between July 7 and 8, 2008, and did not assign anyone to review the CME Portal during the overnight trading session.

After being instructed to liquidate his account, Customer reduced the positions in his trading account over the next two hours. By 5:00 p.m. on July 7, 2008, Customer had liquidated all but 99 long e-mini S&P futures contracts and 39 long lean hog futures contracts. At that time, the net liquidation value of the account was in deficit by approximately $381,000.

Shortly after the markets closed at 5:00 p.m. on July 7, 2008, Customer resumed trading on the CME's electronic trading platform using the give-up process. By about 8:00 a.m. on July 8, 2008, Customer's trading losses had increased to about $872,000, and his account was short about 1,903 S&P e-mini futures contracts.

At approximately 8:15 a.m. on July 8, 2008, the Director of Risk Management called Customer and told him to come to the Alaron office to meet with him and the COO. Because no one at Alaron had monitored the Customer's overnight trading activity and the balancer had not yet accepted Customer's overnight trades, the Director of Risk Management and the COO did not yet know that Customer had been trading during the overnight trading session through his give-up agreement and that the loss had increased by approximately $500,000 since the previous afternoon. The Director of Risk Management and the COO also were unaware of the large short e-mini position in Customer's account. At the meeting, the COO and the Director of Risk Management did not ask about Customer's overnight trading activity, and Customer did not disclose it. Alaron's COO and its Director of Risk Management immediately asked Customer to provide an endorsed blank check to cover the debit once Customer liquidated his account, told Customer to close out his positions by 9:00 a.m., and let Customer return to the trading floor.

Customer returned to the trading floor immediately after the meeting. By approximately 8:40 a.m. on July 8, 2008, he had liquidated his positions and had incurred a loss of approximately $2.5 million. However, at approximately 9:30 a.m., Customer resumed trading electronically through the give-up process. By approximately 10:30 a.m., Customer again offset his trades (or positions), which brought his total net loss to almost $4 million. Throughout this time, Alaron did nothing to restrict Customer's trading.

Alaron had yet to accept any of the Customer's overnight give-up trades. At approximately 10:30 in the morning of July 8, 2008, Alaron's balancer looked at the CME Portal and saw that there were many contracts awaiting acceptance from overnight and morning trading sessions for Customer's account. The balancer contacted the Director of Risk Management, showed him the first screen with the many waiting trades, and asked what to do. Despite internal policy requiring the Director of Risk Management to review all trades before acceptance, the Director of Risk Management did not review Customer's balance and did not review each trade waiting in the CME Portal, but simply informed the balancer to accept all of Customer's trades. Alaron did not know the full extent of the trades that it was accepting. After Alaron's balancer accepted Customer's trades on July 8, 2008 at approximately 10:30 a.m., Customer's account with Alaron had a loss of almost $4 million. Customer stopped trading at that time only because his colleagues physically pulled him off the CME trading floor.

4. Alaron's Supervisory Failures

Alaron did not diligently manage the risk associated with accepting customer trades through the give-up process. Specifically, Alaron failed to: (1) review trades that were sent to Alaron through the give-up screen prior to acceptance, (2) review give-up trades in real-time, (3) review give-up trades during the overnight trading session, (4) put a stop on Customer's trading account to ensure liquidation, and (5) inform the parties to the give-up agreement that Customer was on liquidation status. Notwithstanding the prompt infusion of capital to achieve capital compliance, these supervisory deficiencies allowed Customer's trading activity to negatively impact the firm's capital and thereby put the firm's survival at risk, while undermining the goal of net capitalization requirements to protect other customers and market participants.

D. LEGAL DISCUSSION

Regulation 166.3 imposes on every Commission registrant, except associated persons ("APs") who have no supervisory duties, an affirmative duty to "diligently supervise the handling by its partners, officers, employees and agents ... of all commodity interest accounts carried, operated, advised or introduced by the registrant and all other activities of its partners, officers, employees and agents ... relating to its business as a Commission Registrant." Risk management activity, which exists in principal part to ensure a firm's continued financial viability and, derivatively, to ensure that its capital requirements are met, constitutes other activities relating to a firm's business as a Commission registrant that must be diligently supervised. A violation under Regulation 166.3 is an independent violation for which no underlying violation is necessary. *See, In re Collins*, [1996-1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,194 at 45,744 (CFTC Dec. 10, 1997).

