

**COMMODITY FUTURES CONTRACTS  
FOR AG LAWYERS**

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## TABLE OF CONTENTS

I. INTRODUCTION.....	1
II. OVERVIEW OF COMMODITY FUTURES REGULATION.....	1
A. Commodity Futures Trading Commission.....	1
B. National Futures Association.....	1
C. Designated Contract Markets.....	1
III. CUSTOMER FUNDS PROTECTION.....	1
A. Recent FCM Failures.....	1
1. MF Global, Inc. Insolvency.....	2
2. Peregrine Financial Group Bankruptcy.....	2
B. Regulatory Safeguards in Place Prior to MF Global Failure and Recent Enhancements.....	2
1. FCM Minimum Capital Requirements.....	2
2. Segregation of Customer Funds.....	3
3. NFA Financial Requirements Section 16.....	3
4. NFA Financial Requirements Section 4.....	3
5. Investment of Customer Funds.....	3
6. CFTC Rules Enacted in 2013.....	3
C. CME Group Family Farmer and Rancher Protection Fund.....	4
D. Bankruptcy Protection for Customer Funds.....	4
IV. CUSTOMER/BROKER DISPUTES.....	5
A. Choice of Forum.....	5
1. Pre-dispute Arbitration Agreements.....	5
2. Forum Selection/Venue Clauses.....	6
3. National Futures Association Arbitration.....	6
4. Commodity Futures Trading Commission Reparations Program.....	7
5. Exchange Arbitration.....	8
6. State or Federal Court Proceedings.....	8
7. Other Arbitration Forums.....	8
B. Potential Causes of Action.....	8
1. Unauthorized trading.....	8
2. Churning.....	8
3. Misrepresentation/Fraud.....	8
V. CFTC REGISTRATION ISSUES FOR AGRIBUSINESS FIRMS.....	9
A. The Forward Contract Exclusion.....	9
B. Activities That Require Registration as a Commodity Trading Advisor ("CTA").....	9
1. Exemptions.....	9
2. Services That May Require CTA Registration.....	10
C. Activities That Require Registration as a Futures Commission Merchant ("FCM") or Introducing Broker ("IB").....	10
1. Definitions.....	10
2. Services That May Require FCM or IB Registration.....	10
3. CFTC Enforcement Actions Against Grain Elevators Acting as Unregistered FCMs.....	10
APPENDIX A – NFA Arbitration Statistics.....	13



# COMMODITY FUTURES CONTRACTS FOR AG LAWYERS

## I. INTRODUCTION

This article provides an overview of commodity futures regulation, with an emphasis on issues that are relevant to agricultural producers. Topics include the enhanced regulatory protections for customer funds that were enacted in response to recent brokerage insolvencies, options for resolving customer-broker disputes and CFTC interpretive letters and disciplinary actions arising in the agriculture context.

## II. OVERVIEW OF COMMODITY FUTURES REGULATION

Futures contracts on agricultural commodities have been traded in the U.S. for more than 100 years. Federal regulation of the commodities markets began with the enactment of the Grain Futures Act in 1922.

### A. Commodity Futures Trading Commission

The Commodity Futures Trading Commission ("CFTC") is a federal agency that was created by Congress in 1974 to regulate the futures industry. The CFTC's responsibilities include protecting market participants from manipulation, abusive trade practices and fraud.

With certain exceptions, the Commodity Exchange Act ("CEA"), 7 U.S.C. ¶ 1 et seq. confers exclusive jurisdiction on the CFTC to regulate "transactions involving contracts of sale of a commodity for future delivery." 7 U.S.C. ¶ 2. Such transactions must be conducted on or subject to the rules of a board of trade designated by the CFTC as a contract market. 7 U.S.C. ¶ 6(a).

A broker that takes custody of customer funds must be licensed as a "futures commission merchant" ("FCM"). FCMs are subject to CFTC rules and regulations pertaining to regulatory capital, financial reporting, required notifications and customer protection. Other registration categories include introducing brokers, commodity trading advisors, commodity pool operators, swap dealers, and major swap participants. Individuals associated with registered firms are required to register as "associated persons."

The CFTC generally functions as an "oversight" agency. While it has authority to regulate all industry registrants, routine monitoring of the industry is conducted by self-regulatory organizations which are overseen by the CFTC.

Information gathered from FCM monthly financial reports is posted on the CFTC website, [www.cftc.gov](http://www.cftc.gov).

### B. National Futures Association

The National Futures Association ("NFA"), [www.nfa.futures.org](http://www.nfa.futures.org), is the industrywide, self-regulatory organization for the U.S. futures industry. Membership in NFA is mandatory for all FCMs and substantially all CFTC registrants. NFA is an independent regulatory organization that receives no taxpayer support. It is financed exclusively from membership dues and from assessment fees paid by the users of the futures markets. NFA has authority to promulgate rules for its members, subject to review and approval from the CFTC. NFA conducts periodic compliance examinations of FCMs that are not clearing members of a futures exchange. All FCMs, including clearing members of exchanges, are subject to NFA rules.

Financial data and disciplinary history for all registrants is available on the NFA website. From the NFA home page, click on "Broker/Firm Information (BASIC)."

### C. Designated Contract Markets

Designated contract markets ("DCMs") are exchanges that have received CFTC approval to list futures or option contracts for trading. Agricultural futures contracts listed on the Chicago Board of Trade ("CBOT") include Corn, Soybeans, Soybean Oil, Soybean Meal and Wheat. Agricultural futures contracts listed on the Chicago Mercantile Exchange ("CME") include Live Cattle and Lean Hogs. Cotton futures contracts are traded on the ICE Futures U.S. exchange. Those FCMs that are clearing members of an exchange are subject to periodic compliance examinations by the exchange, rather than by NFA, although all FCMs are bound by NFA rules. Exchange clearing members are subject to additional financial requirements set forth in exchange rules.

Unlicensed persons who trade futures are also required to comply with the rules governing transactions on the exchanges, and they may be held accountable for rule violations. The rules of the commodity exchanges generally provide that any person initiating or executing a transaction and any person for whose benefit such a transaction has been initiated or executed expressly consents to the jurisdiction of the exchange and agrees to be bound by and comply with its rules including, but not limited to, rules requiring cooperation and participation in investigatory and disciplinary processes. See e.g. CME Rule 418. Sanctions for violations may include fines, temporary suspension of trading privileges, or a permanent bar from access to the exchange.

