

UNITED STATES OF AMERICA
Before the
COMMODITY FUTURES TRADING COMMISSION

In the Matter of

John Lee Neuman,

Respondent.

)
) CFTC Docket No: 10-15
)
) **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 John Lee Neuman (“Neuman” or “Respondent”) has violated Sections 4b(a)(2)(i), (ii) and (iii) of the Commodity Exchange Act (the “Act”), 7 U.S.C. §§ 6b(a)(2)(i), (ii) and (iii) (2006), modified and re-designated as Sections 4b(a)(1)(A), (B) and (C), of the Act, as amended by the Food, Conservation, and Energy Act of 2008, Pub. L. No. 110-246, Title XIII (the CFTC Reauthorization Act of 2008 (“CRA”)), § 13102, 122 Stat. 1651 (enacted June 18, 2008), to be codified at 7 U.S.C. §§ 6b(a)(1)(A), (B) and (C). Therefore, the Commission deems it appropriate and in the public interest that public administrative proceedings be, and hereby are, instituted to determine whether Neuman engaged in the violations set forth herein, and to determine whether any order shall be issued imposing remedial sanctions.

II.

In anticipation of the institution of an administrative proceeding, Respondent has submitted an Offer of Settlement (“Offer”), which the Commission has determined to accept. Without admitting or denying the findings of fact herein, Respondent consents to the entry of and acknowledges service of this Order Instituting Proceedings Pursuant to Sections 6(c) and 6(d) of the Commodity Exchange Act, Making Findings and Imposing Remedial Sanctions (“Order”).¹

¹ Respondent consents to the use by the Commission of the findings in this proceeding and in any other proceeding brought by the Commission or to which the Commission is a party. Respondent does not consent to the use of the Offer or the findings in 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 Respondent consent to the use of the Offer or this Order, or the findings consented to in the Offer or this Order, by any party in any other proceeding.

III.

A. SUMMARY

On Friday, June 22, 2007, Neuman, a Chicago Board of Trade (“CBOT”) member and local in the corn options pit, engaged in unauthorized trading in the account of another corn options local. Neuman made unauthorized purchases of several thousand corn futures contracts and ended the trading day with a net long futures equivalent position of approximately 4,000 contracts. Neuman then attempted to hide the unauthorized trades from the account owner by misrepresenting the profits, losses and risks the account was incurring, and by altering the trades and certain parameters in an options analyzer program that the account owner used to monitor Neuman’s trading. By the time all the futures and options positions from the day were liquidated, the account owner sustained trading losses of approximately \$4 million. Neuman’s unauthorized trading and misrepresentation of profits and losses in connection with futures trading violated Sections 4b(a)(2)(i), (ii) and (iii) of the Act, 7 U.S.C. §§ 6b(a)(2)(i), (ii) and (iii) (2006).

B. RESPONDENT

John Lee Neuman has been a local in the corn options pit since September 1997. He is not currently registered with the Commission in any capacity. Neuman was registered with the Commission as a floor broker from May 1993 until February 2008, when his floor broker registration was withdrawn. Neuman was also registered with the Commission as an associated person (“AP”) of a registered introducing broker (“IB”), futures commission merchant (“FCM”) and commodity pool operator (“CPO”) at various times from July 2008 until March 2009, when his final AP registration was withdrawn. From 1993 until January 2007, Neuman traded under a commodity options market only (“COM”) membership, which allowed him to trade only options.² In January 2007, he purchased a CBOT COM membership, and in February 2007 he began leasing a full CBOT membership, which allowed him full exchange trading privileges.

C. FACTS

1. Neuman’s Prior Business Relationship

From April 1999 to August 2006, Neuman was employed as a corn options proprietary trader by a registered FCM. Pursuant to a trading agreement, Neuman traded capital provided by the FCM. Neuman and the FCM evenly split trading profits, and the FCM incurred Neuman’s trading losses. However, in 2005, Neuman’s trading became increasingly unprofitable, and in August 2005, Neuman and the FCM verbally modified their trading agreement. Neuman assumed responsibility for covering his own trading losses. However, in August 2006, the FCM terminated its trading agreement with Neuman, because Neuman continued to lose money trading and assumed levels of risk that Neuman could not cover financially. By the time the

² During the 1993-2007 period, Neuman leased the membership when he was trading his own funds and used a firm owned seat when he was trading a firm’s proprietary funds.

