

NATIONAL FUTURES ASSOCIATION

Legal and Procedural Issues

For NFA Arbitrators

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It should be noted at the outset that these summaries are not all-inclusive. Rather, they are intended as an overview of those legal and procedural issues that frequently arise in NFA arbitration proceedings. Moreover, these summaries are in no way intended as a substitute for the parties' own legal research and analysis.

Churning

Churning is a violation of the anti-fraud provisions of Section 4b of the Commodity Exchange Act (7 U.S.C. § 6b). At its simplest, churning is excessive trading of a customer's account for the purpose of generating commissions. Case law has generally defined churning as a volume or frequency of trading that, in light of the nature of the account and the situation as well as the needs and objectives of the customer, indicates a purpose of the broker to generate commissions rather than to protect the customer's interests. To establish a churning claim, a customer must prove that:

- 1) the person who allegedly churned the account controlled the level and frequency of trading in the account (including defacto control);
- 2) the overall volume of trading was excessive in light of the customer's trading objectives; and
- 3) the person who allegedly churned the account acted with intent to defraud or in reckless disregard of the customer's interests.

Whether an account has been traded excessively is a question of fact that cannot be determined by a specific rule or formula. No precise mathematical test exists. Rather, a number of factors should be considered in light of the needs and objectives of the customer. Among the factors which have been considered by the courts and the Commodity Futures Trading Commission (CFTC) are:

- 1) the commission-to-equity ratio;
- 2) the percentage of day trades;
- 3) departure from a previously agreed upon strategy;
- 4) whether the account was traded while it was undermargined; and
- 5) re-establishment of previously liquidated positions in the same or related contracts.

In considering a churning claim, arbitrators should keep in mind that the turnover of futures contracts, by nature, far exceeds the frequency with which most securities investors alter their portfolios. Day trading, for instance, is commonplace in futures, especially among the professionals. Therefore, the level of trading that can occur without being excessive is much higher for futures than for securities.

See Smith v. Siegel Trading Co., [1980-1982 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,105 (Sept. 3, 1980); *In re Lincolnwood Commodities, Inc. of California*, [1982-1984 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,986 (CFTC 1984); *Gilbert v. Refco, Inc.*, CFTC, No. 87-R223 (June 27, 1991).

Suitability

Neither the Commodity Exchange Act nor CFTC regulations impose suitability requirements on the futures industry.

NFA has adopted a “know your customer” rule instead of a suitability rule. NFA Compliance Rule 2-30 requires that futures commission merchants (FCM), introducing brokers (IB), commodity trading advisors (CTA) and their associated persons (AP) obtain certain information from the customer prior to his opening an account. Specifically, the rule requires that the NFA Member FCM, IB or CTA, or Associate (AP) obtain:

- 1) the customer’s true name and address and his or her principal occupation or business;
- 2) the customer’s current estimated annual income and net worth;
- 3) the customer’s approximate age; and
- 4) an indication of the customer’s previous investment and futures trading experience.

Once this information is obtained, the rule requires the broker to provide each new customer with risk disclosure which includes, *at a minimum*, the risk disclosure statements required by CFTC regulations. The rule clearly recognizes, however, that the information obtained from some customers will show that they need a greater explanation of the risks involved in futures trading and that for some customers the only adequate risk disclosure is to tell them that futures trading is too risky for them. Once that has been done, each customer is free to make the decision whether to trade futures or commodity options. The rule does not require the customer to inform the broker of material changes in his financial condition after the account is opened and the firm has no duty to monitor a customer’s financial condition.

An NFA Member can be held by the Business Conduct Committee to be in violation of NFA Compliance Rule 2-30 without a finding of specific intent. However, a number of cases have held that a violation of the rules of a self-regulatory organization such as NFA does not create a private cause of action in the absence of a finding of fraud although it may demonstrate negligence or failure to supervise.

See *Phacelli v. ContiCommodity Services*, [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,250 (CFTC 1986); *Jensen v. Shearson Hayden Stone*, [1980-1982 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,324 (CFTC 1981); *Merrill Lynch, Pierce, Fenner & Smith v. Goldman*, 593 F. 2d 129 (8th Cir. 1979), *cert. denied*, 444 U. S. 838 (1979).

