U.S. COMMODITY FUTURES TRADING COMMISSION
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Office of Proceedings

PROKOSCH FARMS, INC.,
Complainant,

v.

DEAN MICHAEL HEFFTA, and
WATER STREET ADVISORY, INC.
Respondents.

CFTC Docket No. 16-R017
Served electronically

ORDER GRANTING SANCTIONS AGAINST RESPONDENTS FOR SPOLIATION

Complainant, Prokosch Farms, Inc. (PFI), seeks to recover lost profits due to the alleged failure of Respondents, Dean Michael Heffta and Water Street Advisory, Inc. (WSA), to liquidate its corn put options by the first week of October 2014 as Dale Prokosch, the President of PFI, directed. This failure purportedly cost PFI $241,777.74. However, PFI argues that its ability to prevail on its complaint is prejudiced by the fact that Respondents destroyed most of the phone conversation recordings that occurred during the pendency of their business relationship, which lasted from November 2013 through November 2014. PFI alleges that Respondents retained only phone conversations from October 2014. To this end, PFI moved for spoliation sanctions against Respondents on October 18, 2017. *See* Complainant's Motion for Sanctions & Marshall Decl. (Oct. 18, 2017). In its Sanctions Motion, PFI

requested that either a default judgment be awarded against the Respondents, or in the alternative, that this Office draw an adverse inference in favor of Complainant's allegations due to the missing evidence. Sanctions Motion at 1-2.

The filing of the Sanctions Motions precipitated a flurry of activity on this docket. Each party filed numerous memoranda, including post-hearing briefs, and several affidavits of affirmative testimony in support of their respective positions.[1] I held a hearing on the motion on January 18, 2018, during which I permitted cross-examination and re-direct of Darren Frye, WSA's Chief Executive Officer (CEO); and Michele Chapin, the Chief Compliance Officer (CCO).[2]

There is thus comprehensive evidence as to what happened to the missing phone recordings and the Respondents' state of mind.[3] After carefully reviewing this evidence, I conclude that Respondents were on notice that they had a duty to preserve the entirety of the 2013 and 2014 communications; they nonetheless destroyed them; and they did so with a culpable state of mind.

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[1] *See, e.g.*, Response (Oct. 31, 2017) & Motion for Leave to File Affidavit of Michele Chapin (Nov. 16, 2017); Chapin Affidavit (Nov. 16, 2017); Supp. Chapin Aff. (Dec. 11, 2017); Frye Aff. (Dec. 11, 2017); Heffta Aff. (Dec. 11, 2017); Claimant's Reply Mem. in Supp. of Sanctions Motion & Supp. Marshall Decl. (Nov. 28, 2017); Prokosch Decl. (Nov. 28, 2017);

[2] In an email dated December 11, 2017, I found that Heffta's affidavit was not relevant to the spoliation motion and disallowed him from serving as a witness for the spoliation hearing. In a second email dated January 17, 2018, I ordered that Mr. Frye and Ms. Chapin be sequestered while they were testifying to preserve the credibility and quality of the testimonial evidence.

[3] For the sake of convenience, I frequently refer to Respondents' state of mind and conduct throughout this Opinion and Order as encompassing the named Respondents as well as WSA's CEO and CCO, both registered Principals of WSA.

I. COMPLAINT ALLEGATIONS[4]

PFI, a farming operation, markets corn to three elevators and soybeans to two seed companies. Compl. at 2. On November 21, 2013, PFI retained Heffta and WSA as a consultant to provide it a hedging strategy for its 2014 harvest. *Id.* at 1. It paid WSA $7,500 to create this strategy. *Id.*

According to Dale Prokosch, Heffta repeatedly informed PFI that his strategy would be to exit PFI's put options by the first week of October. *Id.* To that end, PFI placed $81,312.40 in its futures account, held at ADM—a registered futures commission merchant—between January 2, 2014 and May 1, 2014. *Id.* at 2. PFI withdrew that same amount between June and August 2014, leaving $113,818.78 in the account. *Id.*

On August 23, 2014, Heffta sent Prokosch an email containing a graph of corn seasonal prices, noting that "time is ticking." *Id.* Then on September 4, Heffta, Prokosch, and Tim Schactrup (also of WSA) met at Prokosch's farm to discuss PFI's final exit, which would occur the first week of October. *Id.* Prokosch understood that the final exit day would be October 3, 2014. *Id.* at 2-3. In fact, he alleges that by way of email on October 1, 2014 and phone call on October 2, 2014, Heffta reiterated their previously agreed-to exit strategy. *Id.* at 3.

Prokosch then tended to his harvest throughout October, which according to him consumed twelve to sixteen hours a day, seven days a week. *Id.* On October 3, 2014—the date of the agreed-upon exit strategy—the market value of PFI's account

[4] These are allegations only, and have yet to be proven by a preponderance of the evidence.

was $304,590.67. *Id.* at 4. Heffta, however, did not exit the positions on that day. In fact, the positions were held well past that date and the account was closed on November 17, 2014 with just $62,812.93 remaining. *Id.* at 4-5. PFI thus alleges that Respondents' failure to honor the exit strategy caused him $241,777.74 in damages (the difference between the date on which his options should have been exited and the date the account was closed).