FCM terminated its agreement with Neuman, Neuman's overall debt to the firm was approximately \$796,657.

2. Neuman's Following Business Relationship

In August 2006, after the FCM terminated its trading agreement with Neuman, Neuman approached a corn options local seeking a trading relationship. At the time, the corn options local held several accounts at a registered FCM. In August 2006, Neuman and the corn options local entered into a written trading agreement pursuant to which Neuman would trade for one of the corn option local's accounts. Neuman was given power-of-attorney over the corn option local's account in order to effectuate the trading agreement. Neuman was responsible for hedging the risk from trading in the account in accordance with the trading agreement's trading parameters and risk levels.

3. The Trading Agreement

The trading agreement outlined Neuman's trading parameters and risk levels, and specified that Neuman should "strive to trade as flat as possible" and adhere to certain risk levels. It also stated that the corn options local could reduce the risk on Neuman's behalf or require Neuman to reduce the risk incurred in the account. Around the end of 2006, Neuman and the corn options local adjusted Neuman's parameters to more lenient levels by verbal agreement. They subsequently memorialized these risk parameters in a document dated May 17, 2007, entitled "Trading Risk Parameters." The modified parameters allowed Neuman to risk no more than a loss of \$250,000 for a one limit market move in either direction and no more than a loss of \$750,000 for a 20% volatility move in either direction.

Neuman discussed his trading relative to the agreed risk parameters with the corn options local once or twice a week. At times, the corn options local became uncomfortable with Neuman's risk exposure and directed Neuman to reduce his risk. Neuman initially complied with these requests, but would eventually return to higher risk levels after a period of time.

4. The Risk Monitoring System

Both Neuman and the corn options local traded in the corn options pit and hedged the vast majority of their open outcry options trades with electronic futures trades. The corn options local placed his electronic futures orders almost exclusively through a pit clerk that stood in the middle of the pit and whose main function was to accept futures orders from corn options traders for execution on e-cbot, which was the CBOT's electronic trading platform. Neuman also placed the majority of his volume of electronic futures trades through the same pit clerk. However, approximately once a week, Neuman hedged through another clerk whose electronic futures trades were cleared by a different FCM. Neuman's volume of electronic futures orders through this alternative clerk and FCM never exceeded 500 contracts during a one week period.

The corn options local coded an Excel spreadsheet called the "analyzer," which he and Neuman used to monitor their futures and options positions, determine whether they were trading within established parameters, and determine the degree of risk involved in their respective

trading positions. The corn options local employed an order entry clerk to maintain and update the analyzer files. In practice, the order entry clerk fulfilled this responsibility by collecting, among other information, Neuman's trading cards throughout the trading day and entering into the analyzer the quantity, purchase price, month and strike price of each options trade contained on the cards, as well as comparable information for any corresponding futures hedges. Neuman did not input his own trades into the analyzer.

The order entry clerk obtained Neuman's hedge information by downloading it from a website containing electronic fill information. The order entry clerk could only download the e-cbot fills that Neuman executed through the pit clerk and could not obtain the e-cbot fill information for trades that Neuman executed through other execution channels, such as the alternate clerk and FCM that Neuman sometimes used. The order entry clerk learned of Neuman's electronic futures trades transacted through these alternative channels only by reviewing Neuman's account statement or if Neuman explicitly informed him of the trades.

Each morning prior to the opening, the order entry clerk verified the accuracy of the information contained in the analyzer by comparing trade and position data in the analyzer with the information reflected in the prior day's account statements for Neuman and the corn options local. After verifying that he had accurately keypunched open outcry and electronic trade information into the analyzer, the order entry clerk uploaded the most recent version of the analyzer file.

Throughout the trading day, the order entry clerk provided the corn options local and Neuman with updated analyzer reports showing the values of their respective risk parameters. The order entry clerk also would provide the corn options local with an update on Neuman's risk parameters when requested.

