

UNITED STATES OF AMERICA
Before the
COMMODITY FUTURES TRADING COMMISSION

In the Matter of

Refco Overseas Limited,

Respondent.

CFTC Docket No: 04-27

**ORDER INSTITUTING
PROCEEDINGS PURSUANT TO
SECTIONS 6(c) AND 6(d) OF THE
COMMODITY EXCHANGE ACT,
MAKING FINDINGS AND IMPOSING
REMEDIAL SANCTIONS**

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I.

The Commodity Futures Trading Commission ("Commission") has reason to believe that Refco Overseas Limited ("Refco") has violated Section 4c(a) of the Commodity Exchange Act, as amended (the "Act"), 7 U.S.C. § 6c(a) (2002), and Section 1.38(a) of the Commission's Regulations, 17 C.F.R. § 1.38(a) (2004). Therefore, the Commission deems it appropriate and in the public interest that public administrative proceedings be, and they hereby are, instituted to determine whether Refco engaged in the violations set forth herein and to determine whether any order should be issued imposing remedial sanctions.

II.

In anticipation of the institution of an administrative proceeding, Refco has submitted an Offer of Settlement ("Offer"), which the Commission has determined to accept. Refco acknowledges service of this Order Instituting Proceedings Pursuant to Sections 6(c) and 6(d) of the Act, and Making Findings and Imposing Remedial Sanctions ("Order"). Refco, 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 Refco 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 the Order, or with respect to registration issues. Nor does Refco 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. The findings made in this Order are not binding on any other person or entity named as a defendant or respondent in this or any other proceeding.

III.

The Commission finds the following:

A. SUMMARY

On July 10, 2002, an account executive ("AE") at Refco, a futures commission merchant ("FCM") located in London, United Kingdom ("UK"), received simultaneous orders from a customer that comprised two equal-and-opposite spread orders at an identical price differential in cocoa futures contracts on the Coffee, Sugar & Cocoa Exchange ("CSCE"), at the time, a subsidiary of the New York Board of Trade. The Refco AE relayed these equal-and-opposite spread orders to a floor broker in the CSCE cocoa futures pit in New York, who crossed the paired spread orders. The resulting transaction was therefore a virtual financial nullity, excluding commissions, for the customer.

Because the Refco AE either failed to undertake an inquiry to evaluate the orders he received for indications that his participation in the transaction was legally prohibited or knew that the customer's intention was to negate market risk and price competition, and thereby to avoid a *bona fide* market transaction by simultaneously submitting equal-and-opposite spread orders, Refco's AE violated Section 4c(a) of the Act, 7 U.S.C. § 6c(a) (2002), which, *inter alia*, prohibits any person from entering into a transaction that is, or is of the character of, or is commonly known to the trade as, a 'wash sale.' By entering into a wash sale, Refco's AE also violated the proscription contained in Section 4c(a) of the Act, 7 U.S.C. § 6c(a) (2002), against entering into a transaction that is used to cause any price to be reported, registered or recorded that is not a true and *bona fide* price. Further, by accepting and transmitting orders that were not executed openly and competitively, but in a manner that avoided the market risk and price competition that legitimate, competitive trading entails, Refco's AE violated Commission Regulation 1.38(a), 17 C.F.R. § 1.38(a) (2004). Because Refco's AE was an employee of Refco and undertook his actions within the scope of his employment with Refco, Refco is liable for the violations of Section 4c(a) of the Act, 7 U.S.C. § 6c(a) (2002) and Commission Regulation 1.38(a), 17 C.F.R. § 1.38(a) (2004), pursuant to Section 2(a)(1)(B) of the Act, 7 U.S.C. § 2(a)(1)(B) (2002).

B. RESPONDENT

Refco Overseas Limited is a limited liability company incorporated in the UK. Refco's business address is Trinity Towers, 9 Thomas More Street, London, E1W 1YH, UK. It has been listed with the Commission as an exempt foreign firm since September 28, 1990.

