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The Case for Misappropriation under the Commodity Exchange Act: The CFTC Prepares to Exercise New Enforcement Authority in the Derivatives Markets

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The Commodity Futures Trading Commission's ("CFTC") new focus on misappropriation in the commodities and derivatives markets became more tangible on September 28, 2018 with the announcement of the creation of an Insider Trading and Information Protection Task Force ("Task Force") within the Division of Enforcement.[1] The announcement came as the Task Force filed a significant new case against EOX Holdings LLC ("EOX") alleging misappropriation in violation of the Commodity Exchange Act ("CEA") and CFTC's rules. The case and its potential implications are discussed below.

More generally, the extent to which the Task Force redefines the concept of "insider trading" in the commodities and derivatives markets remains to be seen; however, in describing the Task Force's mission, the CFTC stated: "The Commission will thoroughly investigate and, where appropriate, prosecute instances in which individuals have abused access to confidential information—for example, by misappropriating confidential information, improperly disclosing a client's trading information, front running, or using confidential information to unlawfully prearrange trades. In addition, the Commission will ensure that its registrants develop and enforce policies prohibiting the misuse of confidential information, as they are required to do under the law."[2]

Aimed at curbing the misuse of information, the creation of this Task Force likely will result in many more insider trading enforcement investigations and actions in the commodities and derivatives markets. Indeed, misappropriation is now included in the CFTC's Enforcement Manual as one of several "types of prohibited conduct subject to investigation" along with other forms of manipulation and deceptive trade practices.[3] To assist practitioners advising clients active in the commodities markets, this article provides an overview of the relevant law regarding insider trading and how these laws may be enforced by the CFTC under the CEA and related regulations.

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[1] The Task Force is composed of staff from the CFTC's offices in Chicago, Kansas City, New York, and Washington, D.C., is responsible for identifying and investigating those who engage in the improper use of confidential information in connection with any market regulated by the CFTC.

[2] Press Release, Commodity Futures Trading Comm'n, CFTC Charges Block Trade Broker with Insider Trading (Sept. 28, 2018), https://www.cftc.gov/PressRoom/PressReleases/7811-18.

[3] Commodity Futures Trading Commission, Division of Enforcement, Enforcement Manual (May 8, 2019), https://www.cftc.gov/media/1966/download.

Insider Trading under the Historical Commodity Exchange Act

Since its establishment, the CFTC generally maintained the view that the flow of information by market participants facilitated hedging in the futures and options markets. In its mission statement, the CFTC describes its mission as "protect[ing] market users and the public from fraud, manipulation, and abusive practices related to the sale of commodity and financial futures and options, and to foster open, competitive, and financially sound futures and option markets."[4] However, other than in certain limited circumstances, insider trading was not a violation of the CEA.

Prior to the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") in 2010, the CFTC's authority to prosecute insider trading was limited to cases involving CFTC Commissioners, CFTC employees, and CFTC agents.[5] In fact, not only did the CEA lack a prohibition against insider trading in commodities for the general population of traders, but it actually overlooked insider trading since it was basically a means to facilitate efficient pricing of commodities. The concept of insider trading was considered an integral element in the commodity futures and derivatives markets because the purpose of futures markets was to provide a forum for price discovery and risk management. The CFTC even noted that these markets "permit hedgers to use their nonpublic material information to protect themselves against rights to their commodity positions."[6]

Insider Trading under the Commodity Exchange Act in the Post-Dodd-Frank Act Era

As a result of the 2008 financial crisis, Congress enacted, and President Obama signed into law, the Dodd-Frank Act, which instituted a wide-range of changes to the banking, securities, derivatives, and financial services industries. Among other things, the Dodd-Frank Act greatly expanded the scope of the CFTC's reach by amending Section 6(c)(1) of the CEA to prohibit fraud and manipulation "in connection with any swap, or a contract of sale of any commodity in interstate commerce, or for future delivery on or subject to the rules of any registered entity."[7] In theory, the statute could apply to physical commodities, futures, swaps, and options.[8] As a result, the CFTC codified its enforcement powers through the enactment of Rule 180.1, an anti-fraud and anti-manipulation rule similar to Rule 10b-5 under the Securities Exchange Act. The CFTC advised 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

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[4] *Mission and Responsibilities*, U.S. COMMODITY FUTURES TRADING COMM'N, http://www.cftc.gov/About/MissionResponsibilities/index.htm.
[5] *See* 7 U.S.C. § 13(c) (2018).
[6] U.S. Commodity Futures Trading Comm'n et al., *A Joint Report of the SEC and the CFTC on Harmonization of Regulation* 7, (Oct. 16, 2009), http://www.sec.gov/news/press/2009/cftcjointreport101609.pdf.
[7] Dodd Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-2031, § 753 (2010).
[8] *Id.*

agreement, understanding, or some other source), or by trading on the basis of material nonpublic information that was obtained through fraud or deception."[9] Since then, the CFTC has demonstrated its active pursuit of insider trading enforcement with cases brought in 2015, 2016, and 2018. We will discuss these cases in further detail below.

