CFTC Enforcement Outlook: Insider Trading

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Futures and Derivatives; CFTC; White Collar Defense and Investigations

Insider trading is a familiar term to participants in the equities markets; however, this term now has application in the swaps, futures, and commodities markets regulated by the U.S. Commodity Futures Trading Commission (CFTC). In a time of aggressive enforcement, financial market participants should be aware that insider trading is a high priority for the CFTC enforcement program.

The CFTC demonstrated its active pursuit of insider trading with its first insider trading case in October of 2015. This watershed moment was not a single event. Just recently, on September 29, 2016, the CFTC brought its second insider trading case, further demonstrating the agency's utilization of this new enforcement tool.

In this alert, we provide a detailed review of the CFTC's insider trading enforcement activity to date, as well as analogous securities case law, to provide insight into its continued application in the derivatives markets.

Market participants should consider the application of these recent CFTC insider trading enforcement actions to their business, including a review of trading procedures, internal control systems (including access to trading strategies), and compliance programs, in order to minimize the risk of a CFTC insider trading enforcement action.

The CFTC's Expanded Fraud and Manipulation Authority

Section 753 of the Dodd Frank Act prohibits "fraud and manipulation in connection with any swap, or contract of sale of any commodity in interstate commerce, or contract for future delivery."[1] Pursuant to this grant of authority, the CFTC promulgated new Rule 180.1 to "protect

[1] Dodd Frank Wall Street Reform and Customer Protection Act, Pub. L. No. 111-2031, § 753 (2010). By way of comparison, Section 10(b) of the Securities Exchange Act makes it illegal to "use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, or any securities-based swap agreement any manipulative or deceptive device or contrivance." A "contract of sale of any commodity in interstate commerce" refers to activity in the cash commodity markets and a "contract for future delivery" refers to activity in the futures markets.

market participants and promote market integrity" through expanding its insider trading enforcement powers.[2] Rule 180.1 prohibits, in part:

> trading on the basis of material, nonpublic information in breach of a pre-existing duty (established by another law or rule, or agreement, understanding, or some other source), or by trading on the basis of material nonpublic information that was obtained through fraud or deception.[3]

The CFTC intentionally mirrored the language of the U.S. Securities and Exchange Commission's (SEC) Rule 10b-5 due to its long-standing enforcement success in the securities context and its broad anti-fraud protection over securities markets. Though Rule 180.1 is modeled after Rule 10b-5, the derivatives markets operate fundamentally differently than securities markets. Trading on lawfully obtained material nonpublic information or commercial proprietary information (a market participant's own hedging information) is critical to the operation of the derivatives markets, and 180.1(b) clarifies that nothing in the rule creates an affirmative duty to disclose except in instances where disclosure is needed "to make statement[s] made ... not misleading in any material respect."[4] Because the CFTC intends to rely on securities law precedent to help guide the development of insider trading enforcement, examining the contours of insider trading law and its possible applications in the swaps, futures, and commodities markets is critical.

The Classical Theory of Insider Trading Does Not Apply to Derivatives Markets

Under the "classical theory" of insider trading, a corporate insider breaches his or her fiduciary duty to shareholders by trading on material nonpublic information.[5] Corporate insiders have a duty to either (1) disclose material facts known to them, or (2) abstain from trading.[6] In the commodities, futures, and swaps context, insider trading under the classical theory is not feasible because trading on the basis of material nonpublic information is the crux of how derivatives markets operate. Because there is no corollary duty to disclose in the commodities and futures context, classical theory has no direct applicability to corporate insiders.

[2] Prohibition on the Employment, or Attempted Employment, of Manipulative and Deceptive Devices and Prohibition on Price Manipulation, 76 Fed. Reg. 41,398, 41,398 (July 14, 2011).

[3] *Id.* at 41,403. As comparison, SEC Rule 10b-5 makes it unlawful to "employ any device, scheme, or artifice to defraud … To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or ... engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person in connection with the purchase or sale of any security."

[4] *Id.*

[5] *Chiarella v. United States*, 445 U.S. 222 (1980).

[6] *Id.* at 227.