## III. CUSTOMER FUNDS PROTECTION

### A. Recent FCM Failures

Although the commodity futures industry has a long history of successfully safeguarding customer

funds, recent events have called into question the adequacy of customer funds protection.

### 1. MF Global, Inc. Insolvency

Prior to its liquidation in October, 2011, MF Global, Inc. (“MFG”) was one of the largest commodity brokerage firms in the United States, with over 50,000 accounts and \$6 billion in customer assets. It also operated a small securities broker-dealer business, with approximately 400 accounts. MFG’s Chief Executive Officer was Jon Corzine, whose previous positions included Governor of New Jersey, U.S. Senator from New Jersey, and CEO of Goldman Sachs.

On October 31, 2011, MFG reported a shortfall in customer funds to the CFTC. Although the Securities Investor Protection Act (“SIPA”) provides no protection for commodities customers and MFG’s primary business was commodities, not securities, a bankruptcy court-supervised liquidation of MFG was commenced under SIPA. See *In re MF Global Inc.*, Case No. 11-2790 in the U.S. Bankruptcy Court, Southern District of New York.

The shortfall in customer segregated accounts was attributed by the SIPA Trustee to significant transfers of funds out of the customer accounts that were used by MFG for various purposes other than to meet obligations to or on behalf of customers. Due to protections for commodity customers set forth in the bankruptcy laws, the SIPA Trustee was able to make a series of partial distributions to customers over time, and a final distribution in 2014 to satisfy MF Global’s obligation of full restitution for \$1.212 billion in losses sustained by its customers when the company failed in 2011.

### 2. Peregrine Financial Group Bankruptcy

The CFTC filed a civil injunctive complaint in federal district court on July 10, 2012, against Peregrine Financial Group, Inc. (“PFG”), a registered FCM, and its Chief Executive Officer and sole owner, Russell R. Wasendorf, Sr., alleging that PFG and Wasendorf, Sr. committed fraud by misappropriating customer funds, violated customer fund segregation laws, and made false statements regarding the amount of funds in customer segregated accounts in financial statements filed with the CFTC. See *U. S. Commodity Futures Trading Commission v. Peregrine Financial Group, Inc. and Russell R. Wasendorf, Sr.*, Case No. 12-05383, Northern District of Illinois. The complaint states that in July 2012 during an NFA examination PFG falsely represented that it held in excess of \$220 million of customer funds when in fact it held approximately \$5.1 million.

According to Wasendorf’s plea agreement in a related criminal proceeding, he deceived PFG’s regulator, the NFA, by intercepting its requests for

confirmation of PFG’s bank balances using a post office box he set up in the name of U.S. Bank. See *United States v. Russell R. Wasendorf, Sr.*, Case No. CR 12-2021, Northern District of Iowa.

On July 10, 2012, PFG filed a Chapter 7 petition in the U.S. Bankruptcy Court for the Northern District of Illinois. See *In re Peregrine Financial Group, Inc. dba PFG Best*, Case No. 12-27488. Customers of PFG have received a partial distribution of their funds through the bankruptcy court. Customers who traded on US exchanges are scheduled to receive approximately 60% of their account value, and customers who traded on foreign exchanges have received full reimbursement of their account value.

## **B. Regulatory Safeguards in Place Prior to MF Global Failure and Recent Enhancements**

### 1. FCM Minimum Capital Requirements

FCMs are subject to minimum capital requirements. In theory, this capital is available as a cushion to protect customers in the event that a loss is incurred by a fellow customer that exceeds that customer’s margin deposit. Minimum capital requirements for FCMs are set forth in CFTC Rule 1.17 (17 CFR 1.17).

Pursuant to Rule 1.17, FCMs must maintain “Adjusted Net Capital” equal to or in excess of the greatest of the following:

- (1) \$1,000,000;
- (2) The futures commission merchant's risk-based capital requirement, computed as eight percent of the total risk margin requirement for positions carried by the futures commission merchant in customer accounts and noncustomer accounts; or
- (3) For those FCMs that are also registered securities broker-dealers, the amount of net capital required by Rule 15c3-1(a) of the Securities and Exchange Commission (17 CFR 240.15c3-1(a)).

Those FCMs that are also clearing members of the CBOT or CME are subject to additional exchange minimum capital requirements of \$5,000,000 for non-bank FCMs or \$5,000,000,000 for bank FCMs.

A futures commission merchant that is not in compliance with CFTC minimum capital requirements must transfer all customer accounts and immediately cease doing business as an FCM until such time as the firm is able to demonstrate such compliance. A recent amendment to CFTC Rule 1.17 broadened the duty to transfer all customer accounts and cease doing business to cover any FCM “who cannot certify to the Commission immediately upon request and demonstrate with verifiable evidence that it has

sufficient access to liquidity to continue operating as a going concern.”

## 2. Segregation of Customer Funds

### a. **Customers trading on U.S. Exchanges.**

Section 4d(a)(2) of the Commodity Exchange Act, 7 U.S.C. ¶ 6d(a)(2), and CFTC Rule 1.20 require FCMs to separately account for all funds accepted from customers for trading on U.S. exchanges. When an FCM deposits funds with a bank, another FCM or an exchange clearing organization they must obtain a written acknowledgement from the recipient that the funds are segregated for customers of the FCM. While the funds of all of the FCM’s customers may be commingled in one account for convenience, one customer’s funds may not be used to meet obligations of the FCM or any other customer.

### b. **Customers Trading on Foreign Futures Exchanges.**

Pursuant to CFTC Rule 30.7, funds of U.S. customers trading on foreign futures exchanges are accounted for separately in a “Foreign Futures and Options Secured Amount Account.” A futures commission merchant must obtain a written acknowledgment from each depository prior to or contemporaneously with the opening of an account by the FCM with such depository.