In drafting Rule 180.1, the CFTC intentionally mirrored the language of the Securities and Exchange Commission's ("SEC") Rule 10b-5 in light of its history of use in the securities markets.[10] However, as noted above, commodity markets were designed for the purpose of risk management rather than capital formation like the securities exchanges. Because the CFTC relied on securities law precedent to guide the development of insider trading enforcement in commodities markets, it is instructive to examine SEC insider trading precedent to determine its possible applications to swaps, futures, and commodities markets. In general, SEC insider trading laws prohibit trading a security on the basis of material nonpublic information, where the trader has breached a duty of trust or confidence owed to either an issuer, the issuer's shareholders, or the source of the information, and where the trader is aware of the breach.[11] Based upon these rules, the Supreme Court has recognized several theories of insider trading liability, including but not limited to: (1) the classical theory[12] and (2) the misappropriation theory.[13]

The classical theory of insider trading applies when a corporate insider breaches his or her fiduciary duty to shareholders by trading on material, nonpublic information. This theory covers situations in which the insider, such as a company executive or board members, trades in the company's securities prior to the release of news concerning a significant event. While very common in securities enforcement, the CFTC has instead focused its enforcement another theory of insider trading liability: the misappropriation theory.

Misappropriation under the Commodity Exchange Act

Under the CFTC's misappropriation theory of insider trading, a misappropriation claim could be brought when someone trades on material nonpublic information that was lawfully obtained for trading purposes, but used in a way that breaches a pre-existing duty owed to the source of the information.[14] Typically the information is used for a purpose other than the purpose for which it was provided. Insider trading only occurs where a trader acts with requisite scienter by knowingly or recklessly disregarding the fact that the information was material and nonpublic and there was a pre-existing legal duty, such as a "relationship of trust and

[9] Prohibition on the Employment, or Attempted Employment, of Manipulative and Deceptive Devices and Prohibition on Price Manipulation, 76 Fed. Reg. 41398, 41403 (July 14, 2011).
[10] 17 C.F.R. § 240.10b5-1 (2018).
[11] *See id.*
[12] *See Chiarella v. United States*, 445 U.S. 222, 228 (1980).
[13] *United States v. O'Hagan*, 521 U.S. 642, 652 (1997).
[14] 76 Fed. Reg. 41403.

confidence," between the trader and the source that precludes the trader from using the information for his or her benefit.[15]

Nonpublic information is considered the "property" of the person who lawfully possesses it.[16] Therefore, nonpublic information is misappropriated when an individual trades (or attempts to trade) while either "using" or in "knowing possession" of the information without disclosing the intent to trade to the person to whom the duty is owed.[17] With regard to disclosure, the CFTC has indicated disclosing one's intention to trade on nonpublic information prior to actual trading satisfies one's duty of confidentiality.[18] The CFTC does not expressly define what is and is not "material nonpublic information," but examples may include information about pending orders, details of specific transactions, position information for specific market participants, and the intention to enter or exit the market. A pre-existing duty can be established by a law or rule, agreement, or understanding. Drawing from SEC precedent, the CFTC has suggested that certain relationships give rise to a duty of confidentiality.[19] Those relationships must be mutual and ones of "trust and confidence." Such relationships are those where the source and recipient have a history, pattern, or practice of sharing confidences such that the recipient knew or reasonably should have known the source expected confidentiality, such as attorney-client,[20] business, and employer-employee[21] relationships. These relationships need not be based on a fiduciary relationship, part of a continuous chain of dealings, or made explicit such as through a written confidentiality agreement.

The concept of "front running," where a trader uses customer information to trade ahead of the customer's trade, is another way in which the CFTC can enforce misappropriation under the CEA.[22] Although the CFTC declined to adopt a per se rule regarding front running when drafting Rule 180.1, it nevertheless advised that front running is a form of fraud-based manipulation and it has pursued charges on this concept.[23]

Tippers-Tippees under the Commodity Exchange Act

Insider trading liability under a misappropriation theory could also extend to tippers and tippees. Under this theory, a "tipper" provides material, nonpublic information (*i.e.*, a "tip") to a third party, known as the "tippee," and that third party then trades on that information.