II. FINDINGS OF FACT REGARDING SPOLIATION[5]

By November, Prokosch believed there was something wrong with the balance of funds in his account. Accordingly, on November 9, 2014, he sent Heffta an email stating, in relevant part:

> This weekend I believe I have figured out a mistake that was made by you, Dean Heffta and/or your company Water Street Solutions. . . . You need to put your supervisor's, company's owners, and/or insurance providers on notice that I believe a mistake was made. Please be on notice that you need to save all correspondence that we have had from the beginning of our working relationship one year ago, phone calls, emails, text messages, written notes, etc.

Marshall Decl. (Oct. 18, 2017) Ex. 3 (Email from Prokosch to Heffta re Notice (Nov. 9, 2014)) (Preservation Email). This email put Respondents on notice that PFI (1) intended to seek redress for the "mistake that was made," and (2) believed Respondents were under a duty to preserve "all correspondence that we have had from the beginning of our working relationship," which began in November 2013 and continued through at least November 9, 2014. *Id.* Chapin admits that she was

[5] The facts stated in this Section with respect to the spoliation are factual findings I am making based on my review of the extensive evidence presented with respect to this issue.

provided a copy of this email on November 17, 2014, Chapin Aff. ¶ 9 (Nov. 16, 2017), and that she knew then that she was supposed to preserve documents, specifically audio recordings, Hearing Tr. at 55:18-24.

Having been put on notice that there was a dispute, and that they were to preserve documents and recordings, Chapin and Frye then undertook an internal investigation to determine whether any wrongdoing had occurred. As part of this investigation, they only reviewed documents from October 2014, despite the fact that PFI contended the entire course of communication, spanning roughly a year, was relevant. Chapin admitted that Respondents' investigation was limited to October 2014 readily and repeatedly. Hearing Tr. at 66:2-15 ("I limited myself to October, which is what the complaint was."); Chapin Aff. ¶¶ 15-17 (Nov. 16, 2017). Frye was less forthcoming. Although his sworn statement stated that he listened to recorded conversations from October 2014, Frye Aff. ¶4 (Dec. 11, 2017), he seemed to have forgotten that fact during the hearing. First he testified that he listened to calls "from late September all the way through the November time frame." Hearing Tr. at 10:2-5; 10:22-11:1. Then he testified that he did not listen to "tapes of conversations that occurred prior to the beginning of October." *Id.* at 12:11-19. Ultimately, he clarified that he only listened to October 2014 tapes. *Id.* at 13:20-23.

In addition to reviewing the October 2014 phone calls, Chapin "also considered" a November 3, 2014 email sent from Prokosch to Heffta. Chapin Aff. ¶ 18 (Nov. 16, 2017). She specifically relied on the following language from that email:

> I'm generally happy with Water Street Solutions and I think it is extremely unlikely that I find another organization that as closely matches my objectives.
>
> I want to remain on the best possible terms with you and Water Street Solutions, and would hope to return to a consulting relationship as soon as possible.

Id. ¶¶ 18, 25(iv), & Ex. D (Nov. 3, 2014 Email from Prokosch to Heffta). She apparently did not rely on the following language, contained in the very same email:

> I had been extremely happy with the progress we made, which resulted in a peak hedging account balance of $315,565.67 of unrealized profit on 9/30/2014, leaving us with a strong Working Capital Position at that time, and very confident of the direction of our operation. One month later those profits have diminished to the point we now have great concern about our Working Capital Position, at a time our debt level is at a peak as a result of a land purchased *[sic]* that was finalized less than one year ago.
>
> . . .
>
> I think we had an excellent plan in place; the positions were not exited when it was completely necessary.

Id. Ex. D (emphasis added). Perhaps because Chapin did not absorb the contradictory message of the November 3, 2014 email, she did not review any phone conversations held at the same time this email was exchanged.

Chapin and Frye's investigation led them to conclude "with certainty that no mistake or mishandling of any kind had occurred in Prokosch's account." Chapin Supp. Aff. ¶ 7 (Dec. 11, 2017) (emphasis added); Chapin Aff. ¶ 19 (Nov. 16, 2017) (noting that, in part because of the Nov. 3, 2014 Email, she "found absolutely no evidence regarding an instruction by Dale Prokosch to liquidate the position as claimed in his reparations complaint" (emphasis added)). Frye came to the same conclusion. Frye Aff. ¶ 4 (Dec. 11, 2017). In fact, Frye testified that Prokosch must

be mistaken because they had an office-wide plan to liquidate at $3.15 and corn never got there, so the phone conversations could not establish anything different. *See, e.g.*, Hearing Tr. at 11:10-18; Frye Aff. ¶10 (Dec. 11, 2017)). Thus in Frye's estimation, PFI's account could not be handled differently than the office-wide strategy in place. To that end, on December 2, 2014, Frye sent Prokosch a letter stating that "we have conducted an extensive internal review of our records and your account." Frye Aff. (Dec. 11, 2017) Ex. A. Based on that "extensive review," Frye represented that WSA had "found no violation by Water Street Advisory of NFA compliance rules." *Id.*

Prokosch disagreed with that finding, and two weeks later Respondents received notification that Prokosch complained to NFA. Marshall Decl. (received Oct. 19, 2017) Ex. 5 (Email from Chapin to Heffta re Dale Prokosch (Dec. 17, 2014)). Prokosch did not file an arbitration complaint, but his customer complaint prompted an investigation by NFA. To that end, NFA asked Respondents to provide "supporting documentation of the investigation/review that was performed surrounding this complaint, [including] email copies, telephone conversations, and the conclusion that was drawn." Marshall Decl. (received Nov. 29, 2017) Ex. 21 (Email from Da'nita White to Chapin re Complaint (Dec. 17, 2014)).