## 3. NFA Financial Requirements Section 16

NFA Financial Requirements Section 16 was approved by the CFTC on July 13, 2012. Under Section 16, FCMs must:

- Hold sufficient funds in Rule 30.7 secured accounts to meet their total obligations to customers trading on foreign markets. FCMs are no longer allowed to use an alternative calculation method, which allowed FCMs to set aside a lower amount.
- Maintain written policies and procedures governing the maintenance of excess (i.e., proprietary or residual) funds in customer segregated accounts and Part 30 secured accounts. FCMs customarily “top up” customer funds with additional firm money, in order to cover any potential loss incurred by a customer in excess of his margin deposit. Any withdrawals that are in excess of 25 percent of the excess segregated or Part 30 secured funds that are not for the benefit of customers must be pre-approved in writing by senior management.
- File notice with NFA of any withdrawal of 25 percent or more of the excess segregated or Rule 30.7 secured amount funds that are not for the benefit of customers.

- File on a daily basis with the NFA segregation and Part 30 secured amount computations.
- File with the NFA detailed information regarding the depositories holding customer funds and the investments made with customer funds as of the 15th and last business day of each month.
- File with the NFA additional monthly net capital and leverage information.

## 4. NFA Financial Requirements Section 4

NFA has implemented new rules that require FCMs to instruct all depositories for customer segregated and secured funds to report customer funds balances to a third party vendor selected by NFA.

## 5. Investment of Customer Funds

FCMs are permitted to invest customer funds in permitted instruments and retain any appreciation resulting from such investments. MF Global incurred substantial losses from investments in foreign sovereign debt. CFTC Rules 1.25 and 30.7 were amended in December 2011 to remove from the list of permitted investments corporate debt obligations not guaranteed by the United States and foreign sovereign debt. See *Investment of Customer Funds and Funds Held in an Account for Foreign Futures and Foreign Options Transactions*, 76 Fed.Reg. 78776 (Dec. 19, 2011).

## 6. CFTC Rules Enacted in 2013

On November 14, 2013, the CFTC promulgated a massive overhaul of its customer protection rules, *Enhancing Protections Afforded Customers and Customer Funds Held by Futures Commission Merchants and Derivatives Clearing Organizations*, 78 Fed.Reg. 68506.

### a. **FCM Capital Charges for Outstanding Margin Calls**

CFTC Rule 1.17 was amended to require FCMs to take a capital charge for margin calls outstanding more than one day, rather than the previous three-day practice. As a result of this new requirement, grain and livestock producers may need to maintain excess funds with their brokers in order to ensure that accounts are fully margined at all times, causing an added financial burden for producers.

### b. **Qualifications of Accountants**

FCMs are required to obtain annual audits of their financial statements. Following the failure of Peregrine Financial Group, it was reported that PFG’s outside auditor was a home-based solo practitioner with limited relevant experience. Changes to CFTC Rule 1.16 provide that “a certified public accountant engaged to conduct an examination of a futures

commission merchant must be registered with the Public Company Accounting Oversight Board and must have undergone an examination by the Public Company Accounting Oversight Board, and may not be subject to a permanent or temporary bar to engage in the examination of public issuers or brokers or dealers registered with the Securities and Exchange Commission as a result of a Public Company Accounting Oversight Board disciplinary hearing.”

#### c. Disclosures to Customers

Revisions to CFTC Rule 1.55(b) require an FCM to provide a statement that: (1) customer funds are not protected by insurance in the event of the bankruptcy or insolvency of the FCM, or if customer funds are misappropriated in the event of fraud; (2) customer funds are not protected by the Securities Investor Protection Corporation (“SIPC”), even if the FCM is a broker-dealer registered with the SEC; (3) customer funds are not insured by a derivatives clearing organization (“DCO”) (such as the CME clearinghouse) in the event of the bankruptcy or insolvency of the FCM holding the customer funds; (4) each customer’s funds are not held in an individual segregated account by an FCM, but rather are commingled in one or more accounts; (5) FCMs may invest funds deposited by customers in investments listed in CFTC Rule 1.25; and (6) funds deposited by customers may be deposited with affiliated entities of the FCM, including affiliated banks and brokers.

In addition, the revised rule requires each FCM to provide a detailed firm specific disclosure document that addresses firm specific information regarding its business, operations, risk profile, and affiliates that would be material to a customer’s decision to entrust funds to and do business with the FCM. This information is required to be posted on the firm’s website and updated at least annually.

#### d. FCM Risk Management Program

CFTC Rule 1.11 mandates that each futures commission merchant establish, maintain, and enforce a system of risk management policies and procedures designed to monitor and manage the risks associated with the activities of the FCM. The risk management unit must be independent of the business unit of the FCM that is responsible for handling customer funds.

### C. CME Group Family Farmer and Rancher Protection Fund

Commodity customer funds are not protected by SIPC, even if the FCM is also a broker-dealer registered with the SEC. The MF Global trustee was appointed by SIPC, even though SIPC was only responsible for paying claims to a small fraction of MF Global’s customers. The futures industry has been studying the feasibility of implementing an insurance

program similar to SIPC, but no proposals have been adopted to date.

In April 2012, CME Group established a \$100 million Family Farmer and Rancher Protection Fund to provide further protection of customer segregated funds for U.S. family farmers and ranchers who use CME Group markets to hedge their crops and livestock. Under the terms of the Family Farmer and Rancher Protection Fund, farmers and ranchers using CME Group products will be eligible for up to \$25,000 per participant in the case of losses resulting from the future insolvency of a clearing member or other market participant. Farming and ranching cooperatives also will be eligible for up to \$100,000 per cooperative. If losses in a future failure total more than \$100 million, participants will be eligible for a pro-rata share of the fund, up to \$100 million.

Clearing members and eligible family farmers, ranchers and agricultural cooperatives must register in advance with CME Group and provide certain documentation in order to substantiate their eligibility. However, following the insolvency of Peregrine Financial Group, CME Group accepted retroactive applications from farmers, ranchers and agricultural co-operatives to register for benefits.

### D. Bankruptcy Protection for Customer Funds

The commodity broker bankruptcy provisions are set forth in Chapter 7, Subchapter IV of the Bankruptcy Code, 11 U.S.C. §761. Subchapter IV is captioned “Commodity Broker Liquidation.” When the debtor is also a securities broker-dealer (such as in the MF Global case), SIPC may seek a liquidation proceeding under the Securities Investor Protection Act (“SIPA”). Under 15 U.S.C. § 78eee, a SIPA liquidation shall be removed to the U.S. Bankruptcy Court after the appointment of the Trustee, but the case does not lose its character as a SIPA liquidation. A SIPA “liquidation proceeding shall be conducted in accordance with, and as though it were being conducted under chapters 1, 3, and 5 and subchapters I and II of chapter 7 of title 11 of the United States Code.” 15 U.S.C. § 78fff. If the debtor is a commodity broker, the Trustee shall have the duties specified in subchapter IV of chapter 7. 15 U.S.C. § 78fff-1.

