UNITED STATES OF AMERICA
Before the
COMMODITY FUTURES TRADING COMMISSION

LOS ANGELES TRADING GROUP, INC.	CFTC Docket No. 06-R-026
v.	
PEREGRINE FINANCIAL GROUP, INC., EMPIRE FUTURES LCC, REUBEN SHUSHMAN, JAMES FRANCIS KELLY and TIMOTHY WATSON MERRYMAN	OPINION AND ORDER

The complainant in this reparations case, Los Angeles Trading Group, Inc. ("Los Angeles"), appeals from the dismissal of its Complaint.[1] In his initial decision, the Administrative Law Judge ("ALJ") dismissed Los Angeles's Complaint for cause, finding that respondents' alleged actions, if anything, were breaches of contract, not violations of the Commodity Exchange Act ("CEA") or of Commission regulations. The ALJ held further that there was no reparations jurisdiction because all parties were members of the National Futures Association ("NFA") which has mandatory arbitration requirements for disputes among members. We affirm the dismissal for cause of this case, but do so on somewhat different grounds from those relied upon by the ALJ.

BACKGROUND

Los Angeles is a registered introducing broker ("IB"). Of the named respondents, Peregrine Financial Group, Inc., ("Peregrine") is a registered futures commission merchant ("FCM"). Empire Futures LLC ("Empire") is a commodity trading advisor

[1] Because this case was dismissed below, for purposes of this appeal the Commission relies primarily on the facts as alleged in Los Angeles's complaint, supplemented by certain documentary evidence submitted by the parties in proceedings before the ALJ. *See FDIC v. Shearson Lehman Hutton, Inc.*, [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 25,044 at 37,900 (CFTC April 26, 1991)(relying on pleadings and discovery materials for facts on appeal of dismissal of reparations claim).

("CTA"). Reuben Shushman is the president of Empire. The Complaint does not clearly identify the positions of the remaining respondents, James Francis Kelly and Timothy Watson Merryman, but implies that they are principals or employees of Peregrine. The Complaint states that "Complainant is informed and believes" that the respondents were, at all relevant times, "the agents, servants, and/or employees of each other." Complaint at ¶ 7. Los Angeles contends that fraudulent representations and failures to disclose made to Los Angeles by respondents caused Los Angeles's customers to lose money in trading, thereby injuring Los Angeles's business and causing it to lose future commissions.

According to the Complaint, on or about April 20, 2004, Los Angeles and Peregrine entered into a "Clearing Agreement for Guaranteed Introducing Brokers" ("Clearing Agreement"). Complaint at ¶ 8. Under the agreement, Los Angeles was to submit its customers' futures trades to Peregrine for processing. Complaint at ¶ 9.

The Complaint alleges that, as a result of the Clearing Agreement, Los Angeles also "was forced by Respondent PFG, Kelly and Merryman to utilize the services of what they claimed to be a highly touted Commodity Trading Advisor ... to trade its customer accounts." Complaint at ¶ 10. The CTA was Empire. *Id.* The text of the Clearing Agreement does not contain language requiring Los Angeles to use the services of a commodity trading advisor, or of Empire in particular, and the Complaint does not so allege. However, according to the Complaint, Los Angeles told Peregrine that it did not wish to make use of Empire's services. In response, Peregrine, Kelly , and Merryman "made clear that as Complainant's guarantor, Complainant would need to utilize

Empire...." Complaint at ¶ 11. "Pursuant to Respondents' insistence, every customer of Complainant was directed to utilize the services of...Empire." Complaint at ¶ 12.

The Complaint further alleges that, before the Clearing Agreement was signed, Peregrine represented that it "supports its Introducing Brokers to expedite success" and "would share information relevant to [Los Angeles]." Complaint at ¶¶ 13-14. However, Peregrine did not disclose to Los Angeles that Los Angeles would be required to use the services of a CTA recommended by Peregrine or that the CTA in question "had already began (sic) to destroy accounts under management, losing a considerable amount of equity for customers...." Complaint at ¶¶ 13-14.