5. Neuman's Trading Of July Corn Futures Contracts On June 22, 2007

Friday, June 22, 2007 was the expiration date for options on July 2007 corn futures contracts. On that day, Neuman, trading for the account, cleared a total of 13,041 July corn futures, buying 11,082 contracts and selling 1,959 contracts. The vast majority of these trades appeared to have been speculative, because there were no corresponding options trades. Neuman was also trading corn futures and options across other trading months. At the conclusion of trading, Neuman's position in the account was long 8,903 July futures, with a net overall delta exposure long 3,993 contracts, futures and options positions in six corn trading months combined. The margin call on the account was approximately \$8 million.

6. Discovery of Neuman's Unauthorized Trading

Between 11:00 a.m. and 11:30 a.m. that day, the corn options local asked his order entry clerk to print an analyzer report summary for the account that Neuman was trading. The analyzer report showed Neuman long approximately 3,100 contracts, which violated their trading agreement. When the corn options local realized that Neuman was taking on risk that exceeded their agreement, he instructed Neuman to liquidate his position. Although Neuman responded that he would, he did not reduce his risk. Instead, he continued to buy futures, so that by 12:10 p.m. he was long 8,000 July corn futures contracts in the account. To conceal his trading from

the corn options local, Neuman began using the alternate clerk and FCM to execute the long July corn futures trades rather than sending the trades through the pit clerk. The trades executed through the alternate clerk and FCM did not appear on the analyzer report.

Later that afternoon, the corn options local received another analyzer report from his order entry clerk, and this time the report showed that Neuman, trading the account, was long 2,661 contracts, which the corn options local interpreted to mean that Neuman was reducing his position down from 3,100. At around that time, Neuman also verbally assured the corn options local again that he was reducing his position. In reality, Neuman continued to add to his long futures position by buying additional futures contracts through the alternate clerk and FCM until five minutes before closing. As before, these trades did not appear in the analyzer report.

At the close of trading that afternoon, Neuman told the order entry clerk that he needed access to the analyzer file in order to review the risk profile of his trades. When Neuman finished at the computer, the order entry clerk uploaded the analyzer file and printed the analyzer report. Neuman had altered the analyzer file to reflect a smaller position and a greater account value than he actually had.³

Over the weekend of June 23-24, 2007, the order entry clerk downloaded Neuman's June 22 analyzer file and compared it to Neuman's account statement from the FCM carrying the account. When the order entry clerk attempted to reconcile the account statements for the account that Neuman was trading with the trades reflected in Neuman's analyzer file, the clerk realized that trades listed in the account statement were missing or incorrectly represented in the analyzer file. The discrepancies between Neuman's analyzer trades and the trades in his account statement fell into three categories: 1) differences between the quantity and price of trades in Neuman's analyzer file and Neuman's account statement; 2) a trade in Neuman's analyzer file that was not reflected in Neuman's account statement; and 3) trades in Neuman's account statements that were not in Neuman's analyzer file.

After the order entry clerk corrected the inaccurate trade information in the analyzer by reconciling it with his account statement, Neuman's account value decreased by \$1.2 million and his overall position increased to approximately 4,000 long futures contracts. Further, the trade discrepancies Neuman caused masked \$8 million in margin calls that Neuman was not able to cover.

³ When Neuman finished at the computer, the order entry clerk uploaded the analyzer file and printed the analyzer report, which showed Neuman was long by only 3.5 futures contracts. In fact, Neuman's position was actually long 3,993 futures contracts in a declining market. After completing his review of the analyzer file and Neuman's trading cards, between 2:30 and 3:00 p.m., the order entry clerk reported to the corn options local that Neuman's final position for the day was long 3.5 futures contracts. Neuman's position is a net of futures and options positions, which accounts for the fraction of a futures contract.

7. Liquidation of Neuman's Corn Futures Position and Losses Suffered

After the order entry clerk discovered the discrepancies between the trades in the analyzer file and the trades Neuman had actually placed in the account, the clerk immediately called the corn options local and told him what he had discovered. The corn options local then tried to reduce the damage Neuman had done.