Misappropriation Theory of Insider Trading Does Apply to Derivatives Markets

Though the classical theory of insider trading does not have much applicability in the commodities, futures, and swaps context, the "misappropriation theory" of insider trading is applicable and appears to be the CFTC's current principal avenue for enforcement. Under misappropriation theory, fraud occurs when "a person misappropriates confidential information for … trading purposes, in breach of a duty owed to the source of the information."[7] The deception targeted by misappropriation theory occurs when a fiduciary "feigns loyalty to its principal while secretly converting the principal's information for personal gain."[8] Therefore, under misappropriation theory, it is unlawful for *anyone* to trade on material nonpublic information in breach of a duty to the source of the information.[9] This duty may be derived from a fiduciary relationship,[10] or another relationship of trust and confidence.[11]

Misappropriation theory in the derivatives context is reflected in the text of Rule 180.1, which establishes that "any person who engages in deceptive or manipulative conduct in connection with any swap, or contract of sale of any commodity in interstate commerce, or contract for future delivery ... [who] trad[es] on the basis of material nonpublic information in breach of a pre-existing duty, or by trading on the basis of material nonpublic information that was obtained through fraud or deception may be in violation of rule 180.1."[12]

Therefore, the elements of a misappropriation cause of action in the swaps, futures, and commodities context are as follows:

1. Defendant held a relationship of trust and confidence with the source of material nonpublic information;

2. Defendant obtained such information from a person or entity to whom he or she owed the duty to disclose or abstain;

3. Defendant knowingly or recklessly breached his duty by trading, or attempting to trade a swap, commodities contract, or futures contract.;

    a. while either "using" material nonpublic information, or while in "knowing possession" of material nonpublic information; and

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7 *United States v. O'Hagan*, 521 U.S. 642, 652 (1997).
8 *Id.* at 653.
9 *Id.*
10 *See Id.* at 652 ("a fiduciary's undisclosed, self-serving, use of a principal's information to purchase or sell securities, in breach of a duty of loyalty and confidentiality, defrauds the principal of the exclusive use of that information").
11 *See Chiarella v. United States*, 445 .S. 222, 230 (1980) ("liability is premised upon a duty to disclose arising from a relationship of trust and confidence between parties to a transaction"); *see also Dirks v. SEC*, 463 U.S. 646, 655 (1983) (extending classical theory to include temporary insiders like lawyers, accountants, and consultants who are temporary fiduciaries of the corporation).
12 Prohibition on the Employment, or Attempted Employment, of Manipulative and Deceptive Devices and Prohibition on Price Manipulation, 76 Fed. Reg. 41,398, 41,403 (July 14, 2011).

b. will personally benefit from his or her own trading.

In addition to the elements above, there is an "in connection with" requirement and a *scienter*, or the intent to defraud, requirement that applies to each element of a misappropriation cause of action. The phrase "in connection with" requires that the "manipulative device, scheme or artifice to defraud" be employed or attempted with a jurisdictional product, i.e. a swap, commodities contract, or futures contract. Rule 10b5-1 in the securities context requires "possession" of material nonpublic information to satisfy the "in connection with" element.[13] In the derivatives markets, because of the CFTC's heavy reliance on 10b-5 precedent, it will likely adopt the "possession" standard embraced by the SEC.

Finally, *scienter* overlays each element of an insider trading cause of action. Rule 180.1 provides the CFTC with a powerful choice of intent standard to pursue, the traditional specific intent versus reckless disregard, an easier burden for the CFTC to reach in proving scienter. As applied to the elements, the defendant must know or be reckless in not knowing that there exists a relationship of trust and confidence. Secondly, the defendant must know or be reckless in not knowing that the information is nonpublic.[14] Lastly, the defendant must trade, or attempt to trade a swap, commodities contract, or futures contract product while "using"[15] the material nonpublic information, or while in "knowing possession"[16] of the information.

