UNITED STATES OF AMERICA
Before the
COMMODITY FUTURES TRADING COMMISSION

CLIFFORD W. HEDRICK	CFTC Docket No. 05-R067
v.	OPINION and ORDER
RICHARD ALLEN ESTRADA, FARR FINANCIAL, INC., WILL S. MCCOY, RICHARD ALLEN ESTRADA D/B/A THE TRADING CLUB	

Respondents appeal the Administrative Law Judge's ("ALJ's") decision finding them liable for fraud and recordkeeping violations under the Commodity Exchange Act ("Act") and Commission regulations and awarding $110,716.20 to the Complainant, plus interest and the filing fee. We reverse and dismiss the Complaint with prejudice.

BACKGROUND

On July 8, 2005, Clifford W. Hedrick ("Hedrick"), an accountant by profession, filed a Complaint seeking reparations against respondents Richard Allen Estrada ("Estrada"), an introducing broker ("IB") and commodity trading advisor ("CTA") doing business as Richard Allen Estrada d/b/a the Trading Club ("Trading Club"), Farr Financial, Inc. ("Farr"), a non-clearing futures commission merchant, and Will S. McCoy ("McCoy"), an associated person ("AP") of the Trading Club. GX 2.[1] Hedrick claimed that his losses were the result of unauthorized trading committed by respondents in violation of Commission Regulation 166.2, 17 C.F.R. § 166.2, the failure to supervise McCoy in violation of Commission Regulation 166.3, 17 C.F.R. § 166.3, and the respondents' failure to comply with the IB trading standards of

[1] The "Group" exhibits offered by Hedrick are cited as "GX ___," Complainant's Exhibits are cited as "CX ___" and Respondents' Exhibits as "RX ___." The transcript of the hearing is cited as "Tr. at ___."

Commission Regulation 155.4, 17 C.F.R. § 155.4. Hedrick also alleged that respondents violated National Futures Association ("NFA") compliance rules regarding discretionary accounts and suitability.

The Complaint stemmed from Hedrick's purchase in 2003 and 2004 of put options on corn and sale of corn futures contracts traded on the Chicago Board of Trade, betting heavily on a decline in the corn futures market. While the price of corn was high when the strategy was adopted, it went higher, resulting in the losses that Hedrick claims. Hedrick also did three short-term transactions in Eurocurrency futures contracts on the Chicago Mercantile Exchange, contributing to his losses.

In their Answers, the respondents denied any wrongdoing. They also denied that "suitability" or other NFA requirements may be the basis of a reparations award. Respondents further challenged whether the violations Hedrick alleged proximately caused the damages he claimed. Moreover, because respondents contended that Hedrick had never complained regarding any of the transactions entered for his account, although they asserted that he was kept informed of the transactions' particulars and his obligation to object, respondents raised affirmative defenses that Hedrick had ratified all the transactions, that he was estopped to deny that the transactions had been duly authorized and that he may not recover, in any event, because he failed to mitigate his damages.

Prior to the hearing, Hedrick admitted that a violation of NFA rules is not a basis on which reparations may be awarded. RX 1 & 2 at ¶ 101. He also did not seek discovery regarding his failure to diligently supervise claim under Commission Regulation 166.3 and his

trading practices claim under Commission Regulation 155.4.[2] With regard to his unauthorized trading claim under Commission Regulation 166.2, Hedrick alleged in his Complaint that:

> I never a) 'specifically authorized' any of my account trades where McCoy specified 1) the precise commodity interest to be purchased or sold and 2) the exact amount of the commodity interest to be purchased or sold or b) authorized in writing the introducing broker or any of their associated persons to effect transactions.

GX 2 at 4 (emphasis in the original). Hedrick admitted that the Trading Club's representatives had always recommended the purchase or sale of a precise commodity interest, and that these trades were discussed with him prior to their execution. His only remaining claim was that the respondents had engaged in unauthorized trading because they failed to mention the exact amount when they recommended the purchase or sale of a precise commodity interest, as required by Commission Regulation 166.2(a).[3]

The other facts of the case are undisputed. In early November 2003, McCoy, an AP of The Trading Club, contacted Hedrick, and Hedrick went online on November 20 to electronically execute an account agreement with respondent Farr. GX 1; RX 1& 2 at ¶¶ 53, 102(a). Estrada is a third party beneficiary of that agreement. *Id.* at 1, 25-26, ¶ 25. The account

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[2] Although Hedrick mentioned these claims in his pre-hearing brief, he offered no testimony or other evidence in support of these claims.