The Complaint alleges that Empire represents that "its primary objective is to develop a long-term financial advisory relationship with each client by growing the client's portfolio via prudent risk management...." Complaint at ¶ 10. However, according to the Complaint, shortly after Los Angeles referred its customers to Empire, "Empire began a reckless trading scenario which exceeded the customers' risk tolerance, exceeded the stated products to be traded and exceeded the stated trading strategy to be utilized by the CTA." Complaint at ¶ 12. As a result, Los Angeles's referred customers quickly lost most or all of their investment and closed their accounts. Complaint at ¶¶ 12, 15.

The Complaint charges that the respondents' alleged failure to disclose, prior to the execution of the Clearing Agreement, that Los Angeles would be forced to utilize the services of Empire and that Empire had begun "to destroy accounts under management losing a considerable amount of equity" constituted violations of section 4b and 4o of the Commodity Exchange Act, 7 U.S.C. §§ 6b, 6o. Complaint at ¶¶ 26, 27. The Complaint

also alleges that respondents made "misrepresentations concerning Respondent Empire's trading success and/or track record...." Complaint at ¶¶ 34-37.[2]

Los Angeles claimed damages of $200,000, primarily in the form of lost commissions that Los Angeles contends would have been earned from customers who stopped trading with Los Angeles and customers that Los Angeles contends that it would have acquired in the future. Complaint Amendment re: Statement of Damages in Support of Reparations Complaint for Damages for Violations of CEA.

The respondents filed motions to dismiss, making three primary arguments. First, the respondents stated that Los Angeles, as well as all of the respondents, were members of the NFA. The respondents pointed out that under section 2(a) of the NFA's Member Arbitration Rules, NFA members are required to arbitrate disputes among themselves. Peregrine Motion to Dismiss and for Summary Disposition at 3-4. Thus, according to the respondents, Los Angeles, as a condition of its membership in the NFA, had agreed to arbitrate any disputes with the respondents and was required to do so rather than pursue a reparations proceeding before the CFTC.

The respondents further argued that Los Angeles's relationship with the respondents did not fall within the scope of either section 4b or section 4o of the CEA, 7 U.S.C. §§ 6b, 6o, the two CEA anti-fraud provisions relied upon by Los Angeles. The respondents relied on *Commodity Trend Service v. CFTC*, 233 F.3d 981, 992 (7th Cir. 2000) and *Hammond v. Smith Barney, Harris Upham & Co.*, [1987-1990 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,617 at 36,658 n.16 (CFTC March 1, 1990) for the proposition that CEA section 4b applies only to fraud by persons acting as an agent

[2] The Complaint also alleged that the respondents' behavior constituted the common law torts of negligence and interference with prospective economic advantage as well as breach of contract. Complaint at ¶¶ 38-55.

for, or in an agency-like relationship with, the victim of the fraud. According to the respondents, the fraud alleged by Los Angeles did not arise in connection with any agency or agency-like relationship with the respondents.[3] The respondents further pointed out that CEA section 4o, 7 U.S.C. § 6o, prohibits fraud by commodity trading advisors against their clients. The respondents argued that Los Angeles had no cause of action under section 4o because none of the respondents provided trading advice to Los Angeles on its own behalf, so that Los Angeles was not a client of the respondents for purposes of section 4o.

Finally, the respondents argued that Los Angeles's breach of contract and common law tort theories could not be a basis for a reparations claim because, apart from counterclaims, CEA section 14 authorizes only reparations claims for violations of the CEA, or of rules, regulations, or orders under the CEA. 7 U.S.C. § 16(a)(1).