Nonpublic Information in the Derivatives Markets

In the securities context, nonpublic information is any information that "has not been disseminated in a manner making it available to investors generally ... without favoring any special person or group."[17] In the swaps, futures, and commodities context, most information used in the trading process is considered nonpublic information (e.g., positions, hedging programs, physical commodity holdings) and as a result there has been no duty to disclose such material nonpublic information prior to the consummation of a transaction. However, now under Dodd-Frank, the only time the duty applies is when a trader has made a statement and must then share nonpublic information to make such statement not misleading. Specifically, Section 6b(b) of the CEA states that a person in a futures or swap transaction does not have to "disclose to the other person nonpublic information that may be material to the market price, rate, or level of the commodity transaction ... except as necessary to make any statement ... not misleading."[18]

[13] Rule 10b-5, 17 C.F.R. § 240.10b-5(1) (2016). Some Circuits require a showing that the information played a causal role in the decision to "use" the material nonpublic information. *See SEC v. Bauer,* 723 F.3d 758, 776 (7th Cir. 2013) (allowing an inference of "use" to be drawn from "knowing possession" of material nonpublic information).
[14] *SEC v. Materia*, 745 F.2d 197, 202 (2d Cir. 1984).
[15] *See United States v. Smith*, 155 F.3d 105,1067–69 (9th Cir. 1998) (allowing the "use" standard to be satisfied by showing material nonpublic information was a "significant factor" in the trade).
[16] *See United States v. Royer*, 549 F.3d 886, 899 (2d Cir. 2012) (requiring awareness of the material nonpublic information when the trade is made or attempted).
[17] Selective Disclosure and Insider Trading, 65 Fed. Reg. 51,716, 51,721, Release Nos. 33-7881,34-43154, IC-24599 (Aug. 24, 2000) (adopting release for Regulation FD and Rules 10b5-1 and 10b5-2).
[18] Commodity Exchange Act, 7 U.S.C. §6b(b) (2016).

A Relationship of Trust: Fiduciaries and Temporary Insiders

Loyalty and confidentiality are the hallmarks of a relationship of trust. Though fiduciary relationships like the employer-employee and attorney-client relationship are the quintessential types of relationships of trust, the Supreme Court also extended this treatment to "temporary insiders" like underwriters, accountants, consultants, and others who temporarily owe fiduciary-like duties to a corporation.[19] In *United States v. O'Hagan*, the Supreme Court highlighted that only "recognized duties" could be encompassed by a relationship of trust though it left those possibilities open for interpretation. [20] *United States v. Chestman* established that "a fiduciary duty cannot be imposed unilaterally by entrusting a person with confidential information."[21] Accordingly, there must be explicit acceptance, or implicit acceptance derived from a relationship of trust for any duty to attach.[22] When a tipper (a person who provides material non-public information to a third party) stands in a relationship of trust to the source of confidential information, a duty to disclose one's intentions with the confidential information or to abstain from trading arises.[23]

Relationships giving rise to the duty to disclose or abstain are as follows:

- employer-employee
- attorney-client
- temporary insider to shareholders of corporation[24]
- business relationship[25]

Courts differ on what non-business relationships trigger the duty to disclose or abstain:

- marriage [26]
- friendship[27] or
- members of a social club[28]

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[19] *Dirks v. SEC*, 463 U.S. 646, 655, n.14 (1983).
[20] *United States v. O'Hagan*, 521 U.S. 642, 666 (1997) (explaining that the theory is limited to those who breach a recognized duty).
[21] *United States v. Chestman*, 947 F.2d 551, 567 (2d Cir.1991).
[22] *United States v. Falcone*, 257 F.3d 226, 234 (2d Cir. 2001).
[23] *O'Hagan*, 521 U.S. at 653.
[24] *Dirks,* 463 U.S. at 655.
[25] *Falcone*, 257 F.3d at 234 (2d Cir. 2001).
[26] *United States v. Yun*, 327 F.3d 1263 (11th Cir. 2003) (marriage sufficient); *Chestman*, 947 F.2d at 551 (2d Cir. 1999) (marriage insufficient).
[27] *SEC v. Conradt*, 947 F. Supp. 2d 406 (S.D.N.Y. 2013) (friendship sufficient).
[28] *SEC v. Kirch*, 263 F. Supp. 2d 1144 (N.D. Ill. 2003) (members of a social club sufficient); *United States v. Kim*, 184 F. Supp. 2d 1006 (N.D. Cal. 2002) (members of a social club insufficient).

