

UNITED STATES OF AMERICA
Before the
COMMODITY FUTURES TRADING COMMISSION

In the Matter of:

Mark Vaughn
637 Park Drive
Flossmoor, Illinois 60422,

Respondent.

CFTC Docket No. 02-06

ORDER INSTITUTING PROCEEDINGS
PURSUANT TO SECTIONS 6(c), 6(d)
AND 8a OF THE COMMODITY
EXCHANGE ACT, AS AMENDED, AND
FINDINGS AND ORDER IMPOSING
REMEDIAL SANCTIONS

I.

The Commodity Futures Trading Commission (“Commission”) has reason to believe that Mark Vaughn (“Respondent” or “Vaughn”) has violated Section 166.3 of the Commission’s Regulations, 17 C.F.R. § 166.3 (2001). Therefore, the Commission deems it appropriate and in the public interest that a public administrative proceeding be, and hereby is, instituted to determine whether Vaughn engaged in the violation as set forth herein and to determine whether any order should be issued imposing remedial sanctions.

II.

In anticipation of the institution of this administrative proceeding, Vaughn has submitted an Offer of Settlement (“Offer”) that the Commission has determined to accept. Without admitting or denying the findings herein, Vaughn acknowledges service of this Order Instituting Proceedings Pursuant to Sections 6(c), 6(d) and 8a of the Commodity Exchange Act and Findings and Order Imposing Remedial Sanctions (“Order”). Vaughn consents to the use of the findings herein in this proceeding and in any other proceeding brought by the Commission or to which the Commission is a party.¹

¹ Respondent does not consent to the use of the Offer or his Order as the sole basis for any other proceeding brought by the Commission other than a proceeding to enforce the terms of this Order, nor does Respondent consent to the use of the Offer, or the findings in the Order consented to in the Offer, by any other person or entity in this or any other proceeding. The findings made in the Order are not binding on any other person or entity named as a defendant or respondent in any other proceeding.

III.

The Commission finds that:

A. SUMMARY

From at least March 1997 through February 1999 (“the relevant time”), Mark Vaughn, the former chief operating officer of LFG, LLC (“LFG”), at the time a registered futures commission merchant (“FCM”),² failed to diligently supervise LFG employees or agents in their handling of discretionary foreign customer accounts introduced to LFG by two foreign introducing brokers (“IBs”): a German national and a foreign corporation (collectively, “the German customer accounts”). Discretionary trading of the German customer accounts included substantial day-trading, generated high commissions relative to the equity in their accounts and resulted in substantial trading losses to those customers. Despite the presence of several indicia of possible churning that continued over a period of approximately one and one-half years, Vaughn and LFG failed to undertake any meaningful review of the trading activity in the German customer accounts. As a result, Vaughn, directly and as a controlling person of LFG, failed to diligently supervise in violation of Commission Regulation 166.3, 17 C.F.R. § 166.3 (2001).

B. RESPONDENT

Respondent Mark Vaughn is 52 years old and resides at 637 Park Drive, Flossmoor, Illinois 60422. He has been registered with the Commission as a floor broker (“FB”) pursuant to Section 4e of the Commodity Exchange Act, as amended (“Act”) since at least January 1982. During the relevant period of time, Vaughn also was the chief operating officer of LFG. Vaughn was responsible for supervising all of the day-to-day operations of LFG. LFG’s Compliance and Risk Departments and all of LFG’s operations staff reported directly to Vaughn. In that capacity, Vaughn directly supervised all of LFG’s various supervisors, managers, IBs and associated persons (“APs”).

² In an unrelated matter, on August 20, 2001, the Commission accepted an offer of settlement from LFG and entered an order requiring it to withdraw its registration as an FCM in *In re LFG, LLC*, CFTC Docket No. SD 01-01. LFG is presently in bankruptcy proceedings. *In re LFG, LLC, Debtor*, Chapter 11 Case No. 01 B 12604 (N.D. Ill.).

C. FACTS

1. The German customer accounts

In March of 1997, one of LFG's APs arranged for a German national to become a new foreign IB of LFG.³ The German national was not registered with the Commission in any capacity. LFG's Due Diligence Committee, whose ultimate responsibility was to approve new IB business brought to the firm and which included Vaughn and certain LFG department heads, performed a due diligence review on the German national. During the due diligence review, LFG learned that the German national:

- (a) had only six months of personal trading experience;
- (b) intended to engage only in discretionary trading; and
- (c) intended to engage primarily in day-trading.

After the due diligence review, the German national became an IB of LFG and executed a foreign broker clearing agreement ("FB Agreement") with Vaughn on behalf of LFG. From March 1997 to March 1998, the German national introduced eleven foreign customer accounts to LFG. In each of these accounts, the customer gave trading discretion over his or her account to a trader in Germany who was associated with the German national and was not registered with the Commission. The German national received commissions for trading the customer accounts.