Misrepresentations About and Failure to Disclose Risk

The anti-fraud provision of Section 4b of the Commodity Exchange Act (7 U.S.C. § 6b) prohibits misrepresentation and non-disclosure of or downplaying of risks involved in futures and options transactions. CFTC regulations require most commodity professionals to provide prescribed risk disclosure documents to their customers. However, merely providing the risk disclosure document is not sufficient if oral representations are made that are inconsistent with or downplay the risk disclosure document or if other material facts involving the transaction are not disclosed.

See *Miller v. Kirch*, [1980-1982 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,488 (CFTC 1982); *Gordon v. Shearson Hayden Stone, Inc.*, [1980-1982 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,016 (CFTC 1980); CFTC Regulations §§ 1.55, 4.21, 4.31 and 33.7 (17 C.F.R. §§ 1.55, 4.21, 4.31 and 33.7).

High Pressure Sales

High-pressure sales tactics are violations of the anti-fraud provision of Section 4b of the Commodity Exchange Act (7 U.S.C. § 6b).

Securities case law defines high-pressure sales tactics as follows:

An offering to a customer of securities of certain issuers in large volume by means of an intensive selling campaign by telephone or direct mail, without regard to the suitability to the needs of the customer, in such a manner as to induce a hasty decision to buy the security being offered without disclosure of the material facts.

The definition is essentially the same for futures. Futures cases emphasize that high-pressure sales are characterized by the broker's emphasis on selling as large a volume as possible without regard to the needs of customers, the soundness of the investments themselves, or the accuracy and completeness of representations made to induce customer investment. In such situations, the broker generally stresses the urgency of the investment and the need to take immediate action, creating an impression that the customer is allowing quick and easy profits to slip through his fingers unless he acts immediately.

See CFTC v. Crown Colony Commodity Options, Ltd., 434 F. Supp. 911, (S.D.N.Y. 1977); *In re Apache Trading Corporation*, 2 Comm. Fut. L. Rep. (CCH) ¶ 24,413 (CFTC 1989).

Unauthorized Trading

CFTC Regulation § 166.2 (17 C.F.R. § 166.2) provides that no FCM, IB or AP may directly or indirectly effect a transaction in a commodity interest for the account of any customer unless, before the transaction, the customer or a person designated by the customer to control the account:

- 1) instructed the FCM, IB or AP to make the trade, specifying the type of contract, the number of contracts and whether to buy or sell; or
- 2) authorized in writing the FCM, IB or AP to make trades in the account without the customer's specific authorization.

Unless the person making the trades has been given discretion over the account, a showing that the trades were not authorized in advance will generally sustain an authorized trading claim. However, if the customer ratified the trades in question, or if the claim is based on trades that were liquidated because the account was undermargined, the claim will generally not be sustained. In addition, unauthorized trading can arise in a case involving a discretionary account if the customer limited the scope of the broker's authority and the broker exceeded those limits.

Liability for unauthorized trades is based on the lack of authorization and does not depend on a showing that the trades were unfair. Similarly, it is not necessary to show that the defendant acted with an evil motive or an intent to injure the customer.

See Baker v. Edward E. Jones & Co., [1975-1977 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,241 (CFTC 1976), *rev'd* [1980-1982 Transfer Binder] ¶ 21,167 (CFTC 1981); *In re John S. Morris*, 34 Agric. Dec. 316 (1975); *In re Douglas Steen*, 21 Agric. Dec. 1076 (1962); *Smith v. Murlas Commodities*, [1987-1990 Transfer Binder] Comm. Fut. L. Rep. ¶ 24,439 (CFTC 1989).

Order Execution

A broker is obligated to get the customer the best execution possible given market conditions. A broker is liable for breach of contract if he or she negligently executes (or fails to execute) an order and the customer would have gotten a better fill but for the broker's negligence.

Unlike the securities industry, however, there is no specialist system in the futures industry and no one is obligated to make a market or to ensure that there is a buyer for every would-be seller (or vice versa). In fact, it is generally illegal for a broker to take the other side of an order the broker has been given to execute, to fill an order in the back office or anywhere outside the designated trading area on the exchange, or to execute the order at a price not trading in the designated trading area at the time.