Prokosch warned NFA that the scope of WSA's investigation materials would be limited to those materials that supported WSA's version of events, comprised only of October 2014 conversations. He advised NFA:

> [B]e sure to review conversation in September; and at the time the hedges were put into place in April through August, and in November

> after the money is lost. The whole relationship I had with this individual does not add up to something that is logical to me. He will likely point toward some specific October conversations only, and try to skip over the fact that he did not do what he said he would do, at least that is the experience I had while complaining directly to him.

Marshall Supp. Decl. (Nov. 28, 2017) Ex. 23 (Email from Prokosch to NFA re Attached (Jan. 29, 2015)). Nonetheless, there is no evidence that NFA broadened its inquiry beyond WSA's own limited investigation materials.

NFA called Chapin on January 28, 2015, and informed her that unless she heard otherwise within two weeks, she could assume that NFA would be taking no further action with respect to the PFI investigation. Chapin Aff. ¶ 22 (Nov. 16, 2017). In February 2015, almost immediately following that phone call, NFA began an audit of WSA's books and records. *Id.* ¶ 23. According to Chapin, "[t]his included a review of the trading statements, order tickets, email communications and recorded conversations between Dale Prokosch and Heffta." *Id.* But both Chapin and Frye state repeatedly that this audit was completely independent of and unrelated to Prokosch's complaint. Hearing Tr. at 30:13-25 (Frye); 77:4-11 (Chapin).

NFA sent Frye a letter at the conclusion of its audit, which ended July 2015. It read, in relevant part, "Summarized below are the material deficiencies we identified in the specific items tested and discussed with you during the July 1, 2015 exit interview." Marshall Supp. Decl. (Nov. 28, 2017) Ex. 27 (Letter from NFA to Frye at 1 (July 7, 2015) (emphasis added)). One specific material deficiency it found was that "[c]ertain order tickets were not on file. Specifically, customer 034-77317 gave a broker in the main office time and price discretion on October 2, 2014, but no written order ticket was created." *Id.* at 3-4. During the hearing, it was

clarified that Customer 034-77317 was Complainant, PFI. Hearing Tr. at 63:24-64:2. Frye was unaware of this fact. Hearing Tr. at 35:15-36:21; 37:7-40:11.

Notwithstanding the fact that there was a material deficiency found as to Respondents' failure to execute PFI's trading directions, Respondents state repeatedly that NFA concluded WSA had committed no wrongdoing as to PFI. *See* Tr. at 62:5-63:17; 76:19-77:11; Chapin Aff. ¶ 24 (Nov. 16, 2017) ("NFA made no findings supporting the claim that Heffta had failed to liquidate the position in the Prokosch Farms' account."). And both Chapin and Frye's attitude towards NFA's actual audit findings was cavalier at best, dismissive at worst. Neither thinks "material deficiencies" are something serious. Frye dismisses them as "very minor," "correctible," and "no issue." Hearing Tr. at 36:14-21. He described the term "material deficiency" as NFA's "standard" way of describing problems, and something NFA "always say[s]." *Id.* Chapin stated that a material deficiency was "technically . . . a wrongdoing, [which] didn't have any impact on my findings for the claim." *Id.* at 77:12-18.

In any event, once NFA sent the deficiency letter in July 2015, WSA's CEO and CCO thought its preservation obligations were over. *See, e.g.*, Chapin Supp. Aff. ¶¶ 7-8 (Dec. 11, 2017); Frye Aff. ¶¶ 5-6 (Dec. 11, 2017). This is due to several conceded failures of understanding on the part of the Respondents.

First, Respondents did not know what their preservation obligations were. *See, e.g.*, Hearing Tr. at 19:17-20; 56:20-24, 57:11-12. Chapin stated, "After receiving the November 9 Prokosch Email, I assumed Water Street was required to

preserve documents and conversations regarding Prokosch's trading account, but I was uncertain with respect to the scope and duration." Chapin Supp. Aff. ¶ 4 (Dec. 11, 2017). Despite being "uncertain" about the extent of her preservation obligation, Chapin did not seek to inform herself what the limits or requirements of what her obligations were. She did "not speak with outside counsel regarding Water Street's obligations." Chapin Supp Aff. ¶ 4 (Dec. 11, 2017). And when I asked "What did you do to inform yourself of your legal obligations? You said you were uncertain, what did you do to become certain?" She responded "I didn't do, I didn't go outside the company, or ask any kind of counsel, or get any legal advice. We were – it wasn't an issue in my mind. . . ." Hearing Tr. at 58:12-59:6.

Second, the CEO and CCO did not know the difference between an investigation and litigation. For example, Frye testified "I wasn't aware that we needed to preserve the information past what the NFA had investigated. I didn't know that it was a matter that could go on, I did not know that, and neither would have [the CCO]." Hearing Tr. at18:21-19:1.[6] And Chapin stated that once the NFA audit concluded in July 2015, she "considered this a closed or concluded matter," Chapin Supp. Aff. ¶¶ 7-8 (Dec. 11, 2017), despite having earlier testified that NFA's audit was unrelated to PFI's complaint. They did not realize that an NFA

[6] *See also id.* at 8:17-24 (Frye) (after NFA's investigation "a year had gone by, yes, this matter was closed in my mind, and I was not aware that I had to keep the information."); *id.* at 33:9-16 (Frye) ("[Chapin] let me know that there was a complaint filed with the CFTC, and I was surprised that after looking at all of this, the year and a half previously that this was still an open situation, so I asked her to call the NFA and to ask them how they could support us, or what information, because they've already been through all this with their findings.").

investigation could not, by design, bring any relief to Complainant. Hearing Tr. at 8:18-9:1 (Frye).