On July 27, 2006, the ALJ issued a decision dismissing the matter for cause. The court noted that both the complainant and the respondents were NFA members and that the NFA, absent circumstances not present in the case, requires that disputes among members be arbitrated pursuant to NFA arbitration rules. The ALJ also found that Los Angeles's claim did not involve a customer claim against a registered entity but rather involved a contract dispute between NFA members, and stated that the reparations forum lacks jurisdiction to adjudicate private contractual disputes. The ALJ concluded by holding that the reparations forum lacks jurisdiction to adjudicate disputes between members of the NFA and that Los Angeles had failed to state a cause of action under section 14 of the CEA, therefore requiring dismissal of the case.

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[3] Peregrine acknowledged that it acted as Los Angeles's agent for purposes of executing customer trades, but contended that this limited relationship did not give Los Angeles standing under section 4b for the particular fraud claim asserted by Los Angeles.

Los Angeles has appealed the decision dismissing its Complaint.

DISCUSSION

We affirm the dismissal of Los Angeles's Complaint but do so on somewhat different grounds from the ALJ. We hold that the relief sought by Los Angeles is not available in a reparations proceeding under section 14 of the CEA. Section 14(a)(1)(A) authorizes the Commission to award "actual damages proximately caused by [a violation of the CEA]." The Commission has held that this language refers primarily to out-of-pocket losses and does not extend to compensation for lost profits except in limited circumstances where lost profits are directly caused by a respondent's law violation and the magnitude of the losses is determinable with reasonable particularity. *Adams v. Black Diamond Futures & Trading, Inc.*, [Current Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 30,492 at n.8 (Apr. 11, 2007); *Stiller v. Shearson, Loeb Rhodes, Inc.*, [1982-1984 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,780 at 27,155, 27,155 nn. 6, 7 (July 11, 1983). In practice, the Commission generally has limited recovery for lost profits in reparations cases to cases involving the unauthorized liquidation of a complainant's market position. *Id.*

In this case, Los Angeles seeks damages in the form of commission revenues that it contends it would have earned from existing and newly acquired customers were it not for customer losses resulting from the trading advice provided by Empire. This form of damages does not fall into any exception to the Commission's interpretation of section 14(a)(1)(A) as generally limited to out-of-pocket losses. Moreover, even construing the Complaint, as amended by Los Angeles with regard to damages, in a generous fashion, the relationship between the lost income stream alleged by Los Angeles and any law

members pursuant to the NFA's Member Arbitration rules.[5] We hold that Los Angeles is bound by the obligation to arbitrate that it assumed as an NFA member.

Under the Commission's rules, arbitration agreements between customers and registrants cannot require a customer to waive the right to pursue a reparations remedy under CEA section 14.[6] 17 C.F.R. § 166.5(c)(3). Los Angeles, however, is not a "customer" within the meaning of 17 C.F.R. § 166.5 because it was acting in the capacity of an IB in the transactions relevant to this case and was not trading on its own account. 17 C.F.R. §§ 166.1(c); 166.5(a)(2). As a result, the Rule 166.5(c)(3) prohibition of waiver of the right to pursue reparations does not apply here. Similarly, no statutory provision gives a registrant who is not acting as a customer the right to pursue a reparations action in contravention of an NFA rule. *See Gans v. Merrill Lynch Futures, Inc.*, 814 F.2d 493, 495-96 (8th Cir. 1987)(no CEA policy against arbitration in absence of conflict with relevant CFTC regulations). Thus, no statutory or regulatory provision precludes the Commission from holding Los Angeles to the terms of the NFA Member Arbitration Rules. We find no reason why any possible right of Los Angeles to pursue reparations under CEA section 14 should supersede Los Angeles's obligations under the NFA Member Arbitration Rules.

There are, moreover, good reasons for requiring Los Angeles to pursue its rights against fellow NFA members through NFA arbitration rather than the Commission's reparations procedure. As noted above, Los Angeles was not acting as a customer in this

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[5] Other respondents apparently are associated persons of NFA members rather than members themselves. Under NFA Member Arbitration Rule 2(b), arbitration of disputes between NFA members and associates are arbitrable at the election of the person filing the claim.