Where order execution is an issue, the arbitrators will probably want to see copies of the office orders, the floor orders, and the "time and sales" or "time and price" records kept by the exchange for that particular contract.

See also the summary on FCM Liability for Floor Orders, page 22.

See Commodity Exchange Act §§ 4a, 4b, 4c (7 U.S.C. §§ 6a, 6b, 6c) and CFTC Regulations 155.2-155.4 (17 C.F.R. §§ 155.2-155.4).

Improper Liquidation/Margin Claims

Commodity futures contracts are traded on margin, a concept that should not be confused with margin trading in the securities industry. The latter constitutes an extension of credit by a broker that is secured by the securities of the customer. In contrast, margin for commodity futures is a good faith deposit of money that is designed to assure performance of the contract by the parties.

Futures margins are designed to protect the FCM and the entire clearing system from insolvency losses which would harm firms and other customers. Accordingly, case law generally gives the FCM wide latitude in liquidating a customer's undermargined account. An FCM may, but is not required to, liquidate a customer's account immediately upon a customer's failure to post margin. An FCM is not generally liable unless its decision to liquidate or not liquidate was arbitrary, unreasonable or wrongful. In addition, most customer agreements give the FCM the authority to change margin requirements and liquidate undermargined accounts on little or no notice.

See Modern Settings, Inc., et al. v. Prudential-Bache Securities, Inc., et. al., No. 83 Civ. 6291 (RLC) (S.D.N.Y. 1989), [1987-1990 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,595 (1989); *Olmos v. Golding, et al.*, No. 88 C 8366 (N. D. Ill. 1989), [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,893 (1989).

Failure to Supervise

CFTC Regulation 166.3 (17 C.F.R. § 166.3) requires futures professionals to properly supervise persons under their direction and control. Generally, a person has fulfilled this responsibility, and will not be liable for failure to supervise, if:

- 1) procedures have been established (where practical) that would reasonably be expected to prevent or detect the wrongful conduct;
- 2) the person has reasonably discharged the duties and obligations imposed upon him/her by the procedures; and
- 3) the person does not know, and does not have reason to know, about the wrongful conduct.

Where a person fails to follow procedures in areas central to his or her responsibilities that, if followed, would have revealed the wrongful conduct, or where the person knows or has reason to suspect the wrongful conduct and does not even investigate it, that person has probably violated CFTC Regulation 166.3. However, a number of cases have held that CFTC Regulation 166.3 does not create a private right of action.

See CFTC v. Commodities Fluctuations Systems, 583 F. Supp. 1382 (S.D.N.Y. 1984); *In the Matter of GNP Commodities, Inc.*, [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 25,360 (CFTC 1992); *In the Matter of Interstate Securities Corporation*, [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 25,295 (CFTC 1992); *Riddick v. Shearson Lehman/American Express, Inc.*, [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,478 (CFTC 1985); *Bennett v. E. F. Hutton Co.*, 597 F. Supp. 1547 (N.D. Ohio 1984).

Breach of Fiduciary Duty

A breach of fiduciary duty owed to a customer by a commodity professional is a violation of the anti-fraud provisions of Section 4b of the Commodity Exchange Act (7 U.S.C. § 6b) if it involves scienter. In other words, the arbitrators must find that the respondent's wrongful acts were committed intentionally or with reckless disregard for his duties under the Act.

A person has an obligation to disclose material information to a party with whom he has a fiduciary relationship. However, the nature of the fiduciary duty to disclose may vary depending on the nature of the relationship with the customer and the degree of trust and confidence of the customer in the broker.

A fiduciary relationship does not arise merely because a commodity professional offers advice and counsel upon which the customer has a right to place trust and confidence. However, where the commodity professional is handling a discretionary account, he becomes the fiduciary of his customer in a broad sense. In this instance, the commodity professional must:

- 1) manage the account in a manner consistent with the customer's stated needs and objectives or the needs and objectives apparent from the customer's investment and trading history;
- 2) keep informed regarding the changes in the market that affect his customer's interest and act responsibly to protect those interests;

- 3) keep his customer informed as to each completed transaction; and
- 4) explain forthrightly the practical impact and potential risks of the trading strategy the commodity professional is engaged in on behalf of the customer.