Third, they were not aware that Prokosch had two years under the statute of limitations to bring a reparations complaint before the Commission. *See, e.g.*, Hearing Tr. at 18:21-22 (Frye); 21:2-12 (Frye); 68:8-25 (Chapin). This is despite the fact that the Customer Agreement, which they or their agents drafted, stated it clearly. *Id.*; Compl. Ex. A-2 at ¶22. Chapin stated that as part of her extensive investigation she reviewed the entire Customer Agreement. Hearing Tr. at 68:11-12. But when asked about the statute of limitations provision of the Customer Agreement, she dismissed it as "fine print at the bottom," which is not something she "went through." *Id.* at 69:10-14.

Finally, WSA never sought to have its CCO trained in document preservation and other matters. Chapin started as an Administrative Assistant for Compliance/New Accounts in September 2012. Chapin Aff ¶ 1 (Nov. 16, 2017). She became the Chief Compliance Officer four months later, in January 2013. *Id.* The outgoing CCO was going on maternity leave and trained Chapin to replace her. Hearing Tr. at 15:19-16:17. In terms of her training, it was informal and included "going to the FCM and reading and looking over rules and interpretations, and understanding what to do, and what not to do, and asking a lot of questions, [because] there is no formal training program that you can go to for compliance. . . ." *Id.* at 16:18-17:4. In particular, Chapin admitted she received no training on document preservation practices during litigation. *Id.* at 55:5-7.

Despite claiming to not knowing anything about WSA's preservation obligations, WSA's CEO destroyed all phone recordings between Complainant and Respondents outside the month of October 2014, well before the expiration of the statute of limitations. Frye states that in March or April 2016, "I obtained information regarding software that would automatically delete phone recordings and documents in the ordinary course of business." Frye Aff. ¶ 7 (Dec. 11, 2017). He purchased the software in June 2016, which deleted anything older than one year. *Id.*; *see also* Hearing Tr. at 43:25-45:3. Both Frye and Chapin admit that Chapin—WSA's Chief Compliance Officer—was not involved in, or even made aware of, the purchase or implementation of this software that automatically destroyed records. Frye Aff. ¶ 7 (Dec. 11, 2017); Chapin Supp. Aff. ¶ 3 (Dec. 11, 2017). He does not know the name of the document-destruction software he implemented. Hearing Tr. at 43:16-17.

Frye did make sure to save the October 2014 phone calls from automatic destruction by "stor[ing those] in a different place." Hearing Tr. at 45:3-11. Frye kept those recordings not "on the normal storage system" because "those [were] the ones that we looked at." *Id.* at 45:3-46:2. Thus WSA was capable of preserving all the evidence requested by PFI; it chose not to.

When Chapin finally discovered in the summer of 2016 that WSA implemented a new document destruction system, she was unconcerned:

> When I was informed in the late summer of 2016 that Water Street had purchased, installed and had begun to utilize document destruction software to erase conversations, I had no reservations about its use, nor did it dawn on

> me or cross my mind that this would somehow run counter to or in violation of any obligation to hold documents requested by Prokosch.

Chapin Supp. Aff. ¶ 8 (Dec. 11, 2017). Both Frye and Chapin believe that "Water Street did not destroy relevant documents" because "Water Street retained all of the recordings . . . that [it] had tendered to NFA," which "had access" to all the recordings. Frye Aff. ¶ 9 (Dec. 11, 2017); Chapin Supp. Aff. ¶ 8 (Dec. 11, 2017). PFI disagrees, and for the reasons that follow, I find Respondents' position untenable both as a matter of fact and law.

III. DISCUSSION AND LEGAL ANALYSIS

A Judgment Officer, by virtue of her inherent powers, has "broad discretion to draw adverse inferences when a party has destroyed (or concealed) evidence that is relevant to a proceeding." *In re Global Minerals & Metals Corp.*, [2003-2004 Transfer Binder] Comm. Fut. L. Rep. ¶ 29,529 at 55,285, 2003 WL 21448869, at *1 (CFTC June 24, 2003); *Cf.* 17 C.F.R. § 12.35 (authorizing decisionmaker to issue a default order or draw an inference that missing documents would have been adverse to the party, among other sanctions, for failure to comply with a discovery order). In deciding whether to draw an adverse inference, three elements must be satisfied:

> (1) The party having control over the evidence had an obligation to preserve it when it was destroyed or altered; (2) the destruction or loss was accompanied by a "culpable state of mind"; and (3) the evidence that was destroyed or altered was "relevant" to the claims or defenses of the party that sought the discovery of the spoliated evidence, to the extent that a reasonable factfinder could conclude that the lost evidence would have supported the claims or defense of the party that sought it.

Witter v. Skelton, CFTC No. 08-R045, Comm. Fut. L. Rep. ¶ 32,669, 2013 WL 3357168, at *4 (CFTC July 1, 2013) (quoting *Smith v. Napolitano*, 626 F. Supp. 2d 81, 101 (D.D.C. 2009)). However, no such inferences may be drawn "unless the destruction occurred at a time when the party had an obligation to preserve that material." *In re Global Minerals & Metals Corp.*, 2003 WL 21448869, at *2.