[3] Commission Regulation 166.2 provides, in relevant part:

> No futures commission merchant, introducing broker or any of their associated persons may directly or indirectly effect a transaction in a commodity interest for the account of any customer unless before the transaction the customer, or person designated by the customer to control the account:
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> (a) Specifically authorized the futures commission merchant, introducing broker or any of their associated persons to effect the transaction (a transaction is ``specifically authorized" if the customer or person designated by the customer to control the account specifies (1) the precise commodity interest to be purchased or sold and (2) the exact amount of the commodity interest to be purchased or sold); or
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> (b) Authorized in writing the futures commission merchant, introducing broker or any of their associated persons to effect transactions in commodity interests for the account without the customer's specific authorization . . . .

17 C.F.R. § 166.2.

agreement contained the risk disclosure statements prescribed by Commission regulations, warning Hedrick about the risks involved in trading futures and options. GX 1 at 2-3, 3-7; RX 1& 2 at ¶ 54. Although Hedrick had never traded futures or options, he indicated in his account application that he had traded stocks for twenty years and was the comptroller of the company that employed him. GX 1 at 1. Before trading began, Hedrick confirmed his understanding that trading in commodity futures and options involved a high degree of risk. RX 1 & 2 at ¶¶ 2(f) and (g). Hedrick then reaffirmed his "desire to open an account with The Trading Club to speculate in the commodities market," Tr. at 14, and "on [his] own accord, of [his] own volition," he deposited $150,000 into his newly opened account. Tr. at 15-16; GX 2 at 1.

Thereafter, Hedrick entered into a number of option and futures transactions from December 18, 2003 to February 26, 2004.[4] Each of the transactions was recommended by the Trading Club and was discussed in advance with Hedrick. Tr. at 18, 25, 98, 132-33, 136-37, 138-140; RX 1& 2 at ¶¶ 4-5, 16, 21-22, 32 and 39. In those discussions, the Trading Club's representatives recommended the purchase or sale of a precise commodity interest. RX 1&2 at ¶ 51. Before each trade, Hedrick agreed to the Trading Club's recommendation, Tr. at 17, 25; *see id.* at 135, 140. Every filled order was reported to Hedrick by phone and was also

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[4] Specifically, on December 18, 2003, Hedrick purchased puts on 50 March 2004 corn futures contracts (RX 5 at 1); on December 29, 2003, he sold 24 March 2004 corn futures contracts (RX 5 at 8) and on January 14, 2004 he sold 12 additional contracts (RX 5 at 22). On February 19 and 20, 2004, Hedrick's short position in corn futures was rolled over from March to May. On February 19, Hedrick sold 37 May 2004 corn futures contracts. He also purchased two March 2004 corn futures contracts on that date (RX 5 at 50) and purchased 35 more on February 20 (RX 5 at 52). Hedrick's put options expired without value on February 23 (RX 5 at 54). On February 27, his short May 2004 corn futures position was closed out with the purchase of 37 contracts (RX 5 at 59). As a result of these transactions, Hedrick's account was debited an aggregate of $109,320.90, including market losses of $94,862.50, fees totaling $2,678.40 and commissions totaling $11,780.00 (*see* RX 5 at 1, 8, 22, 50, 52, 54, 59).

Hedrick also traded Eurocurrency futures contracts on the Chicago Mercantile Exchange. These involved a two-contract day trade authorized on January 13, 2004 and executed the following day; a 3-contract day trade authorized and executed on January 22, 2004; and a 3-contract round-trip trade authorized and entered into on January 25, 2004 and closed out on January 27, 2004. As a result of these transactions, Hedrick's account was debited an aggregate of $1,395.30, including market losses of $462.50, fees totaling $172.80 and commissions totaling $760.00. *See* RX 1, 2 at 5.

instantaneously confirmed to Hedrick online, RX 1&2 at ¶¶ 4(c) & (d), 5(c) & (d), 16(d) & (e), 16(g) & (h), 21(e) & (f), 22(f) & (g), 32(h) & (i) and 39(c) &(d); Tr. at 104, 110-111, since he had expressly agreed to electronic communication in lieu of hard copy form by mail. While his account was open, Hedrick could confirm "how much [he] was investing, any commissions or amounts" simply by "look[ing] on-line at [his] account," GX 2 at 1, and he could likewise review his trade confirmations and account statements. Hedrick looked on-line multiple times while his account was open. Tr. at 67-70. When he opened his account, Hedrick agreed that his confirmations and account statements would be "deemed correct and . . . conclusive and binding upon [him] if not objected to in writing immediately after transmittal to [him]" and that his failure promptly to object would be "deemed ratification of all actions taken." GX 1 at 23; RX 1& 2 at ¶ 55. Before any trade was made, Hedrick expressly acknowledged his "responsibility to monitor [his] account and review every confirmation statement and report discrepancies to The Trading Club as soon as possible." RX 1& 2 at ¶¶ 1 and 2(h). Despite these acknowledgements, Hedrick never objected or complained to the Trading Club at any time about the way his account was handled. RX 1& 2 at ¶¶ 62, 63.