Public customers of a commodity broker have a priority in bankruptcy. If there is a shortfall in customer segregated funds, 11 U.S.C. § 766(h) imposes a duty upon the trustee to distribute “customer property” to the rightful customers in preference to substantially all other claims:

“Except as provided in subsection (b) of this section, the trustee shall distribute customer property ratably to customers on the basis and to the extent of such customers’ allowed net equity claims, and in priority to all other

claims, except claims of a kind specified in section 507 (a)(2) of this title that are attributable to the administration of customer property.”

Section 20(a) of the Commodity Exchange Act empowers the CFTC to define “customer property,” to establish the “method by which the business of such commodity broker is to be conducted or liquidated after the filing of the petition,” and to prescribe “how the net equity of a customer is to be determined.” 7 U.S.C. § 24(a). The CFTC has promulgated detailed regulations pursuant to this statutory grant of authority. Under CFTC Rule 190.08 (17 C.F.R. 190.08), “customer property” is defined to include all property of the debtor’s estate, to the extent that property set aside for customers is insufficient to satisfy in full all claims of public customers.

#### IV. CUSTOMER/BROKER DISPUTES

##### A. Choice of Forum

A customer with a complaint against his broker will generally have more than one option for pursuing his claim. Depending upon the circumstances, the customer may be entitled to file a lawsuit in state or federal court, a “reparations” complaint before the CFTC, or an arbitration claim before the NFA, a commodity exchange or a private arbitration forum such as the American Arbitration Association.

##### 1. Pre-dispute Arbitration Agreements

The choices available to a customer may be limited by a pre-dispute arbitration agreement. The package of account-opening forms provided by an FCM to its customers generally includes an arbitration agreement. However, CFTC Rule 166.5, 17 CFR 166.5, places significant restrictions on the terms of pre-dispute arbitration agreements.

Under Rule 166.5, arbitration agreements must be voluntary. Signing an arbitration agreement must not be made a condition for a customer to open an account or otherwise utilize the services of a CFTC registrant. The arbitration agreement must disclose this fact in large boldface type.

Customers signing an arbitration agreement must be given a choice of three arbitration forums when a dispute arises. The list must include:

- “(A) The designated contract market, if applicable and if available, upon which the transaction giving rise to the dispute was executed or could have been executed;
- (B) A registered futures association; and
- (C) At least one other organization that will provide the customer with the opportunity to select the location of the

arbitration proceeding from among several major cities in diverse geographic regions and that will provide the customer with the choice of a panel or other decision-maker composed of at least one or more persons, of which at least a majority are not members or associated with a member of the designated contract market, if applicable, or employee thereof, and that are not otherwise associated with the designated contract market (mixed panel), if applicable...”

The requirement in Rule 166.5 to offer the customer a choice of a non-member or “mixed” panel is intended to alleviate the perception that industry arbitration panels are stacked in favor of the industry. However, a customer’s attorney should not assume that a mixed panel is more advantageous in all cases. Arbitration panelists who are affiliated with the industry may have relevant expertise that would be helpful in deciding the claim, and in many cases, they have no tolerance for the “bad apples” that tarnish the reputation of the industry.

A pre-dispute arbitration agreement may not require any customer to waive the right to file a “reparations” complaint with the CFTC pursuant to Section 14 of the Commodity Exchange Act, 7 U.S.C. ¶ 18 and CFTC Rule 12.13. The arbitration agreement must advise the customer in writing that he or she may seek reparations by an election made within 45 days after the CFTC registrant notifies the customer that arbitration will be demanded under the agreement. The customer must also be advised that if he or she seeks reparations and the CFTC declines to institute reparations proceedings, the claim or grievance will be subject to the pre-existing arbitration agreement and aspects of the claim or grievance that are not subject to the reparations procedure (i.e., do not constitute a violation of the CEA or the rules thereunder) may be required to be submitted to arbitration.

The restrictions on the terms of arbitration agreements do not apply to customers that are deemed to be “Eligible Contract Participants” as defined in 7 U.S.C. ¶ 1a(18). A person who is an Eligible Contract Participant may negotiate any term of an agreement or understanding with a CFTC registrant in which the Eligible Contract Participant agrees, prior to the time a claim or grievance arises, to submit such claim or grievance to any settlement procedure provided for in the agreement.

An agricultural producer will qualify as an Eligible Contract Participant if it has a net worth exceeding \$1,000,000 and enters into an agreement, contract, or transaction in connection with the conduct of the entity’s business or to manage the risk associated

with an asset or liability owned or incurred or reasonably likely to be owned or incurred by the entity in the conduct of the entity's business. See 7 U.S.C. ¶ 1a(18)(A)(v)(III). A typical commodity futures account agreement entered into for hedging purposes by a producer with a net worth exceeding \$1,000,000 would satisfy the foregoing criteria.

## 2. Forum Selection/Venue Clauses

The standard customer agreement used by most FCMs will contain a provision requiring all disputes to be resolved in the state and city in which the FCM is headquartered, typically either New York or Chicago. Courts generally enforce such agreements. If the customer claim is arbitrated, the arbitration forum may enforce this provision.

## 3. National Futures Association Arbitration

The majority of customer-broker disputes are resolved through NFA arbitration. NFA arbitration is mandatory for member firms if arbitration is demanded by a customer, even if the customer declined to sign a pre-dispute arbitration agreement when the account was opened.

### a. **Filing a Claim**

Arbitration is generally mandatory for any dispute for which arbitration is sought by a customer against an NFA member firm or employee thereof, or an NFA Associate (a person whose registration is sponsored by a member firm). Filing fees and hearing fees are paid by the claimant and based on the size of the claim. A claim for \$100,000 in damages requires a filing fee of \$1050 and a hearing fee of \$1275. The respondent is assessed a service fee when the answer to the arbitration claim is filed. For claims of more than \$50,000 and up to \$100,000, the service fee is \$275. For claims exceeding \$100,000, the service fee is \$675. The cost of the arbitration program is subsidized by the NFA, and all arbitrators agree to serve for a nominal fee. For these reasons, the costs to the parties are substantially lower than the costs incurred in a typical American Arbitration Association ("AAA") arbitration.

