



New Insider Trading Prohibitions in the Commodities Markets

September 15, 2016



Upcoming L&C Webinars and Events



Chief Compliance Officer Updates

October 13, 2016 | 10:00 AM ET | Webinar

Presenters: Charles Mills, Micah Green, Marc Spitzer, Michael Dunn, Richard Shilts, Daniel Mullen and Matthew Kulkin of Steptoe & Johnson LLP



Futures 101: An Introduction to U.S. Futures Markets and Regulation

October 18, 2016 | 2:00 -5:00 PM CT | Chicago, IL

Moderator: Bonnie Litt of Goldman Sachs

Panelists: Gary DeWaal of Katten Muchin Rosenman LLP; Maureen Guilfoile of CME Group; Kimberly Johns of Goldman Sachs and Katie Trkla of Foley & Lardner LLP



CFTC and SRO Enforcement Trends

November 17, 2016 | 10:00 AM ET | Webinar

Presenters: Geoffrey Aronow and Michael Sackheim of Sidley Austin LLP

Learn more and register at FIA.org/lc

Administrative Items

The webinar will be recorded and posted to the FIA website following the conclusion of the live webinar.

A question and answer period will conclude the presentation.

- Please use the “question” function on your webinar control panel to ask a question to the moderator or speakers. Questions will be answered at the conclusion of the webinar.

CLE certificates will be emailed shortly after conclusion of the webinar.

Time to Increase Awareness of the CFTC's New Focus

- Today's topics:
 - How will the CFTC fit the square peg of insider trading into the round hole of derivatives (listed and OTC) and commodities trading?
 - How did we get here?
 - What is misappropriation of material non-public information in the derivatives and commodities world?
 - In what directions is the law likely to develop?
 - How can you manage the risk of insider trading?



Recent Developments

July 19, 2016

Bank Traders Arrested on FX Front Running Charges

- On July 19, 2016, FBI agents arrested two HSBC executives at JFK airport for **alleged fraud and front running of client orders** in the FX markets
 - HSBC was not named as a defendant in the complaint
- According to the **criminal complaint**, the alleged scheme involved misuse by the bank's traders of non-public information about a large client order (\$3.5bn of U.K. pounds), paired with trading that was "executed in a manner designed to cause the price of sterling to spike... to the benefit of HSBC and the defendants, and at the expense of the Victim Company."

December 8, 2015

CFTC Settlement with Arya Motazed

Allegation: From September to December of 2013, Arya Motazed 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**

Penalty: \$216,956 restitution

\$100,000 penalty to the CFTC; plus \$100,000 penalty to NYMEX
Permanent trading ban

Significance: First, the order expressly references the securities laws **“relationship of trust and confidence”** construct, which is not limited to fiduciary relationships

Second, it applies a **recklessness** standard to misappropriation claims

Third, the settlement order likely was meant to put market participants on notice of the CFTC’s intention to pursue misappropriation claims based on this more expansive view of pre-existing legal duties

May 23, 2016

Risk.net Interview with CFTC Enforcement Staff

CFTC CLAMPS DOWN ON INSIDER TRADING IN DERIVATIVES

*BANK TRADERS WHO LEAK INFORMATION ABOUT DERIVATIVES TRADES
TO HEDGE FUNDS COULD FACE CHARGES, CFTC OFFICIALS SAY*

- **New examples of potential insider trading cases:**
 - “One example [of insider trading under the CEA] might be an employee of a bank who sits on the futures and swaps desk. If he **discloses the bank’s positions to a hedge fund trader** who trades on that information – not necessarily even against the bank – we could charge both the employee of the bank as well as the hedge fund trader.”
 - Another example was based on allegations arising out of the 2012 JPM Whale Trade that the bank’s CIO **leaked some of its positions to hedge funds** whom it suspected of trading against it. “If those allegations were true, and those traders [in the investment bank] leaked the [CIO's] positions in exchange for a personal benefit, we could have gone after the leakers and the tippees.”