The CFTC's First Insider Trading Enforcement Actions Based on the Misappropriation Theory

In re Motazedi

In December of 2015, the CFTC charged its first insider trading enforcement action based on the misappropriation theory. *In re* Motazedi involved a gasoline trader, Motazedi, who on 12 occasions placed gas and oil futures trades for his personal account ahead of trades for his employer's trading account.[29] This practice has traditionally been referred to as "front-running." Here, Motazedi's personal orders received preferential pricing to the disadvantage of the company's orders placed thereafter. The CFTC found that Motazedi misappropriated the company's confidential information regarding "price, amounts, and times at which the company intended to trade futures."[30] He breached his duty of loyalty and confidentiality to his employer by "generating profits in his personal account at the disadvantage the company account."[31] Motazedi settled with the CFTC and was required to pay $216,955 in restitution, and $100,000 plus interest in civil penalties. Moreover, Motazedi received permanent trading and registration bans.

In re Ruggles

On September 29, 2016, the CFTC brought another insider trading enforcement action based on the misappropriation theory. *In re* Ruggles also involved an employee trading oil and gasoline futures.[32] Like Motazedi, Ruggles used his knowledge of his employer's trading strategies, which he was responsible for developing and implementing, to enter trades in his personal accounts that would be executed against his employer's trades, or the trades of other market participants, at prices beneficial to Ruggles.[33] The CFTC concluded that Ruggles's conduct intentionally or recklessly breached his duty to his employer not to misappropriate material nonpublic information.[34] Ruggles's settlement with the CFTC required him to disgorge over $3.5 million in profits and to pay $1.75 million plus interest in civil penalties. Ruggles also received permanent trading and registration bans.

These cases mark the CFTC's intent to pursue insider trading under misappropriation theory in the swaps, futures, and commodities markets. Though the Motazedi and Ruggles cases are straight-forward applications of misappropriation theory, the next logical step in CFTC enforcement points towards tipper and tippee liability.

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[29] *In re* Motazedi, CFTC No. 16-02, WL 7880066 (Dec. 2, 2015).
[30] *Id.* at *3.
[31] *Id.*
[32] *In re* Ruggles, CFTC No. 16-34 (Sept. 29, 2016).
[33] *Id.* at 4.
[34] *Id.* at 6.

Tipper/Tippee Liability: The Next Step in CFTC Misappropriation Theory

Insider trading liability under misappropriation theory also extends to tippers and tippees. Tippers have a relationship of trust with the source of material nonpublic information. Because of this relationship, they have a duty not to disclose this information improperly.[35] Tippees are individuals who receive material nonpublic information from tippers. Upon receipt, the duty not to disclose is "inherited" from the tipper.[36] In a straight-forward misappropriation case, such as the CFTC cases cited above, a tipper intentionally or recklessly trades on material nonpublic information in breach of his duty to the source. In tipper/tippee misappropriation cases, the tipper does not trade on the information, but instead passes it along to a tippee in exchange for a personal benefit.[37] While the element of personal benefit is the only additional requirement for tipper liability, tippee liability has slightly different elements. "Tippee liability requires that (1) the tipper breached a duty by tipping confidential information; (2) the tippee knew or had reason to know that the tipper improperly obtained the information; and (3) the tippee, while in knowing possession of the material nonpublic information, used the information by trading or tipping for his own benefit."

When multiple tippers and tippees pass along material nonpublic information it is called a tipping chain. Tipping chains involve multiple tippers and tippees several steps removed from the source. The most simple example of a tipping chain is when a tipper passes along confidential information to a tippee, who in turn passes the information along to a third person, who trades on the information. Non-trading tippees are called intermediary tippees, while trading tippees are called remote tippees. Often tipping chains have many layers with multiple intermediary tippees and remote tippees. In establishing intermediary liability and remote liability in tipping chains, often the more attenuated the connection is from the source of the breach, the more difficult it will be to establish their knowledge of the scheme. Specifically, it is most difficult to prove that; (1) a tippee knew or was reckless in not knowing that the initial tipper breached a duty to the source, and (2) that the tippee knew of the personal benefit the initial tipper received in exchange for his breach.[38]