In March 1998, the LFG AP arranged for a corporation organized in the Cayman Islands, but whose main offices were in Germany, to become another foreign IB of LFG. This foreign corporation also was not registered with the Commission in any capacity. LFG's Due Diligence Committee, including Vaughn, performed a review of this foreign corporation. During the due diligence review, LFG learned that the foreign corporation:

- (a) had provided no information about its past futures trading experience nor any verifiable references; and
- (b) had an "undetermined" Dun & Bradstreet rating due to a lack of "managerial, commercial and financial information" about the firm.

After the due diligence process, the foreign corporation became an IB of LFG and executed a FB Agreement with Vaughn on behalf of LFG. From April 1998 to December 1998, the foreign corporation introduced twenty-one customer accounts to LFG. In each of these accounts, the customer gave trading discretion over his account to the foreign corporation.

The LFG AP performed a number of tasks associated with the German customer accounts, including securing approval for the new accounts from LFG's New Accounts

³ This LFG AP ("the AP") resided in Germany and did not maintain an office at LFG. Nor did LFG have a branch office location in Germany where the AP transacted business. However, the AP visited LFG's offices in Chicago, Illinois and divided his time between Germany, Chicago and traveling between the two locations. He reported directly to Vaughn.

Department, transmitting applications to and from the customers, receiving his customers' account statements, and conferring with the order desk regarding the handling of these accounts. In addition, the AP received commissions for trades made in the German customer accounts.

2. Apparent Churning of the German Customer Accounts

A review of the German customer accounts by Vaughn or any other LFG staff would have revealed the following indicia of possible churning of these accounts during the relevant time period:

- (a) The 32 accounts had monthly commission-to-equity ratios in excess of 20% in 147 of 177 total trading account-months. In fact, in more than a third of the account-months, commission-to-equity ratios exceeded 40% and the ratios exceeded 100% in 6 months⁴;
- (b) At least 61% of all of the trades executed for the 32 accounts were day trades;
- (c) At least \$383,401.67 in gross commissions were generated from the trading in the 32 accounts; these commissions equalled more than 80% of the total losses; and
- (d) 31 of the 32 accounts lost money and the losses in the 31 losing accounts were at least \$476,946, accounting for at least 87% of each of those customers' investments.

3. The Failure to Diligently Supervise the Handling of Customer Accounts

LFG distributed a Policy & Procedures Manual ("Manual") to its staff, IBs and all other commodity professionals who introduced accounts to LFG. This Manual was intended to serve as a guideline to the firm's and its IBs' day-to-day operations. It made no distinction between the handling of foreign versus domestic customer accounts.

The Manual provided that an "office supervisor" was required to "review all accounts transacting significant day trading activity to determine that this kind of activity is consistent with the customers' investment objectives," and "review all accounts incurring large realized losses during a month." To do so, the office supervisor had to conduct monthly reviews of monthly statements as well as certain other reports detailing customer account activity for all accounts, which included monthly commissions, summaries of day trades, overnight and spread activity, and purchase and sale amounts on all closed out transactions and monthly realized profits (losses). The Manual also provided that the supervisor must review orders for all discretionary accounts, initial all order tickets to ensure that they are properly marked "discretionary" and review the activity in all discretionary accounts on a monthly basis in order to determine that the activity is consistent with any disclosures or strategies which have been conveyed to the customer.

⁴ Although not dispositive, a monthly commission to equity ratio in excess of 18 percent may be indicative of churning. See *In re Lincolnwood Commodities, Inc. of California*, [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,986 (CFTC Jan. 31, 1984).

Neither Vaughn nor any other LFG staff reviewed the order tickets on a daily basis nor did they conduct the monthly review of the discretionary German customer accounts in order to monitor the activity in those accounts. Moreover, the FB Agreements between the German national, the foreign corporation and LFG provided that the foreign broker “shall diligently supervise an Account over which discretionary authority is granted and shall maintain a written record that such supervision was performed.” However, neither Vaughn nor any other LFG staff supervised the foreign brokers to insure that they, in turn, were supervising the activities in their discretionary accounts as set forth in the FB Agreement executed by Vaughn.

Although the purported practice of LFG and Vaughn was to supervise each LFG AP’s handling of his or her customer business, neither Vaughn nor any other LFG staff supervised the activities of the subject AP in connection with his handling of the German national’s and the foreign corporation’s customer accounts. Vaughn conceded that he personally did not review the subject LFG AP’s customers’ accounts and also that he did not know whether anyone else at LFG had conducted such a review in order to determine if the account activities were consistent with the customers’ objectives. In fact, LFG’s Director of Compliance, who reported directly to Vaughn, never conducted a churning analysis for any customer accounts at the firm, foreign or domestic. The LFG Compliance Department did not have a reliable equity run from which to review the trading of LFG’s customer accounts. Indeed, LFG knew of, but never corrected, this problem, which precluded a complete review of customer account activity.