Back To The Beginning

Insider Trading Under the Pre-Dodd-Frank CEA

- **Conventional wisdom: Insider trading is generally a permissible and integral practice in commodities and derivatives markets.**
 - Generally no fiduciary relationship because with commodities and derivatives there are no company/issuer insiders and no shareholders
 - Understood that company will trade based on its own proprietary information
- Only certain types of insider trading were prohibited under the pre-Dodd-Frank CEA, for example:
 - **CEA § 4c(3)** – Prohibits **federal employees** from **trading futures or swaps** for personal gain based on price-sensitive non-public information acquired as a result of their position
 - **CEA § 9(e)(1)** – Prohibits **employees, members of the governing board or a committee of a registered entity** (e.g., futures exchanges, SDRs) or a registered futures association from willfully and knowingly trading futures or swaps or disclosing improperly any material non-public information obtained through special access related to the performance of such duties

Insider Trading and the Misappropriation Theory Under the Post-Dodd Frank CEA

- **CEA § 6(c)** – The fraud-based anti-manipulation provision (modeled on SEC Rule 10b-5)
- **CFTC Rule 180.1** – The CFTC noted that a misappropriation claim could be brought when someone trades on material non-public information that was **lawfully obtained, but used in a way that breaches a pre-existing duty**
- A duty established by law or rule, or agreement is readily understood
- However, until recently, the CFTC has been publicly silent as to what **“understandings, or other sources”** establish a duty not to trade commodities or derivatives when in possession of inside information



October 1, 2015

CFTC Enforcement Division Presentation at ISDA

- A senior official from the CFTC's Enforcement Division participated in an enforcement symposium hosted by ISDA . The CFTC official:
 - Provided overview of CFTC's misappropriation authority under CFTC Rule 180.1
 - Offered **expansive interpretation of CFTC's misappropriation authority** and what may give rise to a **"pre-existing duty"** with regard to material, non-public information:
 - Relationships defined by law, agreement, or understanding (explicit or implicit)
 - Described how, like the SEC, the CFTC's authority included the ability to pursue **tipplers and tippees**
 - Suggested that the Enforcement Division would pursue alleged misappropriation **aggressively** in the commodities markets

May 1, 2016

PLI Government Enforcement Panel

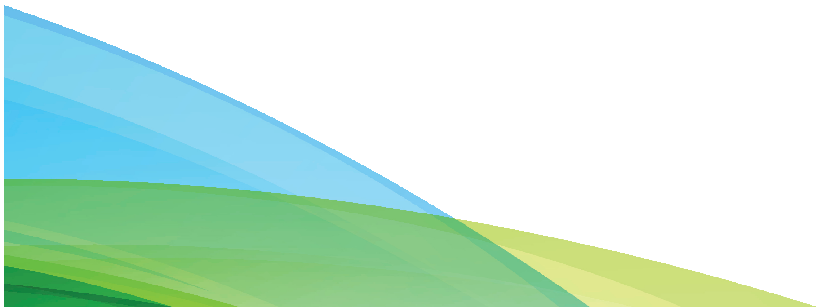
- Chief of the DOJ's Securities & Financial Fraud Unit said most people think of equities when it comes to insider trading, but **the same incentives also affect the swaps and derivatives markets**
 - DOJ anticipates that there will be new misappropriation cases in the commodities space over the next year or two
 - According to the DOJ official, it is likely DOJ's focus on this subject will bring out insider trading cases in the FX space – when traders get market-moving info, they can act on it, but **if the information is obtained in violation of a trust or duty to a client, then it can sound in fraud** – see July 2016 charges against HSBC's traders
- **Yates Memo:** “[The DOJ has] shifted the presumption on what a corporate resolution looks like: Now, our attorneys must get approval if they decide not to bring charges against individuals and may not release individuals from civil or criminal liability except under the rarest of circumstances.”

Elements of a Misappropriation Claim

CFTC Definition of Misappropriation

A person **deceives** another when he or she:

1. Misappropriates
2. Material
3. Non-public information for trading purposes, in
4. Breach of a duty owed to the source of the information (*i.e.*, relationship of “trust and confidence”)