C. FACTS

On July 10, 2002, in what took the form of a 'give up' trade, a Refco AE in the UK received simultaneous orders by telephone from a customer in Singapore for two equal-and-opposite spread orders in CSCE cocoa futures contracts.² The first order instructed the Refco AE to buy 450 September 2002/December 2002 cocoa futures spreads at a 19-point price differential.³ The second order instructed the Refco AE to sell 450 September 2002/December 2002 cocoa futures spreads also at a 19 point price differential, and to give up this spread trade up to another UK-based FCM with whom the customer maintained an account. The Refco AE relayed the customer's simultaneous and paired equal-and-opposite spread orders to a floor broker in the CSCE cocoa futures pit in New York, who crossed the spread orders at the indicated 19-point price differential. Thus, the customer was on both sides of the transaction.

D. LEGAL DISCUSSION

1. Refco entered into Wash Sales in Violation of Section 4c(a) of the Act

Section 4c(a) of the Act makes it "unlawful for any person to offer to enter into, enter into, or confirm the execution of a transaction" that "is, is of the character of, or is commonly known to the trade as, a 'wash sale'" A wash sale is a form of fictitious transaction. *In re Gimbel*, [1987-1990 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,213 at 35,003 (CFTC Apr. 14, 1988), *aff'd as to liability*, 872 F.2d 196 (7th Cir. 1989); *In re Goldwurm*, 7 A.D. 265, 274 (CEA 1948).

Wash sales are deemed harmful, in part, because they draw victims into the market through the creation of illusory price movements. *See Wilson v. CFTC*, 322 F.3d at 559; *Reddy v. CFTC*, 191 F.3d 109, 115 (2d Cir. 1999). *See also CFTC v. Savage*, 611 F.2d 270, 284 (9th Cir. 1980) (wash sales may mislead market participants because they do not reflect the forces of supply and demand); *In re Piasio*, [1999-2000 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 28,276 at 50,691 (CFTC Sep. 29, 2000) (wash sales are "grave" violations, even in the absence of customer harm or appreciable market effect, because "they undermine confidence in the market mechanism that underlies price discovery.")

The central characteristic of a wash sale is the intent to avoid making a *bona fide* transaction or taking a *bona fide* market position. *In re Citadel Trading Co. of Chicago, Ltd.*, [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,082 at 32,190 (CFTC May 12,

² *The CFTC Glossary: A Guide to the Language of the Futures Industry* defines a "give up" as "a contract executed by one broker for the client of another broker that the client orders to be turned over to the second broker. The broker accepting the order from the customer collects a fee from the carrying broker for the use of the facilities. Often used to consolidate many small orders or to disperse large ones."

³ An order to buy a spread, e.g., "buy September 2002/December 2002," refers to buying the nearby futures contract (i.e., September 2002) and selling the later futures contract (i.e., December 2002). Conversely, an order to sell a spread refers to selling the nearby futures contract and buying the later futures contract.

1986). The factors that indicate a wash result are (1) the purchase and sale (2) of the same delivery month of the same futures contract (3) at the same (or a similar) price. *In re Gilchrist*, [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,993 at 37,653 (CFTC Jan. 25, 1991). Here, on two separate occasions, Refco's customer purchased and sold the same delivery month of the same futures contract at the same price with the intention of avoiding a *bona fide* transaction.

In addition to the factors enumerated in *Gilchrist*, the liability of the customer initiating the wash sale depends upon evidence demonstrating that the customer intended to negate market risk or price competition. *Piasio*, ¶ 28,276 at 50,685. Market risk or price competition is negated "when it is reduced to a level that has no practical impact on the transactions at issue." *Gimbel*, ¶ 24,213 at 35,004 n.7. Similarly, the liability of a participant in the wash sale depends upon the demonstration that the participant knew, at the time he chose to participate in the transaction, that the transaction was designed to achieve a wash result in a manner that negated risk. *In re Bear Sterns & Co.*, [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,994 at 37,665 (CFTC Jan. 25, 1991).