[6] There is an exception, not relevant to this case, for customers who are eligible contract participants. 17 C.F.R. § 166.5(a)(2).

case. The legislative history of section 14 indicates that the reparations procedure was "primarily intended as a forum for aggrieved customers...."[7] Providing special protection for access to the reparations procedure by customers, but not registrants, makes sense in light of the fact that registrants can be expected to have a greater level of sophistication than most customers. Moreover, the mandatory arbitration requirement of the NFA's Member Arbitration Rules was specifically reviewed and approved by the Commission before it took effect. Letter of June 25, 1999 from Jean A. Webb, Secretary of the Commission to Daniel J. Roth, NFA General Counsel re Proposed Member Arbitration Rules 2, 3(a), 7(e), 7(f) and 10(g)—Mandatory Member v. Member Arbitration.

In its brief on appeal, Los Angeles does not assert that it is not bound by NFA's Member Arbitration Rules. Instead, it argues that it falls within an exception to the mandatory arbitration requirement for members. NFA Member Arbitration Rule 2(a)(1) provides that arbitration of disputes between members is not mandatory if "the parties, by valid and binding agreement, have committed themselves to the resolution of such dispute in a forum other than NFA." Los Angeles contends that its Clearing Agreement with Peregrine contains such an agreement. Los Angeles relies on language in the agreement stating, "The parties agree that all actions, disputes, claims or proceedings, including but not limited to, any arbitration proceeding, arising directly or indirectly in connection with, out of, or related to or from this agreement...shall be adjudicated only in court, or arbitration proceedings located within the city of Chicago, State of Illinois." This venue provision, however, plainly does not commit the parties to the Clearing Agreement to resolution of disputes in a forum other than an NFA arbitration. There is

[7] H.R. Rep. No. 93-975, 93d Cong., 2d Sess. 22 (1974).

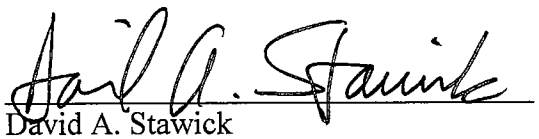
no reason why an NFA arbitration cannot take place in Chicago—where NFA is headquartered—in a fashion fully consistent with the quoted language of the Clearing Agreement. Los Angeles thus presents no persuasive reason for relieving its obligation to arbitrate disputes with Peregrine and Empire under the NFA Member Arbitration Rules.

CONCLUSION

For the foregoing reasons, we affirm the ALJ's initial decision dismissing the Complaint for cause.[8]

IT IS SO ORDERED.[9]

By the Commission (Acting Chairman LUKKEN and Commissioners DUNN, SOMMERS and CHILTON).



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

Dated: March 18, 2008

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[8] Three pleadings filed by Los Angeles shortly after issuance of the ALJ's decision require little discussion and do not alter our conclusion affirming the dismissal of this case for cause. Complainant's Opposition to Renewed Motion to Dismiss makes arguments substantially similar to those in Los Angeles's brief on appeal, which, in relevant part, we have reviewed and rejected. Los Angeles's Renewed Motion for Order of Default contends that the respondents should be subject to default because they never filed formal answers to the Complaint. However, the Office of Proceedings accepted the respondent's prematurely filed motions to dismiss in lieu of answers. Since this case was resolved without the need for a factual hearing, Los Angeles suffered no prejudice from not receiving point by point responses to the factual assertions in its Complaint. Finally, Los Angeles filed a Motion to Set Aside Dismissal for Cause. This motion identifies no procedural errors or other extraordinary circumstances that would justify setting aside the initial decision and holding further proceedings below rather than continuing with the usual procedure of obtaining review of the merits of the initial decision by an appeal to the Commission.

[9] Under Sections 6(c) and 14(e) of the Commodity Exchange 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.