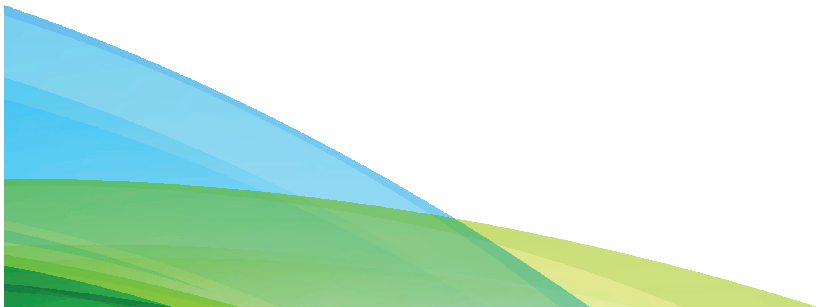


CFTC Definition of Misappropriation (*cont'd*)

- **How does the CFTC describe “misappropriation”?**
 - Non-public information is considered the “property” of the person who lawfully possesses it
 - Therefore, non-public 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
 - The CFTC has indicated that it intends to take the position that disclosing one’s intention to trade on non-public information prior to actual trading satisfies the duty of confidentiality
 - However, even if disclosed, trading on non-public information may violate other regulatory and/or contractual requirements

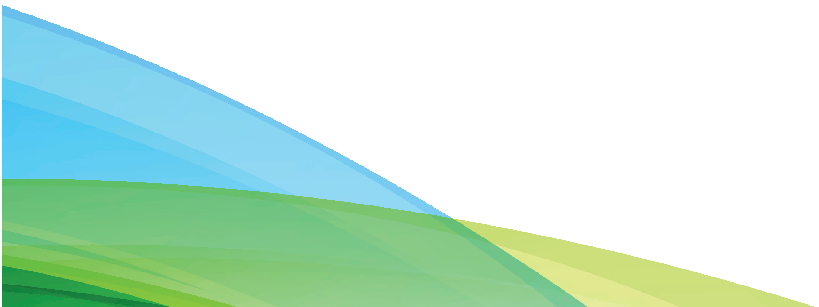
Breach of Pre-Existing Legal Duty

- **When is a pre-existing legal duty, including a relationship of trust and confidence breached?**
 - Insider trading only occurs where a trader acts with requisite scienter by **knowingly or recklessly** disregarding the fact that:
 - The information was non-public, and
 - There was a pre-existing legal duty such as a relationship of trust and confidence between the trader and the source that precludes the trader from using the information for his or her benefit
 - Note: Under the misappropriation theory the trader **obtains** the information lawfully; the breach occurs when it is **used** in an impermissible manner



Relationship of “Trust and Confidence”

- Drawing from SEC precedent, the CFTC has suggested that certain relationships give rise to a duty of confidentiality:
 - The relationship must be one of **“trust and confidence”**
 - The relationship must be **mutual**
- However, the duty of confidentiality does **not** need to be:
 - Based on a **fiduciary** or business relationship
 - Part of a **continuous** chain of relationships or dealings
 - **Explicit** (e.g., a written confidentiality agreement)



“Understandings and Other Sources”

- **What types of relationships create an expectation of “trust and confidence”?**
 - Does the recipient agree to keep the information confidential?
 - Do 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? For example:
 - **Attorneys and clients:** *U.S. v. O’Hagan*
 - **Business partners:** *SEC v. Peters* (duty of trust developed based on discussions between long-time friends and business associates regarding a proposed joint venture)
 - But compare: **arms-length negotiations** do not constitute a relationship of trust and confidence
 - **Employer-employee:** *U.S. v. Newman* (broker violated a duty to his employer and clients by misappropriating confidential information and concealing when under a duty to disclose)

What Relationships May be Implicated?

- Registered Futures Commission Merchant / customer (✓)
- Registered Swap Dealer / customer (✓)
- Swap dealer (managing to *de minimis*) / customer (?)
- Registered (and exempt) CTAs / customer (?)
- Voice broker / customer (?)
- Asset management agreement (?)
- Physical supply agreement (?)
- Other (?)



Tipplers and Tippees

- **The CFTC may apply the misappropriation theory to cases involving tips to 3rd parties, who then trade on that information:**
 - In an example provided by the CFTC, a “tipper” provides material, non-public information to a “tippee” in exchange for some “personal benefit”
 - *E.g.*, disclosing the company’s position to a trader at another firm
 - What counts as a sufficient “personal benefit” is currently being litigated in the S. Ct.