A hearing was held before the Administrative Law Judge ("ALJ") on May 1, 2006. With regard to the fact in dispute, Hedrick testified that respondents' had never stated the "exact amount" when they made their trade recommendations, Tr. 17, 37-38, 140, 141, while respondents Estrada and McCoy each testified that the exact amount had always been stated. Tr. at 132, 133, 136-37, 138-39.

The ALJ issued an Initial Decision on November 3, 2006, finding violations of the Act and Commission regulations that were not alleged in the Complaint. Specifically, the ALJ found that the respondents fraudulently managed and solicited Hedrick's account in violation of

Sections 4b(a) and 4c(b) of the Act, 7 U.S.C. §§ 6b(a) and 6c(b), violated Section 4g of the Act, 7 U.S.C. § 6g, by failing to make, produce and retain accurate records relating to their customers' transactions, and violated Commission Regulations 33.10(a) and (c), 17 C.F.R. §§ 33.10(a) and (c), by committing fraud in connection with exchange-traded options transactions. Initial Decision at 21-22. The ALJ held Estrada liable as a controlling person pursuant to Section 13(b) of the Act, 7 U.S.C. § 13c(b),[5] and held The Trading Club liable pursuant to Section 2(a)(1)(B) of the Act, 7 U.S.C. § 2(a)(1)(B), for the acts of its agents acting within the scope of their authority. Farr was also held responsible for the reparations award as the Trading Club's guarantor. The ALJ awarded $110,716.20 to Hedrick, plus interest and the filing fee.

On appeal, respondents challenge the ALJ's decision on numerous grounds. They argue that the ALJ violated the Administrative Procedure Act and denied respondents due process of law by raising and deciding issues of which respondents had been given no notice and no reasonable opportunity to defend. Respondents also contend that Hedrick did not sustain his burden of proving, by the weight of the evidence, that he suffered actual damages "proximately caused" by violations of the Act or Commission Regulations thereunder that he alleged, and that the findings and conclusions of violations in the Initial Decision, which Hedrick did not allege, are not supported by the weight of the evidence. In addition, respondents argue that Hedrick is not entitled to damages because Hedrick ratified all the corn futures and options trades made for his account, is estopped to deny that these trades were duly authorized, and failed to mitigate damages.

Hedrick, who is representing himself *pro se*, did not file a responsive brief.

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[5] We note that controlling person liability is not available in the reparations forum. *See, e.g., Brooks v. Apache Trading Corp.*, [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 25,379 at 39,276 n.16 (CFTC Aug. 27, 1992).

DISCUSSION

Although when a *pro se* litigant is involved in a case, some liberality of interpretation of the pleadings and the nature of the dispute may be countenanced, we agree with respondents that in this case that liberality is outweighed by respondents' "constitutionally-protected right to notice of the charges against [them] and a fair opportunity to defend," *Sanchez v. Crown*, [2005-2007 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 30,183 at 57,726 n.11 (CFTC Jan. 18, 2006). Here, the ALJ held the respondents liable for fraud and recordkeeping violations that were not alleged in the Complaint or could even be reasonably discerned from the Complaint and the discovery process.

Aside from due process concerns, the Commission has emphasized that the presiding officer's proper role is to resolve the parties' dispute, and not to reinterpret or embellish it, *Johnson v. Fleck*, [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,957 at 37,499 (CFTC Nov. 20, 1990). This applies even when a *pro se* litigant is involved. *Id.* In this case, the issue for the ALJ to decide, as narrowed by the parties during discovery, was whether the respondents violated Commission Regulation 166.2(a) by failing to inform Hedrick of the exact amount when they made their trade recommendations. Hedrick's other claims under Commission Regulation 166.2 were disposed of by Hedrick's admissions, which are conclusive in the reparations forum under Commission Regulation 12.33(d), 17 C.F.R. § 12.33(d), and his claims that respondents had violated Commission Regulations 166.3 and 155.4 were abandoned.[6] Moreover, Hedrick's claim of violations of NFA suitability rules, as Hedrick himself admitted,

[6] In this regard, Hedrick did not seek discovery concerning his Commission Regulation 166.3 and 155.4 claims, and although they were discussed in his pre-hearing brief, Hedrick offered no testimony or other evidence regarding those claims. His post-hearing memorandum presented no arguments and cited no evidence regarding these claims. Accordingly, we deem them abandoned. *See Lehoczky v. Gerald, Inc.*, [1994-1996 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,441 at 42,921 (CFTC June 12, 1995) (claims may be abandoned at the hearing).

are not cognizable in reparations. RX 1 & 2 at ¶ 101. *See, eg., Phacelli v. Conticommodity Servs., Inc.*, [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23, 250 at 32,672-32,675 (CFTC Sept. 5, 1986).