The Question of "Personal Benefit": Supreme Court Tipper/Tippee Developments

In early 2016, the Supreme Court granted *certiorari* in the case *United States v. Salman*, an insider trading case which turns on what constitutes a "personal benefit." The case will resolve the Circuit split between the Second Circuit's ruling in *United States v. Newman*, and the Ninth Circuit's ruling in *Salman*. Both cases interpret the Supreme Court's ruling in *Dirks v. SEC*, which defined "personal benefit" as "a pecuniary gain or a reputational benefit that will translate into future earnings," or a "gift of confidential information to a trading friend or relative."[39]

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[35] *Dirks*, 463 U.S. at 559.
[36] *Id.* at 664.
[37] *SEC v. Obus,* 693 F. 3d 276, 286 (2d Cir. 2012).
[38] *United States v. Newman*, 773 F.3d 438, 453 (2d Cir. 2014).
[39] *Dirks*, 463 U.S. at 663–64.

The *Newman* case involved two insider trading chains at two different hedge funds. One chain delivered inside information about Dell, while the other supplied information about NVIDIA. The two hedge fund portfolio managers implicated, Newman and Chiasson, were both three to four steps removed from the source of the confidential information in both tipping chains. The Court held that the personal benefit standard described in *Dirks* did not suggest that "mere friendship particularly of a casual or social nature" was proof of a personal benefit.[40] Additionally, the Court held that there must be a "meaningfully close personal relationship that generates an exchange that is objective, consequential, and represents at least a potential gain of pecuniary or similarly valuable nature" for the personal benefit element to be satisfied.[41]

Conversely, in *Salman*, the tipping chain involved an investment banker in the healthcare sector, his brother, and a close family friend. For almost three years the investment banker shared confidential information with his brother regarding upcoming mergers and acquisitions in the healthcare sector. He did this because "he love[d] [his] brother very much," and out of a desire to "benefit him" and help him "fulfill whatever needs he had."[42] His brother in turn traded on the information, and also encouraged a close friend to mirror his trades in a separate account.[43] The Court held that the exchange of information from the investment banker to his brother was clearly "a gift of confidential information to a trading relative" which constituted a personal benefit under *Dirks.*

These conflicting perspectives on the "personal benefit" element were argued before the Supreme Court just recently in October 2016. As a high-level point, the Justices did not seem to accept Salman's argument that a tipper in the chain should receive some pecuniary gain from passing along the confidential information. The Justices seem to suggest that Salman's argument would be contrary to decades of insider trading case law. Further, the Justices discussed whether there was any difference between an insider trading on inside information and then giving the money to his brother—clearly illegal—and the insider giving information to his brother to allow his brother to make his own trades. They also suggested that helping one's family is the same as helping oneself. However, the government's argument, that any personal benefit at all would subject a tipper to insider trading liability, also faced some resistance, with Justices expressing concerns over the problem of where to draw the line with this expansive approach, suggesting that perhaps the line should be limited to insider trading cases involving family or friends. A final decision on the issue is expected in the new year.

Due to the uncertainty in this area, it is unlikely that the CFTC will pursue any enforcement actions based on tipper/tippee liability until the Circuit split is resolved. Of course, such cases will be resource intensive to construct adequate relationships and tipping chains. It is possible that the CFTC is currently investigating matters under this theory, and will be poised to bring the matters quickly once the Supreme Court resolves the issue of "personal benefit."

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[40] *Newman*, 773 F.3d 438, 452 (2d Cir. 2014).
[41] *Id*.
[42] *United States v. Salman*, 792 F.3d 1087, 1089 (9th Cir. 2015).
[43] *Id.*

Insider Trading Hypotheticals in the Derivatives Markets

Open questions remain regarding how misappropriation theory applies to communications between derivatives brokers, hedgers, and insiders employed by market participants. The hypotheticals below analyze the risk of insider trading liability in several factual scenarios.[44]

Hypothetical One: Four swap traders chat about market activity regarding different hedgers that are active in the market. They openly discuss pricing, volume, and the suspected timing of the swap trades. Could insider trading liability apply to these type of communications?

- Answer: Maybe. However, insider trading liability would likely not apply because the brokers owe no duty to parties on the opposite side of the transaction (hedgers).