Each of these preconditions is met here—that is, Respondents (1) were under an obligation to preserve the evidence; (2) had control over the evidence when it was destroyed; (3) destroyed the evidence with a "culpable state of mind"; and (4) did so with evidence that would have been relevant to Claimant's allegations.

A. Respondents had a duty to preserve the evidence when it was destroyed.

"The obligation to preserve evidence begins when the party receives notice of current or future litigation as to which evidence is relevant." *Witter*, 2013 WL 3357168 at *5 (internal quotation marks and citations omitted). "Once a party reasonably anticipates litigation, it must suspend its routine document retention/destruction policy and put in place a 'litigation hold' to ensure the preservation of relevant documents." *Zubulake v. UBS Warburg LLC*, 220 F.R.D. 212, 218 (S.D.N.Y. 2003). I find that that Prokosch's November 9, 2014 email, which informed Respondents that they needed to: (1) notify their "supervisor[s], company's owners, and/or insurance providers" that "a mistake was made" with his account, and (2) "save all correspondence that we have had from the beginning of our working relationship one year ago, phone calls, emails, text messages, written notes, etc." constitutes notice of future litigation and a preservation demand. Having decided that, the two questions posed in this case are whether the evidence

that Respondents were obligated to preserve includes the pre- and post-October phone recordings, and if so, how long Respondents were required to preserve them.

1. The phone communications from November 2013 through November 2014 were relevant.

I find that the scope of Respondents' preservation obligations did include the entirety of Complainant's and Respondents' phone communications. Respondents argue that no conversations outside the October 2014 are relevant to this litigation, but that view is not supported by the controlling law. The Commission uses a broad concept of relevance when deciding what evidence is relevant in the discovery process, and it includes discovery that may not be directly relevant to the party's case-in-chief:

> Relevance in the discovery context is to be construed broadly to encompass any matter that bears on, or that reasonably could lead to other matter that could bear on, any issue that is or may be in the case. In other words, in the production and inspection of documents at the discovery stage, relevance is defined in terms of the likelihood that useful evidence may be uncovered. It must always be borne in mind that the discovery procedure is not merely for the purpose of producing evidence to be used at the trial, but also for discovery of evidence, indeed, for leads as to where evidence may be located. Moreover, in addition to discovering information pertaining to a party's case in chief, it is entirely proper to obtain information for other purposes such as cross-examination of an adverse witness.

In the Matter of Global Minerals & Metals Corp., CFTC No. 99-11, Comm. Fut. L. Rep. ¶ 28,635, 2001 WL 1002491, at *3 (CFTC 2001) (internal quotation marks and citations omitted). When this broad definition of relevance is combined with the fact that Prokosch alerted Respondents in his Preservation Email that he would be seeking the entire course of communications and not just a small subset of them, it is clear Respondents were under an obligation to preserve all the phone calls, not

just the October 2014 ones. *See Moody v. CSX Transportation, Inc.*, 271 F. Supp. 3d 410, 428 (W.D.N.Y. 2017) ("Courts routinely hold that a party's discovery obligations include taking affirmative steps to ensure that all potentially relevant evidence is retained." (emphasis added)).

In addition, WSA's CEO himself agreed that phone calls outside October 2014 could be relevant. For example, Frye testified that if Prokosch was informed in a September phone call that WSA would "get him out of his hedging position as soon as the price of corn stops going down, and he expected that would be at the beginning of October," that would be relevant. Hearing Tr. at 13:24-14:6. And regarding whether Heffta had time and price discretion regarding PFI's corn put options, when asked if he understood "that that allegation would be, could be easily resolved if we had the tapes from the November phone calls," he answered "I do. And I wish we did." Hearing Tr. at 15:5-15:8 (Frye).

There is no serious dispute that these phone calls could provide answers to questions such as what Prokosch's and Heffta's agreement was coming into October 2014; what Heffta understood about Prokosch's availability to pay attention to his corn put options during the harvest;[7] and what Prokosch communicated after he uncovered the alleged mistake by Respondents in November 2014. The phone calls could also help give context for fully understanding the communications in October 2014, and whether Prokosch ratified Heffta's failure to liquidate his corn put

[7] *See* Prokosch Aff. ¶¶ 8-12 (Nov. 29, 2017).

options according to Complainant's purported instructions. For these reasons, I find the missing phone recordings are relevant.[8]

2. Respondents were under a duty to preserve the evidence through the expiration of the statute of limitations.

I further find that the obligation to preserve evidence remained in effect through the statute of limitations period, since PFI had until that time to file a proceeding in which it could seek redress from the mistake. Respondents argue that they had no reason to think their preservation obligations extended beyond NFA's investigation, Hearing Tr. at 8:17-24 (Frye), 28:17-22 (Frye), and 59:17-21 (Chapin), but that misimpression flows from a misunderstanding about what an investigation is designed to do. An NFA investigation is designed to see whether "any NFA requirement is being, has been or is about to be violated." NFA Rule 3-2. The investigation rules say nothing about making the complainant whole for any losses stemming from such violation. In contrast, NFA has an arbitration mechanism designed to allow claimants to seek awards for purported violations of NFA rules. *See* NFA Code of Arbitration. All of these rules are publicly available on NFA's website, and any of WSA's officers could have educated themselves about the rules that govern their conduct as NFA members if they chose to do so.