At the time of filing a claim, the customer may elect a "member" panel consisting of three persons affiliated with NFA members (attorneys in private practice who perform a significant amount of work representing members are deemed member panelists) or a "mixed" panel including a chairman and at least one other arbitrator who are not affiliated with NFA members. The arbitrators are appointed by the Secretary of the NFA and can only be challenged for cause, such as any circumstances likely to affect an arbitrator's impartiality, including any bias or any financial interest in the result of the arbitration or any past or present relationship with a party. Prior to

appointment, the arbitrators are screened for conflicts of interest.

### b. **Counterclaims, Cross-Claims and Third-Party Claims**

A counterclaim, cross-claim or third-party claim may be asserted in an arbitration brought under the NFA Code of Arbitration ("NFA Code") if the counterclaim, cross-claim or third-party claim arises out of an act or transaction that is the subject of the claim. *NFA Code Section 2.*

### c. **Time Period for Filing Claims**

No arbitration claim may be arbitrated before the NFA unless an arbitration claim or a notice of intent to arbitrate is received by NFA within two years from the date when the party filing the claim knew or should have known of the act or transaction that is the subject of the controversy. To be arbitrable, counterclaims, cross-claims and third-party claims must be asserted in a timely filed answer. *NFA Code Section 5.*

### d. **Pre-Hearing Dismissal of Claims**

The arbitrators have the authority to dismiss, without prejudice, any claim which is not a proper subject for NFA arbitration. *NFA Code Section 6(o).* For example, arbitrators could dismiss an arbitration claim if witnesses or documents essential to a fair and final decision are unavailable, or if some of the parties are not subject to NFA jurisdiction.

### e. **Motion Practice**

Motions to dismiss for failing to state a claim will not be heard by the arbitration panel. Other motions to dismiss must be included in a timely filed answer or reply. Motions for summary judgment may be raised at any time. Motions for directed verdict may be raised at the hearing. To discourage the filing of frivolous motions, a party filing a motion more than 100 days after the last pleading is due will generally be required to pay a filing fee. Motions are generally decided on written submissions or by telephone conference.

### f. **Discovery**

No depositions are permitted. "The parties shall cooperate, without resort to issuance of subpoenas, in the voluntary exchange of material and relevant documents and written information which may serve to facilitate a fair, equitable and expeditious hearing." *NFA Code Section 8(a)(1).* NFA Arbitration Department staff prepare an initial list of documents, tailored to the facts of the case, which the parties are required to produce. After the initial document exchange, the parties may serve "requests for documents and written information."

At least ten days prior to the hearing date, the parties are required to serve their opponents with

copies of all documents they intend to offer into evidence, and a copy must be provided to the NFA.

The parties are also required to prepare a written hearing plan. The hearing plan summarizes each claim; identifies any facts the parties have agreed to; identifies the factual and legal issues in dispute; and lists the witnesses and exhibits that will be presented at the hearing. The hearing plan is due no later than 30 days before the oral hearing date, unless the Panel directs otherwise. *NFA Code Section 8(c)*.

#### **g. Right to Counsel**

A party may be represented at any time throughout the arbitration proceeding by an attorney licensed to practice law in the highest court of any state, by a family member or other person who is representing the party without compensation and who does not have an interest in the outcome of the proceeding, or by an officer, partner or employee of the party. *NFA Code Section 7*. It is not unusual for a claimant to pursue a smaller claim without the assistance of an attorney, and many claims have been successfully pursued without the benefit of legal representation. However, claimants should keep in mind that the respondents are likely to be represented by attorneys who are very experienced in NFA arbitration.

#### **h. Location of Hearing**

Arbitration hearings are generally scheduled at the city nearest to the customer's residence, provided that NFA can locate qualified arbitrators. The NFA Code, Section 9, provides that "the place and time of the hearing shall be determined in the sole discretion of the Secretary, who shall endeavor to accommodate, if possible, the preferences of all parties as indicated in a timely-filed pleading." However, it is the experience of the author that if the parties' preferences are not the same, the preference of the customer will generally prevail, even if the customer has signed an agreement consenting to the venue requested by the respondents.

#### **i. Conduct of the Hearing**

The typical hearing lasts 1-4 days. Opening and closing statements are permitted, and testimony is taken under oath. The proceedings are recorded. The Panel has wide discretion in the conduct of the hearing and need not apply the technical rules of evidence. The Panel may issue subpoenas to compel testimony and production of documents.

#### **j. Summary Hearing**

The proceeding shall be conducted entirely through written submissions, as provided by *NFA Code Section 9(i)*, when:

- (i) the aggregate amount of the claims (exclusive of interest and costs) does not exceed \$25,000, unless the Secretary or the Panel directs otherwise;
- (ii) the aggregate amount of the claims (exclusive of interest and costs) is more than \$25,000 but not more than \$50,000, unless the Secretary or the Panel directs otherwise or one of the parties to the proceeding serves a written request for an oral hearing on NFA, accompanied by a fee of \$675.00, no later than 30 days after the last pleading is due; or
- (iii) the Panel has consented to the written agreement of the parties to waive the oral hearing.

#### **k. Awards**

The panel is required to issue its decision (called an "award", even if no damages are awarded) within 30 days after the closing of the record. The award may grant or deny monetary relief, and may include an assessment of interest, costs or fees. The award is not appealable, but it may be challenged on limited grounds in a state or federal court as provided under the Federal Arbitration Act, 9 U.S.C. ¶ 1 et seq. The President of NFA may suspend a member for failure to pay an award, unless a timely challenge to the award is made.

#### **l. NFA Arbitration Statistics**

NFA publishes its arbitration statistics for recent years on its website, [www.nfa.futures.org](http://www.nfa.futures.org). A report on statistics for the period January, 2011 to March, 2016 is attached to this article as Appendix A. The popularity of the program far exceeds the CFTC's reparations program, suggesting that customer attorneys perceive that the forum is fair to the customer.