See Refco, Inc. v. Troika Investment Limited, 702 F. Supp. 684 (N.D.Ill. 1988); *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Boeck*, 377 N.W. 2d 605 (N.D. Wis. 1985); *Hammond v. Smith Barney Harris Upham & Company, Inc., et al.*, [1987-1990 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,617 (CFTC 1990).

Excessive Commission Rates

Neither the Commodity Exchange Act nor CFTC regulations specifically regulate commission rates. High commission rates do not themselves violate the anti-fraud provisions of Section 4b of the Commodity Exchange Act (7 U.S.C. § 6b). As long as the terms and the fees are made known to the customer and the customer is willing to pay the fees, the level of those fees in and of themselves will not constitute *per se* fraud. However, it is a violation of Section 4b to misrepresent or intentionally not disclose the effect of those commission rates on the potential profitability of futures and options transactions.

Even though high commission rates may not themselves be a violation of the Act, they may be used to help prove other types of violations. For example, high commission rates increase commission-to-equity ratios and may contribute to churning.

See Sundet v. First Commodity Corporation of Boston, [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,287 at 29,451-452 (CFTC 1984); *Schreider v. Rouse Woodstock, Inc., et al.*, [1984-1986 Transfer Binder], Comm. Fut. L. Rep. (CCH) ¶ 22,683 at 30,900 (CFTC 1985); *Marvin v. First National Monetary Corporation, et al.*, [1987-1990 Transfer Binder], Comm. Fut. L. Rep. (CCH) ¶ 24,190 at 34,942-943 (CFTC 1988).

Racketeering Influenced and Corrupt Organizations Act (RICO) [18 U.S.C. §§ 1961-1968]

A person injured as a result of a RICO violation can recover treble damages and reasonable attorneys' fees. In order to prove a RICO violation, the person must be able to show that he or she was injured by a person associated with an "enterprise" that has been engaging in a "pattern of racketeering," which consists of at least two "predicate acts" during a ten-year period. The list of "predicate acts" includes securities fraud, mail fraud and wire fraud but does not include commodity fraud. In some circumstances, however, conduct involving futures transactions may constitute mail fraud or wire fraud.

The legal requirements for proving a RICO violation are very complicated and vary from circuit to circuit. Therefore, the arbitrators should ask the parties to provide them with briefs on what the requirements are.

See H.J. Inc. v. Northwestern Bell Telephone Co., 492 U.S. 229 (1989); *Shearson Lehman/American Express v. McMahon*, 482 U.S. 220 (1987); *Sedima, S.P.R.L. v. Imrex Co., Inc.*, 473 U.S. 479 (1985); *Minpeco, S.A. v. Hunt*, 718 F. Supp. 168 (S.D.N.Y. 1984).

Punitive Damages

Punitive damages are assessed for the avowed purpose of punishing the defendant and deterring others from wrongdoing. To subject a party to liability for punitive damages, the arbitrators must find that the party acted with malice, ill will or conscious disregard of the consequences to others.

The size of the punitive damages award must be reasonable given the circumstances of the case. In deciding what is reasonable, the arbitrators should consider the following:

- 1) what is a reasonable relationship between the punitive damages award and the harm likely to result from the defendant's conduct as well as the harm that actually occurred;
- 2) the degree of reprehensibility of the defendant's conduct, duration of the conduct, the defendant's awareness, whether there was any concealment, and existence and frequency of similar conduct;
- 3) the profitability to the defendant of the wrongful conduct and the desirability of removing profit and of having the defendant also sustain a loss;
- 4) the financial position of the defendant;
- 5) all costs of the litigation;
- 6) the imposition of criminal sanctions on the defendant for its conduct is to be taken into account for mitigation; and
- 7) the existence of other civil awards against the same defendant for the same conduct is to be taken into account in mitigation.