In any event, Respondents' misunderstanding does not provide them safe harbor from the full duration of the limitations period. In *In re Napster, Inc. Copyright Litigation*, a defendant argued that "the probability of litigation rose and

[8] For the reasons stated in Section III.A.1, I also find that the pre- and post-October 2014 phone calls were relevant to the claims and defenses of each party.

fell as threats passed with no action being taken." 462 F. Supp. 2d 1060, 1069 (N.D. Cal. 2006). The court nevertheless found that, despite the fact that a related lawsuit was dismissed, the spoliating defendant had a continuing duty to maintain the documents. *Id.* Similarly, there was nothing to suggest that Prokosch's complaint had been addressed to his satisfaction, and there was no reason to think that the preservation obligation ended before the termination of the limitations period.[9]

And the fact that neither of them knew the limitations period, despite having included it in the Customer Agreement controlling this case, also provides them no defense. They or their agents drafted that Customer Agreement, and they cannot now invoke a burying-their-head-in-the-sand defense to avoid actual or constructive knowledge of it. For these reasons, I find that Respondents should have known they were under a duty to preserve all communications between themselves and Complainant at least through the statute of limitations period expired.

B. Respondents had control over the evidence when it was destroyed.

That Respondents had the requisite control over the evidence is not in dispute. Respondents never asserted that they did not retain control over the phone recordings at issue. In fact, Chapin testified that she kept them pursuant to her record-keeping obligations for one year. Hearing Tr. at 54:14-18. I find, therefore,

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[9] Respondents cite *Davis v. Quaker Valley School District*, 693 Fed. Appx. 131 (3d Cir. 2017) for the proposition that laymen cannot be expected to reasonably foresee a preservation duty. Resp. Supp. Br. at 2 (Jan. 23, 2018). That case is unavailing. First, the alleged spoliator in *Davis* was an elementary school teacher; not the CEO and CCO of a CFTC-registered Introducing Broker. Second, there is no evidence that the plaintiff in *Davis* sent any version of the Preservation Email that Complainant sent in this case.

that Respondents did have control over the missing telephone calls when they were destroyed.

C. Respondents destroyed the evidence with a culpable state of mind.

Respondents argue that they did not have a "culpable state of mind" because they did not nefariously intend to deprive PFI of relevant evidence to prejudice his case. Resp. Supp. Br. at 3 (Jan. 23, 2018). They assert because the destruction was "not intentional" and "not designed to suppress the truth," their misconduct cannot amount to bad faith. *Id.* at 2. These defenses are unsupported by the record.

The law regarding what constitutes a "culpable" state of mind for purposes of awarding an adverse inference in spoliation cases is evolving. Several courts found that negligence was sufficient to substantiate a "culpable state of mind." *Smith*, 626 F. Supp. 2d at 101 (noting that courts may draw adverse inferences "even if deliberate or reckless conduct is not present" (quoting *More v. Snow*, 480 F. Supp. 2d 257, 274-75 (D.D.C. 2007)).[10] Other courts require "bad faith," which includes both the deliberate and reckless destruction of evidence, in order to find that the spoliating party acted with the necessary "culpable state of mind." *See, e.g.*, *Krieger v. United States Dep't of Justice*, 529 F. Supp. 2d 29, 43 (D.D.C. 2008) ("[A]n [adverse] inference is warranted only when a plaintiff sets forth facts sufficient to demonstrate a defendant's bad faith"); *Rice v. United States*, 917 F. Supp. 17, 19

[10] *See also, e.g., Mazloum v. D.C. Metro Police Dep't*, 530 F. Supp. 2d 282, 284 (D.D.C. 2008) (same); *Residential Funding Corp. v. DeGeorge Fin. Corp.*, 306 F.3d 99, 108 (2d Cir. 2002) (same); *Arista Records LLC v. Usenet.com, Inc.*, 608 F.Supp.2d 409, 430 (S.D.N.Y. 2009) (same); *Zubulake v. UBS Warburg LLC*, 220 F.R.D. 212, 220 (S.D.N.Y. 2003) (same).

(D.D.C. 1996) ("[T]o justify the inference, the circumstances of the destruction must manifest bad faith[.]"). I conclude that even under the strictest test of culpability—that is bad faith—Respondents did destroy evidence with a "culpable state of mind."

It is undisputed that Respondents destroyed the phone recordings, despite the fact that they admitted they had received and understood the email notifying them of potential litigation. And they destroyed that evidence not negligently, but with an affirmative act of destruction when they implemented a new document destruction policy that deleted all telephone communications except those they hand-selected as part of their internal investigation. If that misconduct is not sufficiently egregious to constitute a "culpable state of mind"—no matter what the precise legal contours of culpability are—virtually no misconduct is.

Furthermore, I find Chapin's and Frye's testimony not credible for several reasons.

First, both Chapin and Frye believed only the October 2014 phone calls were relevant because that was the month on which they believed PFI's complaint focused. *See, e.g.*, Frye Aff. ¶ 10 (Dec. 11, 2017); Chapin Aff. ¶¶ 16-17, 25 (Nov. 16, 2017); Hearing Tr. at 10:22-25 (Frye); 66:9-15 (Chapin). But this belief fails to explain why they chose to ignore the customer's actual complaint email, which indicated that a year's worth of communications were relevant. It also fails to explain why Chapin relied on an email from Prokosch to Heffta in November 2014 during her investigation, Chapin Aff. ¶¶ 18, 25 (Nov. 16, 2017), but did not find it either necessary or prudent to review recorded phone calls of that same time period.

It finally fails to explain why Chapin relies on the helpful parts of Prokosch's November 3 Email to Heffta but disregards the trading grievances he outlined in the same email.