1. Alaron's Supervisory System Relating to Give-Up Procedures is Inadequate in Violation of Regulation 166.3

In order to prove a violation of Regulation 166.3, the Division must demonstrate that the registrant's supervisory system was generally inadequate or that the registrant failed to diligently administer such a system. *In re GNP Commodities, Inc.*, [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 25,360 at 39,219 (CFTC Aug. 11, 1992), *aff'd sub nom. Monieson v. CFTC*, 996 F.2d 852 (7th Cir. 1993); 43 Fed. Reg. 31,886, 31,889 (July 24, 1978). This is a fact specific undertaking. *GNP Commodities,* ¶ 25,360 at 39,219 ("a proper determination of a FCM's supervisory diligence must remain sensitive to the particular facts and circumstances that influenced the design and execution of the system at issue"). Under Regulation 166.3, an FCM has a "duty to develop procedures for the detection and deterrence of possible wrongdoing by its agents." *Lobb v. J.T. McKerr & Co.*, [1987-1990 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,568 at 36,444 (CFTC Dec. 14, 1989)). "A showing that the registrant lacks an adequate supervisory system can be sufficient" to establish a breach of duty under Regulation 166.3. *Collins*, ¶ 27,194 at 45,744. The lack of an adequate supervisory system can be established by showing that the registrant failed to develop proper procedures for the detection of wrongdoing. *CFTC v. Trinity Fin. Group, Inc.*, [1996-1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,179 at 45,635 (S.D. Fla. Sept. 29, 1997), *aff'd in part, vacated in part and remanded sub nom. Sidoti v. CFTC*, 178 F.3d 1132 (11th Cir. 1999).

Under Regulation 166.3, Alaron, had a duty to supervise diligently all aspects of its business as a Commission registrant. This included diligently monitoring trading utilizing give-up agreements in order to protect the financial security of the firm and to protect Alaron's other customers and other market participants. Pursuant to this regulation, Alaron had a duty to diligently supervise risk management activity. As discussed at length above, it failed to do so with respect to its handling of give-up trades. Specifically, Alaron's deficient risk management procedures included: (1) sporadic daytime monitoring of the give-up screen; (2) failure to monitor the give-up screen during the overnight trading sessions; and (3) failure to have a procedure in place to determine when or how to put trading accounts on liquidation status. The failure by an FCM to implement and enforce give-up procedures of this nature constitutes a failure to diligently supervise. Moreover, as an FCM, Alaron stood as the guarantor of its customer's trades. If Customer's father had not been in a position to honor Customer's trades, Alaron would have had to honor the trades with its own capital.[4]

The Commission has spoken to the need to supervise give-up agreements on a prior occasion. In *In re Szach*, the Commission issued an order finding that as a result of the chief financial officer's supervisory failures, the chief financial officer failed to control the account of a customer who was trading on Eurex through an execution broker and who breached his trading limits by substantial amounts for substantial periods of time. The order found that the FCM had imposed an intra-day trading limit on the customer that was tied to the amount of money in his account and did not allow the customer to carry positions overnight, but that the customer was able to breach those limits. For instance, the order finds that on at least five days before

[4] Although under no legal obligation to do so, Customer's father paid Customer's nearly $4 million debit.

December 21, 1998, the customer had intra-day limits ranging between 200 and 540 contracts but was able to establish positions ranging from approximately 1,000 to 5,700 contracts, and that at the end of the trading day on which he placed the trades that caused the FCM's financial failure, he had established an overnight position of approximately 10,000 contracts. The order also found that the customer sustained huge trading losses on December 21 and 22, 1998, and that as a result, the FCM received two margin calls of approximately $2.85 million and $7.68 million. The order found that neither the customer nor the FCM could satisfy the second margin call, which led to the FCM's filing for bankruptcy protection on December 30, 1998.

In addition, FCMs that clear overnight trading activity need to be vigilant. As the Commission recently found, unchecked overnight trading can result in an FCM becoming responsible for millions of dollars in trading losses. *See, e.g., In re MF Global, Inc.*, [Current Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 31,500 (CFTC Dec. 17, 2009) (Commission sanctioned FCM with civil monetary penalty of $10 million for a variety of supervisory failures, including FCM's failure to diligently supervise the overnight trading activities of an AP on February 26-27, 2008, resulting in futures trading losses of more than $141 million that the FCM had to cover).

By such failures, Alaron failed to supervise diligently the handling by its partners, officers, employees and agents of Alaron's commodity interest business in violation of Regulation 166.3.

IV.

OFFER OF SETTLEMENT

Alaron has submitted an Offer in which, without admitting or denying the findings herein, it:

A. Acknowledges receipt and service of this Order;

B. Admits the jurisdiction of the Commission with respect to all the matters set forth in this Order;

C. Waives: (1) the filing and service of a complaint and notice of hearing; (2) a hearing; (3) all post-hearing procedures; (4) judicial review by any court; (5) any and all objections to the participation by any member of the Commission's staff in the Commission's consideration of the Offer; (6) any claim of Double Jeopardy based upon the institution of this proceeding or the entry in this proceeding of any order imposing a civil monetary penalty or any other relief; (7) any and all claims that it may possess under the Equal Access to Justice Act, 5 U.S.C. § 504 (2006) and 28 U.S.C. § 2412 (2006), and/or Part 148 of the Regulations, 17 C.F.R. §§148 *et seq.* (2010), relating to, or arising from, this proceeding; and (8) any and all claims that it may possess under the Small Business Regulatory Enforcement Act of 1996, Pub. L. No. 104-121, §§ 201-253, 110 Stat. 847, 857-868 (1996), as amended by Pub. L. No.