Between June 25 and June 28, 2007, the next two trading days, the corn options local liquidated the entire balance of the corn futures position that Neuman had acquired for his account. However, the price of July corn futures declined each trading session between June 25 and June 28. The corn options local lost approximately \$4 million liquidating the corn futures position Neuman had amassed on and prior to June 22, 2007.

D. LEGAL DISCUSSION

Neuman Violated Sections 4b(a)(2)(i), (ii) and (iii) of the Commodity Exchange Act

Sections 4b(a)(2)(i), (ii) and (iii) of the Act, modified and re-designated as Sections 4b(a)(1)(A), (B) and (C) by the CRA,⁴ prohibit any person from cheating or defrauding or attempting to cheat or defraud, and willfully deceiving or attempting to deceive any other person by any means whatsoever in or in connection with any order to make or the making of any futures contract for or on behalf of such person, and prohibits any person from willfully making or causing to be made to any other person any false report.

Neuman violated Sections 4b(a)(2)(i) and (iii) of the Act by willfully engaging in unauthorized trading. Unauthorized trading falls within the Act's anti-fraud prohibition when trades are executed without the account owner's permission or contrary to the account owner's trading instructions. *In re Interstate Securities Corp.*, [1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 25,595 (CFTC June 1, 1992) (citing *Cange v. Stotler, Inc.*, 826 F.2d 581, 589-590 (7th Cir. 1987); *Haltmier v. CFTC*, 554 F.2d 556, 560-562 (2d Cir. 1977)). Here, Neuman ignored the account owner's trading instructions to limit trading risk, and instead increased the account's long July 2007 corn futures position in a declining market. Consequently, when the account owner liquidated the account, he suffered losses of approximately \$4 million.

Neuman also violated Sections 4b(a)(2)(i) and (iii) of the Act by willfully misrepresenting and omitting material facts including, but not limited to, trades made, the profit and loss incurred by the trades, and the magnitude of the risk to which he subjected the account. *CFTC v. Rosenberg*, 85 F. Supp. 2d 424, 447-448 (D.N.J. 2000) (overstating account balances

⁴ The June 2008 legislation reauthorizing the Commission revised Section 4b of the Act, among other things. See Section 1302 of the CRA. The objective of the revision was to "clarify that the CEA gives the Commission the authority to bring fraud actions in off-exchange 'principal-to-principal' futures transactions." H.R. REP. NO. 2419, at 981 (2008) (Conf. Rep.). While the CRA did not change the Act's prohibition on misconduct such as that at issue here, it reorganized Section 4b so that similar misconduct occurring on or after June 18, 2008 would be in violation of Sections 4b(a)(1)(A), (B) and (C) of the Act as amended by the CRA, to be codified at 7 U.S.C. § 6b(a)(1)(A), (B) and (C).

and failing to report trade losses to an account owner are material misrepresentations that violate the anti-fraud provisions of the Act).

Finally, Neuman violated Section 4b(a)(2)(ii) of the Act by willfully causing a false report of trades and risk incurred in the account to be issued to the account owner. Numerous courts have found that the making of false reports concerning profitability and risks of trading violates Section 4b(a)(2) of the Act. *See, e.g., CFTC v. Noble Wealth Data Info. Serv., Inc.*, 90 F. Supp. 2d 676, 686 (D. Md. 2000) (defendant's profit claims constituted false reports and fraud within the meaning of the Act), *aff'd sub nom. CFTC v. Baragosh*, 278 F.3d 319 (4th Cir. 2002); *CFTC v. Skorupskas*, 605 F. Supp. 923, 932-33 (E.D. Mich. 1985) (defendants violated Section 4b of the Act by issuing false monthly statements to customers); *CFTC v. King*, No. 3:06-CV-1583-M, 2007 U.S. Dist. LEXIS 33338 at *8 (N.D. Tex. May 7, 2007) (creating and distributing account statements that falsely report trades, account balances and value of account assets violates Section 4b(a)(2) of the Act).