"Just as a customer has a duty not to initiate transactions with an intent to avoid a *bona fide* market position, . . . an FCM has a duty not to accept such orders and transmit them to the trading floor." *In re Three Eight Corporation*, [1992-1994 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 25,749 at 40,445. (CFTC June 16, 1993). Therefore, "[a] broker is responsible for evaluating the orders he receives for indications that his participation in the transaction is legally prohibited." *Id.*, ¶ 25,749 at 40,445; *See also Piasio*, ¶ 28,276 at 50,689 (an account executive has a duty to inquire about a customer's intent when he receives simultaneous orders to buy and sell the same spread).

In this instance, Refco's AE knew that his customer had simultaneously submitted paired equal-and-opposite spread orders at an identical price differential. The Refco AE either failed to undertake an inquiry to evaluate the orders he received for indications that his participation in the transaction was legally prohibited or he knew that his customer intended to negate market risk and price competition, and thereby to avoid a *bona fide* market transaction. Nevertheless, the Refco AE accepted and transmitted this paired order to the CSCE. Accordingly, the Refco AE knowingly participated in a wash sale and therefore violated Section 4c(a) of the Act. Because the AE was a Refco employee and acting within the scope of his employment, Refco is liable for such violation pursuant to Section 2(a)(1)(B) of the Act.

2. Refco Caused Prices to be Reported, Registered, or Recorded at Non-Bona Fide Prices in Violation of Section 4c(a) of the Act

Section 4c(a) of the Act makes it unlawful to offer to enter into, enter into, or confirm the execution of any commodity futures transaction "if such transaction is used to cause any price to be reported, registered or recorded which is not a true and *bona fide* price." Consequently, by knowingly participating in a wash sale, Refco's AE violated Section 4c(a) of the Act. *Gilchrist*, ¶ 24,993 at 37,653. Further, because the AE was a Refco employee and acting within the scope of his employment, Refco is liable for such violation pursuant to Section 2(a)(1)(B) of the Act.

**3. Refco Executed Non-competitive Trades
in Violation of Commission Regulation 1.38(a)**

Commission Regulation 1.38(a) requires that all purchases and sales of commodity futures be executed “openly and competitively.” The purpose of this requirement is to ensure that all trades are executed at competitive prices and that all trades are directed into a centralized marketplace to participate in the competitive determination of the price of futures contracts.⁴ Non-competitive trades are generally transacted in accordance with expressed or implied agreements or understandings between and among the traders. *Gilchrist*, ¶ 24,993 at 37,652. Trades can be noncompetitive even though they were executed in the pit. *In re Buckwalter*, [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,994 at 37,683 (CFTC Jan. 25, 1991) (citing *Laiken v. Dep’t of Agriculture*, 345 F.2d 784, 785 (2d Cir. 1965)).

By accepting and transmitting the paired equal-and-opposite spread orders to the CSCE floor so as to avoid the market risk and price competition which legitimate, competitive trading entails, Refco’s AE, acting within the scope of his employment with Refco, violated Commission Regulation 1.38(a). Accordingly, pursuant to Section 2(a)(1)(B) of the Act, Refco is liable for this violation.

IV.

OFFER OF SETTLEMENT

Refco has submitted an Offer in which it, without admitting or denying the findings herein: (1) acknowledges service of the Complaint and the Order; (2) admits the jurisdiction of the Commission with respect to the matters set forth herein; (3) waives a hearing, all post-hearing procedures, judicial review by any court, any objection to the staff’s participation in the Commission’s consideration of the Offer, all claims which it possess under the Equal Access to Justice Act, 5 U.S.C. § 504 (2000) and 28 U.S.C. § 2412 (2000), and the rules promulgated by the Commission in conformity therewith, Part 148 of the Regulations, 17 C.F.R. §§ 148, et seq. (2004), relating to, or arising from this action, and any claim of Double Jeopardy based upon institution of this proceeding or the entry of any order imposing a civil monetary penalty or any other relief; (4) stipulates that the record basis on which the Order may be entered shall consist solely of the Complaint, Order and findings in the Order consented to in the Offer; and (5) consents to the Commission’s issuance of the Order, which makes findings as set forth below and: (a) orders Refco to cease and desist from violating the provisions of the Act and Regulations that they have been found to have violated; (b) imposes a civil monetary penalty upon Refco of \$25,000; (c) orders Refco to comply with the undertakings consented to in its Offer.