D. VIOLATIONS OF THE REGULATIONS

1. Vaughn and LFG Failed to Supervise in Violation of Regulation 166.3

Commission Regulation 166.3 requires that every Commission registrant (except APs who have no supervisory duties) diligently supervise the handling by its partners, officers, employees and agents (or persons occupying a similar status) of all commodity interest accounts carried or introduced by the registrant. It is well settled that it is unnecessary to prove an independent substantive violation in order to establish a breach of the duty imposed by Rule 166.3. *In re Collins*, [1996-1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,194 at 45,744 (CFTC Dec. 10, 1997); *In re First National Trading Corporation (“FNTC”)*, [1992-1994 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,142 at 41,786 (CFTC July 20, 1994), *aff’d without op.*, *Pick v. CFTC*, No. 95-3761 (6th Cir. Oct. 26, 1996); *In re GNP Commodities, Inc.*, [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 25,360 at 39,219 n.11 (CFTC Aug. 11, 1992), *aff’d in part and rev’d in part sub nom. Monieson v. CFTC*, 996 F. 2d 852 (7th Cir. 1993); *In re Paragon Futures Assn.*, [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 25,266 at 38,849 (CFTC April 1, 1992). As Commission registrants, Vaughn and LFG each had supervisory obligations under Regulation 166.3.

More specifically, Vaughn and LFG had a duty to supervise LFG’s AP and its agent foreign IBs. Regulation 166.3 requires that an FCM have supervisory responsibility over the activities of persons registered with it as APs. *CFTC v. Commodities Fluctuations Systems, Inc.*, 583 F. Supp. 1382 at 1384 (S.D.N.Y. 1984) (Commission registrant was held to have an obligation to supervise those persons registered with it as APs since Congress intended to protect customers by requiring that APs who directly solicit the public be supervised by an entity

registered with the Commission). Moreover, one of Vaughn's acknowledged duties was to supervise the AP who solicited the foreign IBs and provided various services in connection with the resulting German customer accounts.

Vaughn and LFG also had a duty to supervise the foreign IBs' handling of the German accounts because those IBs acted as agents for LFG within the meaning of Regulation 166.3. A number of factors present here evidence that the foreign IBs were acting as agents for LFG. First, there is no evidence that the foreign IBs transacted business with any FCM other than LFG. The foreign IBs distributed LFG's account opening forms to customers, provided customers with LFG risk disclosures and invited customers to talk to LFG in Chicago if any concerns were not satisfactorily resolved by talking to their account executive at the IB level. Further, the contracts between LFG and the foreign IBs required, among other things, that the IBs only use documents supplied or approved by LFG in its dealings with customers. Importantly, the contracts between LFG and the IBs required the IBs to abide by LFG's rules, including those procedures relative to the supervision of discretionary accounts. *Cf. Reed v. Sage Group, Inc.*, [1987-1990 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,943 at 34,303 (CFTC October 14, 1987) (obligations undertaken by an IB to comply with all present or future FCM policies and to use FCM customer agreements are factors, among others, that support a finding that the IB is an agent of the FCM).

LFG's Manual set out certain procedures for supervising the handling of customer accounts. However, neither Vaughn nor any other LFG staff ensured implementation of those procedures for the German customer accounts by the AP, the foreign IBs or anyone else, thereby permitting foreign IBs to apparently churn the accounts introduced to LFG for approximately one and one-half years. Vaughn's and LFG's failure to ensure that LFG's procedures were diligently administered constituted a violation of Regulation 166.3.⁵ *In re GNP Commodities*, ¶ 25,360 at 39,219 (even if an adequate supervisory system is in place, Regulation 166.3 can still be violated if the supervisory system is not diligently administered).

2. Vaughn Is Also Liable as a Controlling Person for LFG's Violations

Section 13(b) of the Act provides: "Any person who, directly or indirectly, controls any person who has violated any provision of this Act ... may be held liable for such violation in any action brought by the Commission to the same extent as such controlled person." In order to establish liability under this Section of the Act, the Division must establish that LFG violated its supervisory responsibilities under Regulation 166.3 and that Vaughn controlled LFG and did not

⁵ The discretionary trading of the German customer accounts generated high commissions relative to the equity in their accounts, resulted in significant trading losses to the customers and engaged in a very high percentage of day trades, each of which is an indication of churning. *In re Paragon Futures Association*, [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 25,266 at 38,847 (CFTC April 1, 1992); *In re Lincolnwood Commodities* [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,986 at 28,250 (CFTC Jan. 31, 1984); and *Hinch v. Commonwealth Financial Group, Inc.*, [1996-1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,056 at 45,021 (CFTC May 13, 1997).

act in good faith or knowingly induced the acts constituting the violation. *Monieson v. CFTC*, 996 F.2d 852, 858 (7th Cir. 1993).