110-28, § 8302, 121 Stat. 112, 204-205 (2007), relating to, or arising from, this proceeding.

D. Stipulates that the record basis on which this Order is entered shall consist solely of this Order, including the findings in this Order;

E. Consents, solely on the basis of the Offer, to the entry of this Order that:

1. Makes findings that Alaron violated Regulation 166.3;

2. Orders Alaron and its successors and assigns to cease and desist from violating Regulation 166.3;

3. Orders Alaron to pay a civil monetary penalty in the amount of two hundred sixty thousand dollars ($260,000), plus post-judgment interest, within ten days of the date of entry of this Order; and

4. Orders Alaron and its successors and assigns to each comply with the undertakings consented to in the Offer and set forth below in Part VI of this Order.

Upon consideration, the Commission has determined to accept Alaron's Offer.

V.

FINDINGS OF VIOLATIONS

Based upon the foregoing, the Commission finds that Alaron violated Regulation 166.3, 17 C.F.R. 166.3 (2010).

VI.

Accordingly, IT IS HEREBY ORDERED THAT:

1. Alaron and its successors and assigns shall cease and desist from violating Regulation 166.3, 17 C.F.R. 166.3 (2010).

2. Alaron shall pay a civil monetary penalty in the amount of two hundred sixty thousand dollars ($260,000), plus post-judgment interest, within ten (10) days of the date of the entry of this Order. Post-judgment interest shall accrue beginning eleven (11) days after the entry of this Order and shall be determined by using the Treasury Bill rate prevailing on the date of entry of this Order pursuant to 28 U.S.C. § 1961. Alaron shall pay its civil monetary penalty by electronic funds transfer, U.S. postal money order, certified check, bank cashier's check, or bank money order. If payment is to be made by other than electronic funds transfer, the payment

shall be made payable to the Commodity Futures Trading Commission and sent to the address below:

Commodity Futures Trading Commission
Division of Enforcement
ATTN: Marie Bateman - AMZ-300
DOT/FAA/MMAC
6500 S. MacArthur Blvd.
Oklahoma City, OK 73169
Telephone 405-954-6569

If payment by electronic transfer is chosen, Alaron shall contact Marie Bateman or her successor at the above address to receive payment instructions and shall fully comply with those instructions. Alaron shall accompany payment of its penalty with a cover letter that identifies itself and the name and docket number of this proceeding. Alaron shall simultaneously transmit copies of the cover letter and the form of payment to: (1) the Director, Division of Enforcement, Commodity Futures Trading Commission, 1155 21st Street, N.W., Washington, D.C. 20581; and (2) the Chief, Office of Cooperative Enforcement, Division of Enforcement, Commodity Futures Trading Commission at the same address. In accordance with Section 6(e)(2) of the Act, 7 U.S.C. § 9a(2) (2006), if Alaron does not pay the civil monetary penalty in full within fifteen (15) days of the due date, it shall be prohibited automatically from the privileges of all registered entities, and, if registered with the Commission, such registration shall be suspended automatically until it has shown to the satisfaction of the Commission that payment of the full amount of the penalty with interest thereon to the date of the payment has been made; and

3. Alaron and its successors and assigns shall comply with the following conditions and undertakings as specified:

a. Registration Withdrawal: Alaron shall withdraw its registrations as an FCM and commodity trading advisor and shall never apply for registration or claim exemption from registration with the Commission in any capacity and shall never engage in any activity requiring such registration or exemption from registration with the Commission, except as provided for in Regulation 4.14(a)(9), 17 C.F.R. § 4.14(a)(9) (2010); and

b. Public Statements: Neither Alaron, its successors or assigns, nor any of their agents or employees under their authority or control shall take any action or make any public statement denying, directly or indirectly, any findings or conclusions in this Order, or creating, or tending to create, the impression that this Order is without a factual basis; provided, however, that nothing in this provision shall affect Alaron's (i) testimonial obligations, or (ii) right to take legal positions in other proceedings to which the Commission is not a party. Alaron and its successors and assigns shall undertake all steps necessary to ensure that all of their agents and employees under their authority or control understand and comply with this undertaking.

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

By the Commission:

David A. Stawick

David A. Stawick
Secretary of the Commission
Commodity Futures Trading Commission

Dated: September 30, 2010