#### **4. Commodity Futures Trading Commission Reparations Program**

The CFTC offers a reparations program which provides a low cost option for filing a complaint against a broker or other CFTC registrant. The reparations program is governed by 7 U.S.C. ¶ 18 and 17 CFR 12.1 et seq. Unless the customer is an Eligible Contract Participant as defined in 7 U.S.C. ¶ 1a(18) which has waived its right to file a reparations complaint, the customer may file a complaint even if a pre-dispute arbitration agreement was signed. In most cases, the filing fee is \$250, substantially less than the fees incurred in an NFA arbitration.

The CFTC's jurisdiction is limited. The customer must prove damages by reason of a violation of the Commodity Exchange Act. Breach of contract and negligence claims that may be permitted in an arbitration forum are not accepted.

Limited discovery is permitted, and cases are assigned to a judgment officer for hearing. While the CFTC's rules contemplate that cases seeking damages of \$30,000 or more will be assigned to an administrative law judge, due to budget constraints the CFTC no longer has any administrative law judges. Hearings are conducted in a manner similar to a bench trial. Hearings are held in major cities convenient to the parties.

Prior to the development of NFA's arbitration program, the reparations forum was the primary avenue of relief for customers, and there is a significant body of case law, published in the CCH Commodity Futures Law Reporter. However, in recent years very few cases have been filed with the CFTC. While NFA arbitrations are typically resolved in a little over one year, reparations cases often languish at the CFTC for several years. Hearings are not promptly scheduled, and minor procedural rulings seem to delay cases for an inordinate amount of time. If the customer prevails at the hearing, the respondents can appeal the case to the full Commission without filing an appeal bond. The CFTC may take several years to rule on an appeal, and unsuccessful appellants are entitled to a further review at the U.S. Court of Appeals for the Circuit in which the hearing was held.

#### 5. Exchange Arbitration

The commodity exchanges also provide arbitration forums for customer claims. These forums are less popular than NFA arbitration, because jurisdiction is more limited. For example, under CME rules, claims must be against members and clearing members of the exchange, associated persons of clearing members of the exchange or guaranteed introducing brokers of clearing members of the exchange and their associated persons. See *CME Rule 601*.

#### 6. State or Federal Court Proceedings

If the customer has not signed an arbitration agreement, the customer's claim may be pursued through a lawsuit in state or federal court. Under 7 U.S.C. ¶ 25, there is a private right of action for violations of the Commodity Exchange Act. Any such action must be brought not later than two years after the date the cause of action arose.

While judges are likely to be less familiar with commodities laws and industry practices than an arbitration panel or CFTC judgment officer, it may be desirable to pursue some claims in court. For example, the ability to depose witnesses or to bring claims against unregistered persons may outweigh the advantages of other forums.

#### 7. Other Arbitration Forums

If the customer demands arbitration after he has signed a pre-dispute arbitration agreement, he must be

offered a choice of arbitration forums by the CFTC registrant. In addition to NFA and exchange arbitration, other private arbitration options, such as the American Arbitration Association, may be offered to the customer. The customer who perceives that industry forums are biased in favor of the respondents may prefer the private arbitration option. In the author's experience, private forums are less likely to offer arbitrators who are knowledgeable about the futures industry.

### **B. Potential Causes of Action**

#### 1. Unauthorized trading

A broker cannot enter a trade on behalf of a customer without specific authorization to make that particular trade. CFTC Rule 166.2 prohibits a broker from directly or indirectly effecting a transaction in a commodity interest for the account of any customer unless before the transaction the customer, or person designated by the customer in writing to control the account, specifies the precise commodity interest to be purchased or sold and the exact amount of the commodity interest to be purchased or sold. Verbal grants of discretionary authority to the broker are not permitted. A written power of attorney is required before a broker or other party can control the trading of a customer account. Losses arising from unauthorized trades are the responsibility of the broker. See *Smith v. Murlas Commodities*, Comm. Fut. L. Rep. (CCH) ¶ 24,439 (CFTC 1989).

#### 2. Churning

Churning is excessive trading conducted for the primary purpose of generating commissions. Damages for churning are normally limited to the amount of commissions charged to the account. The customer must prove that the respondent controlled the account, either by power of attorney, or de facto control. See *Gilbert v. Refco, Inc.*, Comm. Fut. L. Rep. (CCH) ¶ 25,081 (CFTC 1991).

#### 3. Misrepresentation/Fraud

Intentional misrepresentation of the risks of trading may constitute fraud, in violation of Section 4(b) of the Commodity Exchange Act, (7 U.S.C. § 6b). Proof of scienter is generally required. See *Hammond v. Smith Barney Harris Upham & Company, Inc., et al.*, Comm. Fut. L. Rep. (CCH) ¶ 24,617 (CFTC 1990).

A customer may assert that material facts were not disclosed to him prior to his investment. Failure to disclose material facts is a form of fraud. In cases involving failure to disclose a material fact, there is a rebuttable presumption that the customer relied. To rebut the presumption, respondent must persuade the fact finder that the customer would have invested even if he had known the material facts. *Hall v. Paine Webber Jackson & Curtis, Inc.*, Comm. Fut. L. Rep.

(CCH) ¶23,317, at 32,889 (CFTC 1986). The customer's full out-of-pocket loss is the measure of damages in a fraudulent inducement case. *Stern v. G.H. Miller & Co.*, Comm. Fut. L. Rep. (CCH) ¶25,338, (CFTC July 21, 1992).

A departure from an agreed upon trading strategy may also constitute fraud. In *McIlroy v. Dittmer*, 732 F.2d 98, 104 (8th Cir. Ark. 1984) the court found that a "commodity brokerage firm which agrees to trade a customer's account in a particular way must trade the account in the agreed upon way," and failure to do so breaches the firm's fiduciary duty and violates section 4b of the Commodity Exchange Act.

## V. CFTC REGISTRATION ISSUES FOR AGRIBUSINESS FIRMS

Many business activities in the farm community are related, directly or indirectly, to the commodity futures markets. Certain activities may trigger registration requirements.

### A. The Forward Contract Exclusion

Commodity futures trading is a necessary component of risk management for most agribusiness firms, and cash commodities are often purchased and sold under agreements where the price is determined by reference to an exchange traded commodity futures price. In most cases these transactions are not within the scope of the CFTC's jurisdiction. The Commodity Exchange Act prohibits "transactions involving contracts of sale of a commodity for future delivery" unless conducted on or subject to the rules of a board of trade designated by the CFTC as a contract market. 7 U.S.C. ¶ 6(a). However, the term "future delivery" does not include "any sale of any cash commodity for deferred shipment or delivery." 7 U.S.C. ¶ 1a (27). This exclusion from regulation under the CEA is commonly known as the "forward contract exclusion."