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[15] *Id.* at 41404; *In re Motazedi*, CFTC Docket No. 16-02, 6-7 (Dec. 2, 2015).
[16] *O'Hagan*, 521 U.S. at 654.
[17] *Id.*
[18] *See* 76 Fed. Reg. 41402-03.
[19] *Id.* at 41403; *In re Motazedi*, CFTC Docket No. 16-02 at 6-7.
[20] *O'Hagan*, 521 U.S. at 652.
[21] *United States. v. Newman*, 773 F.3d 438 (2d Cir. 2014).
[22] *See In re Motazedi*, CFTC Docket No. 16-02 at 4-5.
[23] 76 Fed. Reg. 41401; *In re Motazedi*, CFTC Docket No. 16-02 at 4-5.

Here, the tipper has a relationship of trust with the source of the material nonpublic information and has a duty not to disclose the information improperly.[24] Upon receipt of the information, the tippee then inherits the duty not to disclose from the tipper.[25] The only difference between tipper liability and a straight-forward misappropriation case is that the tipper does not trade on the information, but instead passes it along to a tippee in exchange for a personal benefit. Tippee liability, on the other hand, has different elements requiring that the tipper breached a duty by tipping confidential information, the tippee knew or had reason to know that the tipper improperly obtained the information, and the tippee, while in knowing possession of the material nonpublic information, used the information by trading or tipping for his own benefit.

CFTC Insider Trading Enforcement

While the CFTC has had an anti-fraud authority to prosecute insider trading since the adoption of Regulation 180.1, it has exercised this authority only three times. The earlier two matters relating to insider trading both reached consent resolutions. Because they were settlements, no court opined on the CFTC's theory of fraud. However, in its most recent action, the CFTC filed a complaint in its first case to be brought on a litigated basis. This new approach provides valuable insight into the enforcement approach that the CFTC may bring to its pursuit of insider trading cases going forward.

In re Motazedi

On December 8, 2015, the CFTC imposed remedial sanctions against a futures trader for allegedly using proprietary and confidential information he learned about his employer's trading activity to trade in his own accounts. The CFTC alleged that from September to December 2013, energy trader Arya Motazedi engaged in insider trading in violation of CFTC Rule 180.1 by executing transactions in his personal accounts ahead of, and to the detriment of, similar transaction in his employer's account. Motazedi received a permanent trading ban and agreed to pay $216,956 in restitution, a $100,000 penalty to the CFTC, and a $100,000 penalty to the New York Mercantile Exchange ("NYMEX").[26]

Rather than charting a new path in its first insider trading enforcement action, the CFTC Order instead adopts the language of securities insider trading law. For example, the order states Motazedi and his employer shared a relationship of trust and confidence that gave rise to a duty of confidentiality. This express reference to the "relationship of trust and confidence" is a securities law construct and is not limited to fiduciary relationships. Furthermore, the order borrows from securities laws in applying a recklessness standard to misappropriation claims.

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[24] *Dirks* v. SEC, 463 U.S. 646, 647 (1983).
[25] *See id.* at 664.
[26] *In re Motazedi*, CFTC Docket No. 16-02.

In re Ruggles

The CFTC's next insider trading enforcement action involved similar allegations of a trader misappropriating the confidential trading information of his employer to benefit his personal trading account in violation of company policies and general duties owed by employees to employers. On September 29, 2016, the CFTC imposed remedial sanctions against a futures and options trader for allegedly using material, nonpublic information he learned while developing his employer's fuel hedging strategy to execute trades for his own benefit. The CFTC alleged that Ruggles engaged in fraudulent, fictitious, and non-competitive trades in crude oil and heating oil futures and options and RBOB gasoline futures on the NYMEX from March to December 2012. Ruggles received a permanent trading ban and agreed to pay $1.75 million to the CFTC and $300,000 to NYMEX in civil monetary penalties, plus $6.3 million in disgorgement of his ill-gotten gains.[27]

Like in *Motazedi*, the CFTC Order in *Ruggles* finds that in his role developing his employer's fuel hedging strategies and executing the employer's trades in particular NYMEX products, Ruggles owed a duty of trust and confidence to act in his employer's best interest and to keep confidential the employer's material, nonpublic information regarding its trading activity. According to the CFTC, Ruggles breached these duties and misappropriated the employer's confidential, material, nonpublic trading information when he sequenced the trades in personal and employer accounts so that the majority of his personal orders were executed against his employer's orders and the remaining personal orders were filled by other market participants at prices advantageous to Ruggles's orders.