Vaughn was the chief operating officer of LFG and was a controlling person of LFG. He oversaw all of the day-to-day customer operations for LFG and had the authority and ability to implement and control review of customer account trading. Similarly situated persons have been found to be controlling persons by the Commission. *See FNTC*, ¶ 26,142 at 41,786 (chief executive officer held to be controlling person); *GNP*, ¶ 25,360 at 39,219 (chairman of the board held to be controlling person). Vaughn failed to ensure that LFG's staff and its agents followed the procedures for reviewing discretionary account activity as set forth in LFG's Manual and FB Agreements with respect to the German customer accounts. Failure to enforce with reasonable diligence a system of internal supervision and control has been held to constitute a lack of good faith. *Monieson v. CFTC*, 996 F.2d at 858, *quoting Harrison v. Dean Witter Reynolds, Inc.*, 974 F.2d 873, 881 (7th Cir. 1992). Consequently, Vaughn also is liable for LFG's violations of Commission Regulation 166.3 as a controlling person.

IV.

OFFER OF SETTLEMENT

Vaughn has submitted an Offer of Settlement in which, without admitting or denying the findings herein, he acknowledges service of this Order, admits the jurisdiction of the Commission with respect to the matters set forth herein, and 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 objection to the staff's participation in the Commission's consideration of the Offer; (6) all claims which he may possess under the Equal Access to Justice Act, 5 U.S.C. § 504 (1994) and 28 U.S.C. § 2412 (1994), as amended by Pub. L. No. 104-121, §§ 231-232, 110 Stat. 862-63, and part 148 of the Commission's Regulations, 17 C.F.R. §§ 148.1, *et seq.* (2001), relating to, or arising from, this action; and (7) 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.

Vaughn stipulates that the record basis on which this Order may be entered shall consist solely of the findings in this Order to which he has consented in the Offer. Vaughn also consents to the use of the findings contained in this Order in this proceeding and in any other proceedings brought by the Commission or to which the Commission is a party. Vaughn further consents to the Commission's issuance of this Order, which makes findings as set forth herein and orders that Vaughn: (1) cease and desist from violating Commission Regulation 166.3; (2) pay a civil monetary penalty of twenty-five thousand dollars (\$25,000) as set forth below; (3) be conditionally registered for a period of one year such that he will be prohibited from acting in any supervisory capacity; and (4) comply with his undertakings as set forth below.

V.

FINDING OF VIOLATIONS

Solely on the basis of Vaughn's consent, as evidenced by the Offer, and prior to any adjudication on the merits, the Commission finds that Vaughn violated Commission Regulation 166.3, 17 C.F.R. 166.3 (2001).

VI.

ORDER

Accordingly, **IT IS HEREBY ORDERED THAT:**

1. Vaughn shall cease and desist from violating Commission Regulation 166.3, 17 C.F.R. 166.3 (2001);
2. Vaughn shall pay a civil monetary penalty ("CMP") in the amount of Twenty-Five Thousand Dollars (\$25,000) within ten (10) business days of this Order and make such payment by U.S. postal money order, certified check, or bank money order, made payable to the Commodity Futures Trading Commission, and addressed to Dennese Posey, or her successor, Division of Trading and Markets, Commodity Futures Trading Commission, 1155 21st Street, N.W., Washington, D.C. 20581, under cover of a letter that identifies Mark Vaughn and the name and docket number of this proceeding. A copy of the cover letter and the form of payment shall be simultaneously transmitted to 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 Respondent fails to make payment of his penalty within fifteen (15) days of the respective due date, he shall be automatically prohibited from trading on or subject to the rules of any registered entity, as defined in Section 1a(29) of the Act, 7 U.S.C. § 1a(29), and his registration and any other registration he may seek shall be suspended automatically, until he shows to the satisfaction of the Commission that payment of the full amount of the penalty with interest thereon to the date payment has been made;
3. For a period of one year after entry of the Order, Vaughn's registration or any other registration he may seek shall be restricted in that he is prohibited from acting in any supervisory capacity; and
4. Vaughn agrees that neither he nor any of his agents or employees under his control 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 factual basis; provided, however, that nothing in this provision shall affect: (i) Vaughn's testimonial obligations; or (ii) his right to take contrary legal positions in other proceedings to which the Commission is not a party. Vaughn will undertake all steps necessary to assure that all agents and employees under his authority and control understand and comply with this agreement.

Unless otherwise specified, the provisions of this Order shall be effective on this date. A copy of this Order shall be served on Vaughn at the address set forth in the caption of this Order, on all contract markets, and on the National Futures Association.

By the Commission.

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

Dated: February 25, 2002