Second, both Frye and Chapin testified repeatedly that they thought their preservation obligations were over once NFA concluded its audit in July 2015. Chapin Supp. Aff. ¶8 (Nov. 16, 2017); Frye Aff. ¶6; Hearing Tr. 7:22-25 (Frye); 8:17-24 (Frye); 18:21-19:1 (Frye); 28:17-22 (Frye); 59:17-21 (Chapin); 63:9-17 (Chapin); 75:4-11 (Chapin). But Frye took pains to save WSA's cherry-picked evidence—that is the October 2014 phone calls—from WSA's new document destruction policy but allowed the remainder of the phone calls to be destroyed. If in fact he believed the matter was over, why not destroy all PFI-related communications, instead of simply those that supported WSA's conclusion?

By way of further example, Chapin and Frye insist that NFA found no wrongdoing with respect to Prokosch's claim. But this insistence fails to explain other facts established by the record, namely that NFA's audit fell on the heels of Prokosch's complaint; NFA made specific "material deficienc[y]" findings; and NFA found that PFI gave Heffta time and price discretion that WSA never implemented. Marshall Supp. Decl. (Nov. 28, 2017) Ex. 27 (NFA Letter (July 7, 2015)).

Furthermore, Chapin and Frye state that the NFA audit had nothing to do with Prokosch's complaint. Hearing Tr. at 30:13-25 (Frye); 77:4-11 (Chapin). But they use the fact that the NFA audit purportedly made no findings with respect to trading in PFI's account as evidence that the Prokosch matter was concluded. *Id.* ¶

25. But if in fact NFA's audit had nothing to do with Prokosch's complaint, how could it be reasonable for Chapin and Frye to rely on any conclusion made with respect to Prokosch in that same audit? They also, confusingly, defend the reasonableness of their document destruction by claiming that NFA had access to all of Prokosch's communications and account documents during the course of their audit, Chapin Aff. ¶ 23 (Nov. 16, 2017), which in their estimation was completely unrelated to PFI's complaint.

Third, Respondents repeatedly represented their investigation was "extensive" and "thorough," both to Complainant and this Office. *See e.g.*, Marshall Supp. Decl. (Nov. 28, 2017) Ex. 11 (Letter from Frye to Prokosch (Dec. 2, 2014)); *Id.* Ex. 12 (Email from Heffta to Prokosch re update (Nov. 20, 2014) (noting "all historical communication" is being reviewed); Hearing Tr. 9:15-18 (Frye);78:3-4 (Chapin); Chapin Supp. Aff. ¶5 (Dec. 11, 2017).[11] They argue that this characterization of their investigation is fair despite: (1) Frye's having admitted that the pre- and post-October emails could provide answers to key questions in this case, Hearing Tr. at 13:24-14:6, 15:5-8, (2) Chapin's having reviewed emails from November 2014, but not phone conversations, Chapin Aff. ¶¶ 18, 25 (Nov. 16, 2017); and (3) Chapin first testifying she reviewed the Customer Agreement, Hearing Tr. at 68:8-12, but then saying she in fact did not review all the language

[11] They even attempted to argue that "all" naturally meant only October. Hearing Tr. at 77:23-78:13.

in the Customer agreement, *id.* at 68:8-25. The record so entirely contradicts the extensiveness of their internal investigation that I simply do not find it credible.

Finally, Chapin and Frye were defensive and absolutist in their testimonial presentation. They were inconsistent (as discussed above); convinced that they had done the best job they could and were not under an obligation to do any better; and completely unwilling to acknowledge and explain the obvious deficits in their defense, namely that in fact their investigation was not extensive, that NFA did make a finding with regards to PFI's account, that the CCO should have undertaken some inquiry as to what WSA's preservation obligations were, and that the NFA audit may have had something to do with Prokosch's complaint. There are only three possible conclusions I can draw from this pattern of inconsistency, ignorance, and audacity, none of which are mutually exclusive:

(1) Frye and Chapin are incapable of fulfilling their duties as CEO and CCO;

(2) They deliberately buried their collective head in the sand by failing to inform themselves of their legal obligations to preserve relevant documents; or

(3) They are lying.

Any combination of these conclusions is sufficient to evince a "culpable state of mind," no matter what the precise legal contours of culpability are.

D. The analysis under amended Federal Rule of Civil Procedure 37 also supports imposing sanctions against Respondents.

As of December 1, 2015, Rule 37 of the Federal Rules of Civil Procedure was amended to require that in order to impose an adverse inference for "electronically stored information," the spoliator must have "acted with the intent to deprive

another party of the information's use." Fed. R. Civ. P. 37(e). In other words, the amended Rule 37(e) "rejects cases . . . that authorize the giving of adverse-inference instructions on a finding of negligence or gross negligence." *Moody*, 271 F. Supp. 3d at 425 (quoting *McIntosh v. United States*, 14-CV-7889, 2016 WL 1274585, *31 (S.D.N.Y. 2016)). Although the Federal Rules of Civil Procedure, and thus the amended Rule 37(e) are not binding, they are instructive. *See Loftin v. E.F. Hutton & Co.*, 1990 WL 294005 at *3 (CFTC Jun. 6, 1990).[12] But even using the amended Rule 37(e) and the case law standards that have developed to implement it as guidance, Respondents' misconduct meets the level of intentionality needed to impose an adverse inference here.