Summary of the Misappropriation Standards

Insider trading under the CEA is:

Engaging in deceptive or manipulative conduct in connection with futures, swaps, or commodities

Proving insider trading through misappropriation requires:

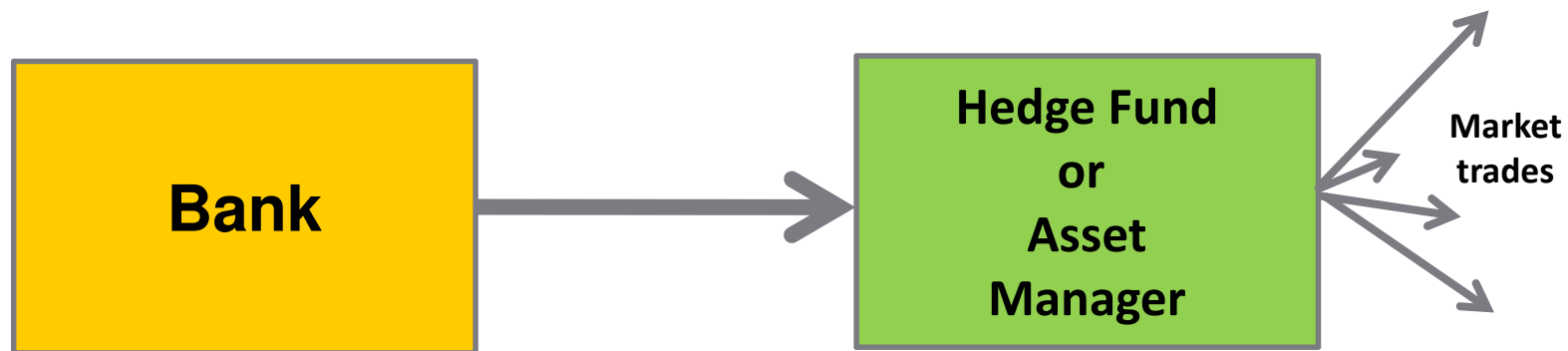
1. **Scienter:** knowing or reckless behavior
2. **Deceit:** *e.g.*, misappropriation of material non-public information in breach of an existing duty
3. **Trading** (or attempting to trade) futures, swaps, or commodities while using or in knowing possession of material non-public information

What types of relationships establish a duty of confidentiality?

When is trading on non-public information “deceptive” and in breach of that duty?

Example of Misappropriation

Non-public information provided freely – not taken through fraud or deceit – *e.g.*, position information, pending orders.



Does a relationship of “trust and confidence” exist between a bank and the fund / asset manager?

Between the bank and the source of the information? (tipper-tippee?)

If the fund / asset manager trades on information provided by the bank, does that breach a pre-existing duty? (to whom?)

Does it depend on the nature of the information, and the purpose for which it was given?

Practical Implications

Where Might the CFTC Draw the Line?

- Insider trading is a relatively new concept for most parts of the commodities markets, but the CFTC may borrow from existing rules / guidance by other regulatory authorities to identify more general standards and best practices:
- CFTC rules applicable to registered entities
 - **Futures commission merchants** are subject to rules regarding the use of confidential customer information
 - **Registered swap dealers** are subject to business conduct standards that require the protection of confidential customer information
- Bank of International Settlements (May 2016)
 - **Global Code of Conduct for the FX Market** sets out “global principles of good practice... to provide a common set of guidance to the market, including in areas where there is a degree of uncertainty about what sort of practices are acceptable, and what are not.”

1. Takeaways from FCM Rules

Long-standing CFTC and NFA rules specifically prohibit FCMs from inappropriately using confidential customer information:

- NFA Rule 2-4: “Members and Associates shall observe high standards of commercial honor and **just and equitable principles of trade** in the conduct of their commodity futures business and swaps business” – which means:
 - Do not **knowingly or recklessly misuse confidential information** or trade secrets in your possession
 - Do not **knowingly trade ahead** of customer orders
 - Exercise **due care** to avoid trading ahead of customer orders
 - Consider separate customer and proprietary trading functions
 - Periodically audit / compare trading in customer and proprietary accounts
- CFTC Rule 155.3 generally requires FCMs to **enforce internal controls** to prevent trading ahead of or disclosing customer orders

2. Takeaways from Swap Dealer Rules

Registered swap dealers are subject to business conduct standards that:

1. **Prohibit** the use of confidential counterparty information in a way that would **tend to be materially adverse** to the counterparty; and
2. **Require** policies and procedures to protect material confidential counterparty information
3. **Permit** the disclosure/use of material confidential information if authorized in writing by the counterparty, or the disclosure/use is necessary (1) for effective execution of any swap with the counterparty; (2) to hedge or mitigate any exposure created by such swap; or (3) to comply with a request of the CFTC, DOJ, an SRO, applicable prudential regulator, or otherwise required by law

Does the counterparty owe an obligation to the swap dealer?