However, the ALJ made no finding as to whether the respondents violated Commission Regulation 166.2(a), the only issue that was properly before him. Instead, the ALJ made findings of fraudulent solicitation and mismanagement of Hedrick's account and recordkeeping violations that were not asserted by the Complainant at any stage of the proceedings.[7] Hedrick made no claim that he was fraudulently induced into entering into the transactions or that his account was fraudulently managed. Nor is there any basis to infer that he intended to raise such issues. And the evidence in the record generally shows that Hedrick had knowingly chosen to trade futures and options, was duly warned of the risk involved as required by Commission regulations, determined for himself how much he was willing to risk, discussed and agreed in advance to every trade that was recommended to him by the Trading Club, was timely informed of every fill and went on-line frequently and repeatedly to review the status of his account. Moreover, Hedrick made no objection at any time regarding how his account was handled, despite his having repeatedly reviewed the status of his account online and having been advised of his obligation to object.

Although Hedrick's Complaint asserted that he thought the trading models e-mailed to him by respondents contained "conservative trading scenarios," GX 2 at 2, which the ALJ cited in support of his fraudulent solicitation theory, Initial Decision at 22, Hedrick did not allege that the respondents deceived him or led him to believe that the trading scenarios were conservative.

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[7] While issues not pleaded or briefed may be tried in reparation cases "with the express or implied consent of the parties," *Smith v. Siegel Trading Co.*, [1980-1982 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,105 at 24,455 (CFTC Sept. 3, 1980), there is no evidence in the record that the parties consented to the ALJ's deciding issues of fraud and recordkeeping violations. In fact, at the hearing when the ALJ *sua sponte* suggested that the case might be a case of fraudulent trade allocation, respondents' counsel objected. Tr. at 29.

The reference to "conservative trading scenarios" in the Complaint is not "a license for a presiding officer to explore creative theories . . . that were neither directly or indirectly contemplated by [the complainant] prior to their articulation by the presiding officer." *Johnson*, ¶ 24,957 at 37,499. Even if this were not the case, the e-mails attached to the Complaint in fact made no representations or claims regarding whether the scenarios were conservative, or any other representation. Moreover, one of the e-mails contained an explicit warning that the risk of loss in futures and options trading can be substantial and cautioned potential investors to carefully consider the risks. There is no other evidence in the record that the respondents made misleading statements or "actively misled" Hedrick regarding the nature of the trading that would take place, the ALJ's findings to the contrary notwithstanding. Initial Decision at 15. As such, there is no evidence that Hedrick's understanding was based on any acts or omissions of the respondents, and his subjective belief alone "is insufficient to show that respondents defrauded or deceived [the] complainant." *Harman v. Murlas Commodities, Inc.*, [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 25,323 at 39,044 (CFTC July 2, 1992).

Similarly, Hedrick's Complaint does not assert the other theories of liability for which the respondents were held liable in the Initial Decision—that the respondents managed the Hedrick account fraudulently or recklessly by allocating trades from other accounts to Hedrick's account and by failing to maintain records reflecting the actual trading in the account. Initial Decision at 12. Both of these theories, like the fraudulent inducement theory, were raised *sua sponte* by the ALJ rather than the parties.

Thus, on this record, we conclude that the primary source of the legal disputes resolved in the Initial Decision was the ALJ, and accordingly the ALJ erred in considering issues of

fraudulent solicitation and mismanagement of Hedrick's account and recordkeeping violations in his Initial Decision. *See Johnson*, ¶ 24,957 at 37,499.

Ordinarily, we would remand the case to the ALJ to resolve the dispute actually raised by the parties—whether the respondents violated Commission Regulation 166.2(a), about which the ALJ made no finding. *Id.* However, a remand is not necessary in this case because the record shows that Hedrick has not established by the weight of the evidence that a violation of Commission Regulation 166.2(a) was committed by respondents. *See Taub v. Lind-Waldock & Co.*, [2000-2002 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 28,550 at 51,970 (CFTC May 30, 2001) (reparations complainant bears the burden of proving facts relevant to respondents' liability "by the weight of the evidence.").