The scope of the forward contract exclusion has been examined extensively, by both the CFTC and the courts. The Commission's interpretations have emphasized the requirement to deliver the cash commodity as a distinguishing characteristic of forward contracts. See, e.g. *Characteristics Distinguishing Cash and Forward Contracts and "Trade" Options*, Comm. Fut. L. Rep. (CCH) ¶ 22,718 (Office of General Counsel, September 30, 1985); *Statutory Interpretation Concerning Forward Transactions*, 55 Fed. Reg. 39188 (September 25, 1990).

The distinctions between forward contracts and futures were addressed by the U.S. Court of Appeals for the Seventh Circuit in *Lachmund v. ADM Investor Services*, 191 F.3d 777,786 (7th Cir. 1999)(citations omitted):

"Cash forward contracts permit parties who contemplate the physical transfer of a commodity to guarantee themselves, prior to the time of delivery, a buyer (or a seller) at a particular price, even though convenience or necessity requires delayed delivery or shipment. The CEA's prohibition of off-exchange contracts for "future delivery" seeks to regulate not this type of contract for the actual physical transfer of a commodity, but instead transactions driven by price speculation."

In several instances, the CFTC has charged firms with illegal marketing of off-exchange futures contracts, and failure to register as a futures commission merchant. See e.g. *In the Matter of Competitive Strategies for Agriculture, Ltd. et al.* Comm. Fut. L. Rep. (CCH) ¶ 27,771 (September 17, 1999) (CFTC Order accepting settlement).

### B. Activities That Require Registration as a Commodity Trading Advisor ("CTA")

A CTA is any person who, for compensation or profit, advises others, directly or through publications, writings or electronic media, as to the value of or the advisability of trading in futures contracts or swap contracts. 7 U.S.C. ¶1a(12). Registration is required unless an exemption is available under 7 U.S.C. ¶ 6m.

#### 1. Exemptions

CFTC Rule 4.14(a)(9) exempts persons who provide standardized advice, such as market newsletter publishers, Internet websites and trading system vendors, from registration as long as they do not direct client accounts or provide commodity trading advice that is based on a particular client's circumstances.

Section 4m(1) of the CEA, 7 U.S.C. ¶6m(1), exempts from registration "any commodity trading advisor who, during the course of the preceding twelve months, has not furnished commodity trading advice to more than fifteen persons and who does not hold himself out generally to the public as a commodity trading advisor." This exemption is narrowly construed.

Unless the CTA restricts his clients to family, friends and existing business associates, he will generally be viewed as "holding himself out to the public" as a CTA. See *CFTC Interpretative Letter No. 91-9*, Commodity Futures Law Reporter (CCH) ¶25,189 (Dec. 26, 1991).

Use of an Internet website to promote the advisor's services would constitute a "holding out" to the public sufficient to trigger a duty to register. See *In the Matter of Summit Energy Services*, CFTC Docket No. 15-12 (January 16, 2015) (available on CFTC website).

Section 4m(1) of the CEA also exempts any "commodity trading advisor who is a (1) dealer, processor, broker, or seller in cash market transactions of any [agricultural] commodity... (2) nonprofit, voluntary membership general farm organization, who provides advice on the sale or purchase of any [agricultural] commodity... if the advice by the person ...is solely incidental to the conduct of that person's business..." .

This exemption is frequently relied upon by the agriculture industry. Advice regarding futures trading is more likely to be deemed incidental by the CFTC when the advice is provided solely for hedging purposes and not for speculation; the advice is not provided to persons who are not customers of the advisor's primary business; there is no extra charge for customers using the advisory services; the advisor does not solicit customers for its advisory service or hold itself out to the public as a CTA; and the advisor does not restrict the customer's choice of brokerage firm.

## 2. Services That May Require CTA Registration

### a. *CFTC Letter 97-91*

An Agricultural Marketing Service was compensated based upon the total bushels of grain produced by its clients. The Service proposed to offer marketing strategies that would include cash contracts as well as futures and options. The CFTC's Division of Trading and Markets ("the Division") found that, if the service recommends the use of commodity futures or options contracts to achieve the client's goals, CTA registration is required. (CFTC Interpretive Letters are available on CFTC website).

### b. *CFTC Letter 98-07*

A business that proposed to teach farmers how to hedge, through trends and using futures, and that would furnish services by fax, seminars and face-to-face interviews for a flat fee was required to register as a CTA.

### c. *CFTC Letter 99-07*

A firm that provided consulting services to country grain elevators proposed to offer hedging advice to grain producers. The Division advised the firm that CTA registration was required in order to offer hedging advice.

## C. **Activities That Require Registration as a Futures Commission Merchant ("FCM") or Introducing Broker ("IB")**

### 1. Definitions

An FCM is any person who solicits or accepts orders for the purchase or sale of a commodity for future delivery and who accepts money, securities or property, or extends credit to margin, guarantee or secure the trades. 7 U.S.C. 1a(28). The solicitation of

an account is deemed the solicitation of an order. See 48 Fed. Reg. 35248, 35250 (August 3, 1983) Registration of FCMs is required by 7 U.S.C. ¶6d(a).

The definition of an IB parallels the FCM definition, except that an introducing broker does not accept customer funds, other than funds payable to a futures commission merchant.

Individuals who are registered with FCMs or IBs as "Associated Persons" ("APs") are not required to register as IBs.

In general, anyone who recommends a broker and receives direct or indirect compensation from the broker is required to register as an IB. Some examples:

## 2. Services That May Require FCM or IB Registration

### a. *CFTC Letter 99-28*

A grain elevator which referred farmers to an FCM's agricultural marketing system (which included using exchange traded futures and options to hedge) and which was to receive referral fees from the FCM had to register as an IB.

### b. *CFTC Letter 99-02*

A sponsor of a futures-related seminar who furnishes a list of attendees to an FCM or IB and who in turn receives discounted commissions or cross-referrals from the broker would be required to register as an IB.