Punitive damage claims are generally arbitrable under the Federal Arbitration Act (9 U.S.C. § 1 *et seq.*), and Section 11 of NFA's Code of Arbitration and the Member Arbitration Rules allows an NFA arbitration panel to award punitive damages. However, the Federal Arbitration Act is not always controlling, and certain states prohibit punitive damages as a matter of public and legal policy. In addition, the parties may have previously agreed by contract to prohibit (or allow) an award for punitive damages. If either party argues that applicable law does not allow punitive damages, or the law is different from what is stated in this brochure, the arbitrators should ask the parties to provide briefs discussing what law applies and whether it prohibits punitive damages. Moreover, if the arbitrators have any question whether a contract between the parties controls whether an award for punitive damages is allowed or prohibited, the arbitrators should ask the parties to brief this issue.

See Pacific Mutual Life Insurance Co. v. Haslip, 499 U.S. 1 (1991); *Mastrobono v. Shearson Lehman Hutton, Inc.*, 514 U.S. 52 (1995); *Lee v. Chica*, 983 F. 2d 883 (8th Cir. 1993); *Barbier v. Shearson Lehman Hutton, Inc.*, 948 F. 2d 117 (2nd Cir. 1991); *Todd Shipyards Corporation v. Cunard Lines, Ltd.*, 943 F. 2d 1056 (9th Cir. 1991); *Fahnstock & Co., Inc. v. Waltman*, 935 F. 2d 512 (2nd Cir. 1991); *Raytheon Company v. Automated Business Systems, Inc.*, 882 F. 2d 6 (1st Cir. 1989); *Willoughby Roofing & Supply Co. v. Kajima International, Inc.*, 598 F. Supp. 353 (N.D. Ala. 1989), *aff'd* 776 F. 2d 269 (11th Cir. 1989); *Garrity v. Lyle Stuart, Inc.*, 353 N.E. 2d 793 (1976).

Clearing Firm Responsibility for Introduced Accounts

Section 2(a)(1)(A) of the Commodity Exchange Act provides *respondeat superior* and general principal/agent standards for imposing liability on employers and principals for acts of their employees or agents. Futures case law has held that the issue of whether one entity is acting as an agent for another turns on an overall assessment of the totality of the circumstances in each case. This case-by-case approach to agency issues under the Act emphasizes that if it can be shown that an IB is a de facto branch office of an FCM, the FCM may be deemed to be primarily liable for a failure to supervise that IB as well as vicariously liable for the acts of the IB.

Issues of FCM liability may arise in connection with two types of IBs:

- 1) independent IBs which maintain adjusted net capital equal to or in excess of the greater of \$30,000 or a specific dollar amount for each office operated by the IB or for each AP sponsored by the IB; or
- 2) guaranteed IBs which, rather than maintain adjusted net capital, operate pursuant to a valid guarantee agreement.

The fact that an IB is “independent” does not mean that it cannot be held to be an agent of an FCM. Rather, the arbitrator must look at all of the facts to determine whether there is an agency relationship.

Certain factors are not sufficient to establish that an IB is an agent of an FCM. For example, an agency relationship is not established if the IB and the FCM work as “independent business entities” and the only services the FCM provides to the IB are “back office” services (e.g., calculating margin and net equity and collecting margin) and sending confirmation, purchase and sale, and monthly statements directly to the customers that had been “introduced” by the IB to the carrying FCM.

With respect to guaranteed IBs, the guarantee agreement between the FCM and the IB provides that the FCM will be jointly and severally liable to the customers of that IB for the IB’s obligations under the Act or any CFTC regulations. When determining FCM liability for the actions of the FCM’s guaranteed IBs, the arbitrators must resolve only two issues:

- 1) whether the alleged conduct of the guaranteed IB involved an obligation of the IB under the Act or any CFTC regulations; and
- 2) whether the conduct occurred while the guarantee agreement was in effect.

If the answer to both questions is “yes,” the FCM is liable.

See Reed v. Sage Group, Inc., [1987-1990 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,943 (CFTC 1987); *Bogard v. Abraham-Rietz & Co.*, [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,273 (CFTC 1984).

Sufficiency of Service of Process

Section 16 of NFA's Code of Arbitration and Section 15 of NFA's Member Arbitration Rules provide that service of process may be accomplished by hand delivery or by first class or certified mail or by use of a generally recognized overnight delivery service to the party's last known business or home address on record with NFA (or on a party's representative if the party has already appeared in the arbitration and has notified NFA that it is represented). NFA serves the Demand on the respondents by certified mail and sends other materials to the respondents by regular mail. Except for a Demand, whenever parties serve documents on NFA they are also required to serve them on all other parties who have appeared in the arbitration by filing a Demand or Answer.