⁴ See Disapproval of Contract Market Rules (CFTC Apr. 27, 1981), 46 F.R. 23516 (Commission disapproving of the Commodity Exchange, Inc.’s proposal to conduct a trading session after the close of regular trading); and Senate Committee on Agriculture and Forestry, Report on H.R. 13113, S. Rep. No. 93-1131, 93rd Cong., 2nd Sess. 16 (1974).

V.

FINDINGS OF VIOLATIONS

Solely on the basis of the consents evidenced by the Offer, and prior to any adjudication on the merits, the Commission finds that Refco has violated Section 4c(a) of the Commodity Exchange Act, as amended (the "Act"), 7 U.S.C. § 6c(a) (2002), and Section 1.38(a) of the Commission's Regulations, 17 C.F.R. § 1.38(a) (2004).

VI.

ORDER

Accordingly, it is hereby ordered that:

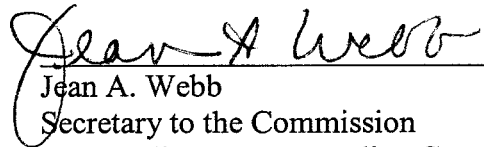
1. Refco cease and desist from violating Section 4c(a) of the Act and Section 1.38(a) of the Regulations;
2. Refco pay a civil monetary penalty in the amount of twenty-five thousand dollars (\$25,000) due within ten days of the date of the Order; payment is to be made by electronic funds transfer, U.S. postal money order, certified check, bank cashier's check, or bank money order, made payable to the Commodity Futures Trading Commission, and sent to Dennese Posey, Division of Enforcement, Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street, N.W., Washington, D.C. 20581, under cover of a letter that identifies Refco as the payee and the name and docket of this proceeding. Refco shall simultaneously transmit a copy of the cover letter and the form of payment to Gregory Mocek, Director, Division of Enforcement, Commodity Futures Trading Commission, 1155 21st Street, N.W., Washington, D.C. 20581. In accordance with Section 6(e)(2) of the Act, 7 U.S.C. § 9a(2), if Refco fails to pay the full amount within fifteen (15) days of the due date, it shall be automatically prohibited from the privileges of all registered entities until it shows to the satisfaction of the Commission that payment of the full amount with interest thereon to the date of payment has been made;
3. Refco acknowledges that failure to comply with the Order shall constitute a violation of the Order and may subject it to administrative or injunctive proceedings, pursuant to the Act; and
4. Refco is directed to comply with its undertakings:
 - a. neither Refco nor any of its agents or employees shall take any action or make any public statement denying, directly or indirectly, any findings or conclusions in the Order, or creating, or tending to create, the impression that the Order is without a factual basis; provided, however, that nothing in this provision affects their: (i) testimonial obligations; or (ii) right to

take legal positions in other proceedings to which the Commission is not a party. Refco shall take all steps necessary to ensure that its agents or employees, if any, understand and comply with this undertaking.

- b. Refco will cooperate fully with the Commission's Division of Enforcement in this proceeding and any investigation, civil litigation and administrative proceeding related to this proceeding by, among other things: (i) responding promptly, completely, and truthfully to any inquiries or requests for information; (ii) providing authentication of documents; (iii) testifying completely and truthfully; and (iv) not asserting privileges under the Fifth Amendment of the United States Constitution.

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

By the Commission



Jean A. Webb
Secretary to the Commission
Commodity Futures Trading Commission

Dated: September 29, 2004