### c. *CFTC Letter 99-07*

A firm that provided consulting services to country grain elevators proposed to promote a hedging service for grain producers. The hedging service would place trades through an account in its own name with a futures commission merchant. The hedging service would initially be responsible for margin payments, but ultimately its customers would be responsible for the profit or loss arising from the transactions. The CFTC staff found that these activities would clearly bring it within the statutory definition of an FCM.

## 3. CFTC Enforcement Actions Against Grain Elevators Acting as Unregistered FCMs

### a. *Gage's Fertilizer & Grain, Inc.*

During the years 2004-2008, in the regular course of its grain elevator business, Gage's Fertilizer solicited and accepted orders from customers for the purchase and sale of commodity option contracts and, in connection with those orders, accepted money from or extended credit to its customers. It then executed and commingled its customers' option contracts in one of Gage's Fertilizer's proprietary trading accounts at one of three FCMs. It billed its customers more than \$315,000 in brokerage fees for the transactions.

Gage's Fertilizer mailed each customer a comprehensive, monthly invoice detailing all of his/her

transactions. These invoices included farm equipment and supply charges, as well as option trades, trading profits and losses, and brokerage fees.

The CFTC charged Gage's Fertilizer with failing to register as a futures commission merchant and charged its President, Steven W. Gage, with failure to register as an associated person of Gage's Fertilizer. The Respondents consented to a CFTC order requiring payment of a \$75,000 civil penalty and disgorgement of \$100,000 of wrongfully obtained profits. See *In the Matter of Gage's Fertilizer & Grain, Inc. and Steven W. Gage*, CFTC Docket No. 10-13, (July 22, 2010) (available on CFTC website).

b. Cameron Charles/Watseka Farmers Grain Co.

On June 18, 2008, the CFTC obtained a consent order of permanent injunction requiring Cameron Charles ("Charles") of Watseka, Illinois, to pay \$100,000 in civil monetary penalties, and permanently prohibiting him from engaging in any commodity futures trading on behalf of himself or others or applying for registration, claiming exemption from registration or engaging in any activity requiring registration with the CFTC. *CFTC v. Cameron Charles*, Case No. 2:05-CV-02144 in the U.S. District Court for the Central District of Illinois.

The CFTC alleged that Charles defrauded his employer, Watseka Farmers Grain Co. Cooperative ("Watseka"), by engaging in unauthorized and illegal speculative trading on its behalf, and that Charles illegally acted as an associated person by accepting and executing futures trades for farmers through Watseka's trading account without proper registration with the CFTC, thereby making Watseka serve as an unwitting unregistered FCM. The futures trades were allegedly documented as hedge to arrive ("HTA") contracts, a type of cash grain contract that is priced by reference to a futures contract, in order to conceal the speculative nature of the trades.

Watseka was a small grain elevator formed by local farmers to market their corn and soybean crops. As Watseka's manager, Charles' responsibilities included hedging Watseka's grain positions on the futures market and reporting such positions to the Illinois Department of Agriculture.

During 2004, Charles allegedly caused Watseka to accumulate a one million bushel speculative long soybean futures position in the Cooperative's hedge account, which he concealed from Watseka's Board of Directors and the Illinois Department of Agriculture by falsifying Watseka's records. The CFTC alleged that Watseka was subject to a 25,000 bushel speculative position limit under the Illinois Grain Code, 240 ILCS 40/10-10. In mid-May 2004, the soybean futures market declined sharply and Watseka received margin calls that it could not meet, forcing the co-op into liquidation.

Charles also pleaded guilty to felony violations of the Illinois Grain Code.



## APPENDIX A



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[Home](#) > [Arbitration and Mediation](#) > **Arbitration Statistics**

### Arbitration Statistics

As of March 31, 2016

#### Cases Filed

Calendar Year	Customer <sup>1</sup>	Member <sup>2</sup>	Total
2016	4	0	4
2015	39	7	46
2014	21	8	29
2013	43	5	48
2012	71	10	81
2011	79	9	88

#### Cases Closed

Calendar Year	Customer	Member	Total
2016	5	1	6
2015	32	6	38
2014	40	6	46
2013	47	9	56
2012	97	8	105
2011	124	13	137

#### Turnaround Time (in months)

Calendar Year	Oral Hearings	Summary Proceedings <sup>3</sup>	Overall <sup>4</sup>
2016	N/A	N/A	7.1
2015	13.9	6.4	5.1
2014	15.5	6.6	6.7
2013	9.5	6.2	6.7
2012	16.8	7.1	6.7
2011	15.4	7.07	12.1

**Number of Closed Cases by Reason<sup>5</sup>**

Calendar Year	Hearings			Settlements	Other <sup>6</sup>
	Oral	Summaries	All		
2016	0	0	0	5	1
2015	2	3	5	16	17
2014	4	6	10	22	14
2013	10	4	14	21	21
2012	14	8	22	35	48
2011	27	31	58	38	41

**Percentage of Closed Cases by Reason**

Calendar Year	Hearings	Settlements	Other <sup>7</sup>
2016	0%	83%	17%
2015	13%	42%	45%
2014	22%	48%	30%
2013	25%	38%	37%
2012	21%	33%	46%
2011	42%	28%	30%

**Awards in Customer Cases**

Calendar Year	Total Awards <sup>8</sup>	Awards to Customers <sup>9</sup>	Average % of Compensatory Claim <sup>10</sup>
2016	0	N/A	N/A
2015	4	2	87%
2014	5	3	12%
2013	11	4	48%
2012	17	6	65%
2011	58	31	79%

<sup>1</sup> These are cases where at least one party is a public customer.

<sup>2</sup> These are primarily cases between and among NFA Members and Associates. None of them involve public customers.

<sup>3</sup> Summary proceedings are decided without an oral hearing and are based on the pleadings and exhibits submitted by the parties.

<sup>4</sup> This is all closed cases, including cases that settle and those that are rejected, withdrawn, or terminated for other reasons.

<sup>5</sup> All cases - Customer and Member.

<sup>6</sup> These are cases that are rejected, withdrawn, or terminated for other reasons (e.g., bankruptcy).

<sup>7</sup> These are cases that are rejected, withdrawn, or terminated for other reasons (e.g., bankruptcy).

<sup>8</sup> All customer cases with a decision, including cases where the customer lost.

<sup>9</sup> Does not include awards where customers were given costs and fees only.

<sup>10</sup> Only in cases where customers received an award.

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