CFTC v. EOX Holdings LLC and Andrew Gizienski

Most recently, on September 28, 2018, the CFTC filed a civil enforcement action in the U.S. District Court for the Southern District of New York alleging that the commodities brokerage firm EOX and one of its brokers, Andrew Gizienski, used material, nonpublic information he learned about the trading activities of other EOX clients to trade on behalf of a longstanding friend and customer. The CFTC alleged that from August 2013 through May 2014, Gizienski exercised discretionary trading authority over an account belonging to a friend, while continuing to broker block trades for other EOX customers and while continuing to have access to material, nonpublic information relating to EOX customers.[28]

During this period, Gizienski allegedly disclosed to his friend confidential information about other customers, such as their identities, trading activity, and positions, in breach of a pre-existing duty of trust and confidence owed to those customers. The CFTC alleges that Gizienski

[27] *In re Ruggles*, CFTC Docket No. 16-34 (Sept. 29, 2016).
[28] *CFTC v. EOX Holdings LLC, et al.*, No, 18-CV-8890 (S.D.N.Y. Sept. 28, 2018).

owed duties of trust and confidentiality to his customers by law or rule, by agreement, and by understanding.

During the relevant period, EOX allegedly maintained written agreements with customers which prohibited EOX from using or disclosing confidential customer information, such as the customer's trading activity, except as necessary for the facilitation of block trades with third parties. Further, Gizienski allegedly was employed by EOX pursuant to a written agreement that expressly provided for his access to this confidential customer information, including the customers' trading histories, patterns, preferences, tendencies, and market positions. This employment agreement allegedly prohibited Gizienski from revealing, disclosing, or communicating such confidential information to anyone outside of EOX, and therefore, Gizienski owed these customers a duty not to misuse their confidential information. Gizienski also allegedly traded in a discretionary account while in possession of, and on the basis of, this confidential information relating to EOX customers. The proposed civil monetary penalty in this pending litigation is $500,000 in fines and a six week trading ban for Gizienski by the exchange.[29]

Considerations for Traders and the Future of CFTC Insider Trading Enforcement

The CFTC's most recent insider trading enforcement action provides valuable insight into the enforcement approach that the CFTC may bring in its pursuit of insider trading cases going forward. By incorporating the key elements from a securities insider trading claim in its first two insider trading enforcement actions, the Commission has endorsed the view that securities and commodities markets are enough alike that the logic of one can rationally apply to the other. Additionally, the CFTC enforcement staff has spoken about other potential areas of enforcement of insider trading under the CEA. One such example the CFTC enforcement team has given relates to bank traders who leak information about derivatives trades to hedge funds.[30] Here, if the bank trader discloses the bank's positions to a hedge fund trader who trades on that information—not necessarily even against the bank—both the employee of the bank as well as the hedge fund trader could face charges.[31] Knowing the CFTC's position is helpful, but this view also creates new questions in its applicability to commodities markets and what this means for future CFTC enforcement.

For example, what comes next and where will the CFTC draw the line? Voice brokers often will discuss market conditions with their clients. Sometimes these conversations involve fairly specific pieces of market intelligence (*e.g.*, someone is going to need to sell volume fast, a facility is going to shut down for unplanned maintenance). When does market color become

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[29] *Id.*
[30] Kris Devasabai, *CFTC Clamps Down on Insider Trading in Derivatives*, RISK.NET (May 23, 2016), https://www.risk.net/derivatives/2458962/cftc-clamps-down-insider-trading-derivatives.
[31] *Id.*

material nonpublic information? What uses of such information are permitted and what are prohibited? What are your obligations as the recipient of such information? What types of information can you share about the company with other market participants? Can such secrets be material and to whom is secrecy owed given that there are no "shareholders" in commodities?

Similarly, what relationships might be implicated under the misappropriation theory? The CFTC has pursued registered futures commission merchant-customer relationships and registered swap dealer-customer relationships. Will the CFTC next pursue swap dealers (managing to de minimis) customer relationships? Or registered (and exempt) commodity trading advisors-customer relationships? Or possibly energy asset management agreements or physical supply agreements?

The formation of the Task Force and the commencement of litigation by the CFTC suggest that the CFTC will now more actively police the misuse of confidential information by commodities markets participants. However, based on the limited fact pattern of the CFTC's first three enforcement actions, specifically an employee taking advantage of knowledge gained through his employment to benefit himself at the expense of his company and its clients, it is not clear how broadly the CFTC intends to police trading on nonpublic information obtained through traditionally accepted commercial activities in the commodities markets. Going forward, commodity trading firms should be aware of the CFTC's interest in insider trading, expect more insider trading enforcement actions in the commodities markets, and make sure that they have policies and procedures in place to prevent the misuse of material, nonpublic information by their employees.