Courts have held that parties "acted with an intent to deprive within the meaning of Rule 37(e)(2),"where:

> (1) evidence once existed that could fairly be supposed to have been material to the proof or defense of a claim at issue in this case; (2) the spoliating party engaged in an affirmative act causing the evidence to be lost; (3) the spoliating party did so while it knew or should have known of its duty to preserve the evidence; and (4) the affirmative act causing the loss cannot be credibly explained as not involving bad faith by the reason proffered by the spoliator.

Moody, 271 F. Supp. 3d at 431 (quoting *Ala. Aircraft Indus., Inc. v. Boeing Co.*, 319 F.R.D. 730, 746 (N.D. Ala. 2017)).

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[12] To be clear, courts have inherent power to sanction parties for discovery abuses such as spoliation, as well as specific powers as defined in the applicable rules. *See, e.g., Chambers v. Nasco, Inc.*, 501 U.S. 32, 44-48 (1991) (noting that courts have inherent power to "fashion an appropriate sanction for conduct which abuses the judicial process" "even if procedural rules exist which sanction the same conduct.").

Using this four-prong test for Rule 37(e) intentionality, it is clear Respondents acted with the culpability level warranting a severe sanction. Each of these factors has been met and addressed elsewhere in this Opinion and Order. *See supra* at 15-17 (explaining factor 1, materiality of evidence); *id.* at 20 (explaining factor 2, Respondents' affirmative act of destruction); *id.* at 14-19 (explaining factor 3, Respondents' duty to preserve evidence); *id.* at 20-23 (explaining factor 4, that the loss cannot credibly be explained).

The facts in this case are not meaningfully different from those in cases where federal trial courts have awarded an adverse inference under amended Rule 37. In *Moody v. CSX Transportation*, the court found that because "defendants allowed the original data . . . to be overwritten, and destroyed or recycled," they "acted with an intent to deprive." 271 F. Supp. 3d at 431. This is true despite the fact that the *Moody* defendants, like the Respondents here, maintained that their actions were "reasonable" and they "did not act culpably." *Id.* at n. 3. Similarly, in *Alabama Aircraft Industries*, the court found an intent to deprive where only selected data was preserved according to procedure and other data was destroyed. 319 F.R.D. at 745-747. The court there found it noteworthy that "[n]o credible explanation has been given as to why" some data was lost, concluding that "[t]his type of unexplained, blatantly irresponsible behavior leads this court to conclude that [defendant] acted with the intent to deprive [plaintiff] of the use of this information in connection with its claims against [defendant]." *Id. See also, e.g.*, *Roadrunner Transportation Svcs., Inc. v. Tarwater*, 642 Fed. Appx. 759, 759-60 &

n.1 (9th Cir. 2016) (upholding imposition of default judgment as sanction for deletion of data after preservation obligations accrued); *Ottoson v. SMBC Leasing & Finance, Inc.*, 268 F. Supp. 3d 570, 579-80 (S.D.N.Y. 2017) (finding that failure to preserve evidence satisfies requisite level of intent under Amended Rule 37(e)); *Brown Jordan Int'l, Inc. v. Carmicle*, 2016 WL 815827, at *37 (March 1, 2016 S.D. Fla.), *aff'd* 846 F.3d 1167 (11th Cir. 2017) (finding an intent to deprive where defendant had no credible explanation for the failure to preserve data, especially as he was represented by counsel).

Likewise, Chapin's and Frye's excuses for affirmatively destroying all phone recordings but those that purportedly support their view of the case are too flimsy to be credible. Thus even under the amended analysis emerging under the revised Federal Rules of Civil Procedure, an adverse inference is warranted here.

E. Costs are appropriate in this case.

The Commission's reparation rules allow awarding reasonable attorneys' fees in connection with the filing of any discovery-related motion precipitated by the other party's discovery misconduct. 17 C.F.R. § 12.30(c). *See also Leal v. Prestige Capital Investments Corps.*, CFTC No. 89-R37, Comm. Fut. L. Rep. ¶ 24,489, 1989 WL 242015, at *9 (CFTC 1989) (awarding attorneys' fees where "Respondents' failure to respond to discovery was without substantial justification"). Here, but for Respondents' misconduct and their destruction of relevant evidence, Complainant would not have undertaken the costs associated with prosecuting their spoliation motion and attorneys' fees are appropriate. That this is a relatively small-value case and Respondents are a small introducing broker is irrelevant. In affirming an

award of costs in connection with motions relating to spoliation, the Second Circuit has noted "that there is no special rule requiring parties to suffer an opponent's open and notorious discovery misconduct in small value cases." *Klipsch Group, Inc. v. ePRO E-Commerce Limited*, 880 F.3d 620, 632 (2d Cir. 2018).

CONCLUSION

Although Complainant has requested a ruling in the form of a default judgment in its favor, I elect not to do so here because the lesser sanction of adverse inference, when combined with an award of attorneys' fees and costs, is sufficient to cure any prejudice to Complainant and sanction the misconduct. However, this Order addresses the Sanctions Motion only; it does not address any additional discovery abuses by Respondents that may shake out as these proceedings unfold. Respondents are on notice that should I find they have compounded their spoliation with additional abuses of the discovery process, a default judgment against them may be the only appropriate sanction remaining.

It is hereby ORDERED that, during the merits phase of this proceeding, an inference be made that the missing evidence would have been adverse to Respondents' defenses. Complainant is further ORDERED to submit an affidavit of reasonable attorneys' fees and costs associated with the filing of its Sanctions Motion no later than September 14, 2018.

Dated: August 8, 2018

Kavita Kumar Puri
Judgment Officer