Under NFA Bylaw 301(i), NFA Members are required to promptly notify NFA of any change of address for themselves or their registered Associates, and NFA is entitled to rely on the most current address when serving a Demand. CFTC Regulation 3.30 requires all registrants to notify NFA of any change of address while registered with the CFTC *and within two years after registration ceases*, and allows NFA to accomplish service by serving a Demand at the last address reported to NFA. If NFA serves the Demand at this address and at any other address NFA has reason to believe the person may be at, an award should be enforced by the courts, even if the person served never receives the Demand and does not have actual knowledge of the arbitration proceeding. However, serving the Demand on a different address or on the person's employer may not be sufficient.

The question of whether a party has been properly served with a Demand for Arbitration will usually, although not always, be decided in a state court. In general, the sufficiency of process can only be raised by the person who claims he or she did not receive the Demand. The person who claims that service was adequate must prove by a preponderance of the evidence that the other person was properly served.

See Ruffolo v. Oppenheimer & Co., Inc., [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 25,368 (D.C.N.Y. 1992); *Green Point Savings Bank v. Taylor*, 460 NYS 2d 121, 92 A.D. 2d 910 (1983); *Frank v. La Bounty*, 275 Ill. App. 30 (1935).

Attorneys' Fees

Attorneys' fees cannot be given to someone just because he or she wins the case. Attorneys' fees can only be awarded in the following situations:

- 1) the parties had a contract which provides for attorneys' fees, in which case the arbitrators must look to the contract to see whether attorneys' fees can be awarded under the circumstances involved in the particular arbitration proceeding;
- 2) the party receiving attorneys' fees recovered damages under a statute that provides for attorneys' fees (e.g., RICO); or
- 3) the party who must pay the attorneys' fees filed a frivolous or bad faith claim, raised a frivolous or bad faith defense, or engaged in willful acts of bad faith during the arbitration. [NFA Code of Arbitration Section 12, NFA Member Arbitration Rules Section 12.]

Before awarding attorneys' fees, the arbitrators should request a detailed account of the attorney's time and expenses broken down by categories (e.g., preparing and filing an answer, requesting and responding to discovery, preparing for hearing, attending the hearing). Since attorneys' fees can include the fees of more than one attorney and of paralegals who worked on the case, the detailed account should show who put in the hours and the party requesting the fees should specify an hourly rate for each individual.

The attorneys' fees awarded by the arbitrators must be reasonable. In other words, if the arbitrators believe that the attorney or the attorney's staff spent unnecessary time on the case or spent a large amount of time developing an unsuccessful legal theory, or if the requested hourly rate is not commercially justified, the arbitrators should adjust the hours or the hourly rate before awarding attorneys' fees. In reaching this decision, the arbitrators may consider the normal hourly rate for an attorney or paralegal but is not bound by that rate. If the attorney is paid a salary (for example, because the attorney is employed by the party who will receive attorney's fees), the arbitrators must decide what a commercially reasonable rate would be. The arbitrators may ask the parties to submit arguments on what is commercially reasonable.

See City of Riverside v. Rivera, 477 U.S. 561 (1986); *Alyeska Pipeline Service Co. v. Wilderness Society*, 421 U.S. 240 (1975).

Subpoenas

Under NFA's Code of Arbitration and Member Arbitration Rules, Section 9(d)(7), the panel may issue subpoenas to non-Members as authorized by law. The Federal Arbitration Act gives arbitrators the authority to issue subpoenas to compel non-parties to testify before the arbitrators. It also gives the arbitrators authority to issue subpoenas for books and records. See 9 U.S.C. § 7.

If the person served with the subpoena will not comply voluntarily, the party who requested the subpoena will have to go to court to enforce it. If federal courts have jurisdiction, they can order a non-party to appear at an arbitration hearing if, and only if, the hearing is held within 100 miles of where the non-party lives or works. See U.S.C.S. Fed. Rules Civ. Proc. 45. In most cases, however, the subpoena will have to be enforced in a state court. While the actual reach of the subpoena may vary from state to state, a state court cannot enforce a subpoena outside its own boundaries. Therefore, the non-party witness will have to live or work in the state where the hearing is held in order for a state court to compel his or her attendance.