IV. FINDINGS OF VIOLATIONS

Based on the foregoing, the Commission finds that Neuman violated Sections 4b(a)(2)(i), (ii) and (iii) of the Act, 7 U.S.C. §§ 6b(a)(2)(i), (ii) and (iii) (2006).

V. OFFER OF SETTLEMENT

Neuman has submitted an Offer in which, without admitting or denying the findings herein, he:

(A) Acknowledges receipt of 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 consideration of the Offer; (6) any and all claims that he 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 Commission's Regulations ("Regulations"), 17 C.F.R. §§ 148.1 *et seq.* (2010), relating to, or arising from, this proceeding; (7) any and all claims that he may possess under the Small Business Regulatory Enforcement Fairness Act of 1996, Pub. L. No. 104-121, §§ 201-253, 110 Stat. 847, 857-68 (1996), as amended by Pub. L. No. 110-28, § 8302, 121 Stat. 112, 204-205 (2007), relating to, or arising from, this proceeding; and (8) 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.

(D) Stipulates that the record upon which this Order is entered shall consist solely of the findings in this Order to which Neuman has consented;

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

- (1) makes findings by the Commission that Neuman violated Sections 4b(a)(2)(i), (ii) and (iii) of the Act, 7 U.S.C. §§ 6b(a)(2)(i), (ii) and (iii) (2006);
- (2) orders Neuman to cease and desist from violating Sections 4b(a)(1)(A), (B) and (C) of Act, as amended by the CRA, to be codified at 7 U.S.C. §§ 6b(a)(1)(A), (B) and (C);
- (3) orders that Neuman, beginning on the third Monday after the date of entry of this Order, be permanently prohibited from engaging, directly or indirectly, in trading on or subject to the rules of any registered entity (as that term is defined in Section 1a(29) of the Act, 7 U.S.C. § 1a(29) (2006)), and all registered entities shall refuse him trading privileges; and
- (4) orders that Neuman comply with the undertakings consented to in his Offer and set forth below in Part VI of this Order.

Upon consideration, the Commission has determined to accept the Offer.⁵

VI. ORDER


Accordingly, IT IS HEREBY ORDERED THAT:

- (1) Neuman shall cease and desist from violating Sections 4b(a)(1)(A),(B) and (C) of Act, as amended by the CRA, to be codified at 7 U.S.C. §§ 6b(a)(1)(A), (B) and (C);
- (2) Neuman, beginning on the third Monday after the date of entry of this Order, is permanently prohibited from trading on or subject to the rules of any registered entity (as that term is defined in Section 1a(29) of the Act, 7 U.S.C. § 1a(29) (2006)), and all registered entities shall refuse him trading privileges; and
- (3) Neuman shall comply with the following undertakings:
 - (a) Neuman, before the third Monday after the date of entry of this Order, shall liquidate all futures and options positions held by him or on his behalf, or in which he has a beneficial interest;

⁵ The CBOT previously brought an action against Neuman arising out of these facts. The Commission is not seeking a civil monetary penalty against Neuman in light of the CBOT's decision in that action requiring Neuman to pay \$4 million in restitution. The Commission believes that the conduct in this matter mandates significant restitution by respondent, and had the CBOT's decision not included that significant restitution, the Commission would have sought a civil monetary penalty against Neuman in this matter.

- (b) Neuman 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
- (c) Neuman shall not act as a principal (as that term is defined in Regulation 3.1(a), 17 C.F.R. § 3.1(a) (2009)), agent or any other officer or employee of any person (as that term is defined in Section 1a(28) of the Act, 7 U.S.C. § 1a(28) (2006)) registered, exempted from registration or required to be registered with the Commission except as provided for in Regulation 4.14(a)(9), 17 C.F.R. § 4.14(a)(9) (2010).
- (d) Neither Neuman nor any of his agents or employees under his 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 Neuman's (i) testimonial obligations; or (ii) right to take legal positions in other proceedings to which the Commission is not a party. Neuman shall undertake all steps necessary to ensure that all of his agents and employees under his authority or control understand and comply with this agreement.

By the Commission.


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

Dated: Aug. 30, 2010