  Though pricing, volume, and timing information is material nonpublic information, the broker received the information from the market and there was no transaction with the hedger and broker. This is analogous to an arm's-length negotiation, and the broker owes no duty to an opposing party in a market transaction. Because the tipper has no duty, no insider trading liability can result. Accordingly, if any of the brokers decided to take positions in the market based on this information, no liability could attach to them as tippees, since the duty to disclose or abstain is derivative of the tipper's duty to the source.[45]

  The only way liability could arise in this case is if the tipper shared confidential information, and the tippee actually had a relationship of trust with the source. If this were the case, the tippee (broker receiving the information) would have the obligation to abstain from acting on the information. Further complicating matters, it is possible that the hedger may shop the inquiry around to one of the brokers who was already tipped about the nature of the deal. At that point, it is unclear what the duty of the tippee would be in negotiating with the other party and when the transaction becomes public.

Hypothetical Two: A trader for a swap dealer discloses its employer's swaps position to a hedge fund, and the hedge fund portfolio manager executes trades based on this information. The hedge fund makes $68 million, and the portfolio manager gives the trader $1 million. Could insider trading liability apply in this scenario?

- Answer: Yes. Insider trading liability will likely apply because the trader breached his relationship of trust with his employer by sharing the employer's position with a third party. The hedge fund portfolio manager (tippee) would inherit the duty of confidentiality from the tipper, and also have liability for insider trading in this case. Finally, with respect to the "personal benefit" element, the portfolio manager (tippee) who traded on the basis of this information made $68 million, and the bank trader (tipper) received $1 million. Both parties personally benefitted from the transaction.

Hypothetical Three: A futures trader learns that his client wants to take a large position in the market. In anticipation of this transaction, the futures trader takes the same position to reduce the costs of covering itself after executing the transaction for its client. Could insider trading liability apply in this scenario?

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[44] These hypotheticals are drawn from recent presentations by CFTC enforcement officials.
[45] *Dirks*, 463 U.S. at 664.

- Answer: Maybe. Under Rule 180.1, insider trading liability may apply in this situation. The practice of "pre-hedging" is when a dealer will take a position ahead of its client to reduce the costs of covering itself after the client order is executed.[46] This is very similar to the "front running" activity punished by the CFTC in the Motazedi enforcement action. Because these transactions take advantage of material nonpublic information, and breach the relationship of trust between broker and client, liability will likely result. Moreover, the CFTC would most likely argue that these transactions drive up the cost of transactions at the expense of clients, and effectively deprive clients of preferential market pricing. As such, "pre-hedging" can be a basis for insider trading liability under the new rule.

  To avoid liability, a trader is well-advised to determine whether to disclose any intention to pre-hedge to his or her clients before engaging in such market activity. Disclosing the intention to pre-hedge eliminates the deception upon which the misappropriation theory of insider trading liability rests. Without deception there is no misappropriation, and no violation.

Contrasting these three hypotheticals demonstrates the fact-specific nature of inquiries regarding insider trading in the derivatives markets.

The Practical Application of CFTC Insider Trading Cases to Your Business

In light of the enforcement trends discussed above, market participants can position themselves to minimize the risk of a CFTC insider trading enforcement action by undertaking a review of the following to make sure there is coverage of insider trading:

- swaps, futures, and commodities trading procedures
- internal control systems (including access to trading strategies)
- compliance programs
- annual training programs

Covington is well-positioned to provide market participants with compliance and enforcement advice related to all areas of CFTC regulation, including event-driven compliance issues and reviews of internal systems and compliance controls. We also regularly defend clients in CFTC and other government investigations and prosecutions concerning derivatives trading.

[46] Futures exchanges provide guidance to market participants on permissible pre-hedging. To date, swap execution facilities have not issued such guidance. This alert does not examine the relevant guidance.

If you have any questions concerning the material discussed in this client alert, please contact the following members of our Futures and Derivatives/CFTC and White Collar Defense and Investigations practices:

Stephen Humenik	+1 202 662 5803	shumenik@cov.com
Anne Termine	+1 202 662 5827	atermine@cov.com
Jason Grimes	+1 202 662 5846	jgrimes@cov.com
James Kwok	+1 212 841 1033	jkwok@cov.com

* Ms. Charli Gibbs-Tabler assisted with the drafting of this alert as a summer associate at Covington. She is currently a law student at Washington & Lee Law School.