The Application of Law to Arbitrators' Decisions

Arbitrators are not required or expected to independently research the law in order to make their decision and are not obliged to know what the law is with respect to the issues presented by the parties. It is the parties' responsibility to research, present and argue the law in their case.

However, if the arbitrators know what the law is, or if the parties argue the law to the arbitrators and the arbitrators have no reason to believe the law was argued incorrectly, they are bound to follow or apply it. Some courts will vacate an award if the arbitrators know what the law is but intentionally choose not to apply it.

See Executive Life Insurance Company of New York v. Alexander Insurance Limited, 1993 U.S. App. LEXIS 17227 (8th Cir. 1993); *National Wrecking Company v. International Brotherhood of Teamsters*, 990 F. 2d 957 (7th Cir. 1992); *Folkways Music Publishers, Inc. v. Weiss*, 989 F. 2d 108 (2nd Cir. 1993); *McIlroy v. PaineWebber, Inc.*, 989 F. 2d 817 (5th Cir. 1993).

FCM Liability for Floor Orders

FCMs are generally liable for negligence by floor brokers for acts within the scope of a floor broker's employment or agency with an FCM. Commodity Exchange Act Section 17(b)(10)(C) [7 U.S.C. § 21(b)(10)(C)] also permits customers to recover *actual* damages through arbitration against an FCM for a floor broker's violations of the Act and of exchange rules. The FCM has liability for the acts of an independent floor broker as well as its own employee providing the customer proves:

- 1) the FCM selected the floor broker;
- 2) the floor broker was an employee or agent of the FCM;
- 3) the floor broker executed or failed to execute the customer's order that proximately caused the customer damage; and
- 4) the floor broker was acting within the scope of his employment or agency.

The customer does not need to name the floor broker as a party to the action against the FCM. Furthermore, if an award has already been entered against the floor broker, the customer does not need to prove the floor broker's violation. The customer does not need to attempt to collect against the floor broker first before pursuing the FCM for damages.

Arbitrators are authorized to award punitive damages against an FCM of up to twice the amount of actual damages. In a case involving punitive damages, the customer must first have obtained an award against the floor broker and attempted to recover against the floor broker or must include the floor broker in his action against the FCM. In addition to the elements of proof required for actual damages, the customer is also required to prove that the FCM willfully and intentionally selected the floor broker with the intent to assist in or facilitate the floor broker's violation.

Written or Oral Settlements

Written or oral settlements are governed by contract law. In order to constitute an enforceable settlement agreement, there must be literally nothing left to negotiate or settle so that all that remained to be done was to sign an agreement. In deciding whether a settlement agreement should be enforced, the arbitrators must consider the following:

- 1) whether all the terms of the alleged agreement have been agreed upon (e.g., a meeting of the minds has been reached);
- 2) whether there has been consideration or partial performance on the settlement agreement;
- 3) if the agreement is oral, whether there has been an express reservation of a right not to be found in the absence of a writing (e.g., whether the agreement was conditioned upon a writing);
- 4) if the agreement is oral, whether the agreement at issue is the type of contract that is usually committed to writing; and
- 5) whether the attorney or representative of the party had authority to negotiate the settlement agreement.

Generally, oral agreements are enforceable in both federal and state courts unless the parties expressly agreed that there would be a writing before the settlement could be deemed final. A party who has agreed to an oral settlement cannot simply change his mind before the settlement is reduced to writing.

See Taylor v. Gordon Flesch Co., 793 F. 2d 858, 862 (7th Cir. 1985); *Glass v. Rock Island Refining Corp.*, 788 F. 2d 450, 455 (7th Cir 1986); *Dhaliwal v. Woods Division*, 52 Fair Emp. Practices (BNA) 1303, 1305-06 (N.D. Ill. 1990); *Winston v. Media Fare Entertainment Corp.*, 777 F. 2d 78, 80 (2d Cir. 1985).

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