The only evidence in support of Hedrick's claim is his testimony at the hearing that he was never told the exact amount when respondents made their trading recommendations. Although the ALJ found Hedrick to be credible, and the Commission generally defers to such findings by its presiding officers in the absence of clear error, the Commission has repeatedly held that factual findings "cannot be based on one party's testimony simply because the presiding officer finds that party's testimony more believable than the testimony of an opposing party." *Violette v. LFG, LLC and Palm*, [2000-2002 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 28,633 (CFTC Sept. 6, 2001); *Sommerfeld v. Aiello*, [1999-2000 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 28,271 (CFTC Sept. 29, 2000). That testimony must be evaluated "in light of the record as a whole." *McDaniel v. Amerivest Brokerage Services*, [1999-2000 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 28,264 at 50,589 (CFTC Sept. 26, 2000).

Our independent review of the record as a whole discloses that Hedrick's testimony is not sufficiently reliable to support a finding that the respondents violated Commission Regulation

166.2(a) by the weight of the evidence. Although Hedrick testified that the respondents never told him the exact amount of the commodity interest to be bought or sold, his testimony is inconsistent with his Complaint, in which he asserted that McCoy "told [me] what he was going to get me into most of the time *and he might mention the number of contracts*." GX 2 at 4 (emphasis added). Moreover, as we have already noted, Hedrick never objected during the time period his account was open over several months, despite having accessed his account online on multiple occasions where he could see his trading confirmations and account statements and despite having been informed of his duty to object if there were any problem with his account. The record shows that although Hedrick had never traded futures or options, he had traded stocks for twenty years and is the comptroller of the company that employs him. GX 1 at 1. And while the ALJ found not credible respondents McCoy and Estrada, who both testified that they told Hedrick the exact amount of the commodity interest to be bought or sold, Tr. at 134-140, the record does not show that the Trading Club or its representatives would have had anything to gain by omitting the exact amount when making trading recommendations, especially where the details of each trade were made available to Hedrick on-line the instant the trade was completed. Tr. at 104, 110-111 and RX 5.

Thus, the record as a whole does not support a conclusion that Hedrick's testimony is sufficiently reliable to substantiate a finding that the respondents violated Commission Regulation 166.2(a). That is outcome determinative in this case, because Hedrick in the reparations forum bears the burden of proving by the weight of the evidence that the respondents violated Commission Regulation 166.2(a), and there is no other evidence in the record to support such a finding. *Violette*, ¶ 28,633 at 52,410.

Even if Hedrick's claim were established by the weight of the evidence, Hedrick also failed to show that respondents' alleged violation of Commission Regulation 166.2(a) was the proximate cause of his damages. In reparations, our cases make clear that a complainant must "demonstrate the respondent's wrongdoing was the proximate cause of the damages he suffered." *Wirth v. T&S Commodities, Inc.*, [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 25,271 at 38,876 (CFTC Apr. 6, 1992); *Steen v. Monex International, Ltd.*, [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 25,245 at 38,273 (CFTC Mar. 3, 1992). In this regard, the complainant must show that the alleged violations were "a substantial factor in bringing about [the complainant's] loss" or that the loss "was a reasonably probable consequence of respondent's conduct." *Muniz v. Lassila*, [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 25,225 at 38,650 (CFTC Jan. 17, 1992).

However, Hedrick failed to show any causal connection between the violation he alleges to have occurred and his losses. The record shows that Hedrick accepted all trading recommendations without complaint for more than two months. Indeed, Hedrick even increased his short corn futures position and then rolled it over to a subsequent month, and repeatedly accessed his account online to monitor his account and its progress. *See generally* RX 1&2. Thus, the record does not support a conclusion that Hedrick would have done anything differently, even if it were conclusively shown that prior to each of his trades he was not informed of the exact amount of the transaction as he alleges.[8]

[8] Because we find that Hedrick has not met his burden of proving a violation of Commission Regulation 166.2(a) and even had he done so has not shown that such a violation was the proximate cause of his damages, we need not, and do not, reach respondent's affirmative defenses of ratification, estoppel and failure to mitigate damages. *See* Respondents' appeal brief at 39-49.

CONCLUSION

For the foregoing reasons, the initial decision of the ALJ is reversed in its entirety, and the Complaint is dismissed with prejudice.

IT IS SO ORDERED.[9]

By the Commission (Commissioners LUKKEN, SOMMERS and CHILTON) (Acting Chairman DUNN not participating).

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

Dated: March 25, 2009

[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.