If not under CFTC Rule 23.410, under CFTC Rule 180.1 (anti-manipulation provision)?

3. Takeaways from the BIS “Global Code” for FX

First phase of Global Code of Conduct

- *Information Sharing, Principle 1:* “Market [p]articipants should clearly and effectively **identify and appropriately limit access** to [c]onfidential [i]nformation.”
- *Information Sharing, Principle 2:* “Market [p]articipants **should not disclose** [c]onfidential [i]nformation to external parties, except under specific circumstances.”
- *Guidance:* Traders and other firm personnel “should not disclose [c]onfidential [i]nformation to any individual under any circumstances where it appears likely that such individual will **misuse the information.**” “Confidential [i]nformation obtained from a [c]lient, prospective [c]lient, or other 3rd party is to be **used only for the specific purpose for which it was given**, except as provided above or otherwise agreed with a [c]lient.”



Implications for Commodities and Derivatives Traders

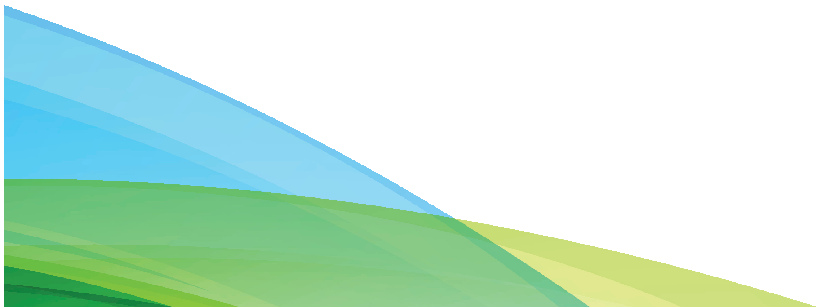
- **Consider how to monitor and control trading based on market color vs. non-public information received from counterparties or other market participants**
 - Distinguish between trading on **your** non-public information, and trading on non-public information obtained from **another source**
- **For non-registrants, consider whether to adopt written policies and procedures similar to those described in CFTC Rule 23.410(c)**
 - Address how to handle material non-public information – *e.g.*, outages, congestion, changes to supply/demand
- **For all market participants, consider conducting a compliance review to assess the adequacy of existing policies and procedures, and to identify relationships that may trigger heightened scrutiny**
 - Review confidentiality obligations with counterparties and brokers



Implications for Commodities and Derivatives Traders

Address feasibility of distinguishing between “market color” and confidential information

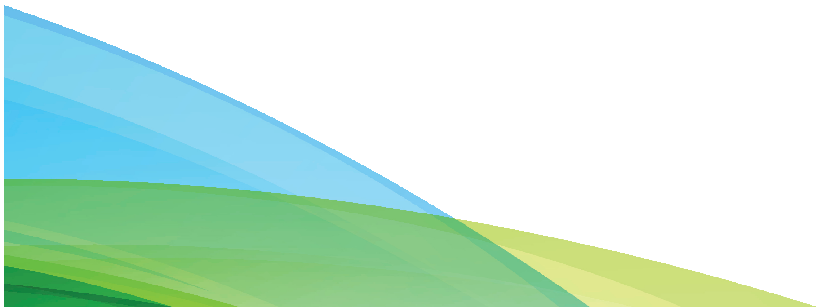
- BIS Global Code distinguishes between market color and confidential information
- Certain forms of market color are more likely to give rise to insider trading concerns than others. Concerning communications may include references to:
 - Specific client names, other methods for communicating a client’s identity or trading patterns (*e.g.*, code names which implicitly link activity to a specific market participant)
 - Specific client groups, locations, and strategies that allow market participants to derive underlying confidential information
 - Exact rates, volumes, or locations that relate to a single client



Implications for Commodities and Derivatives Traders

Examples:

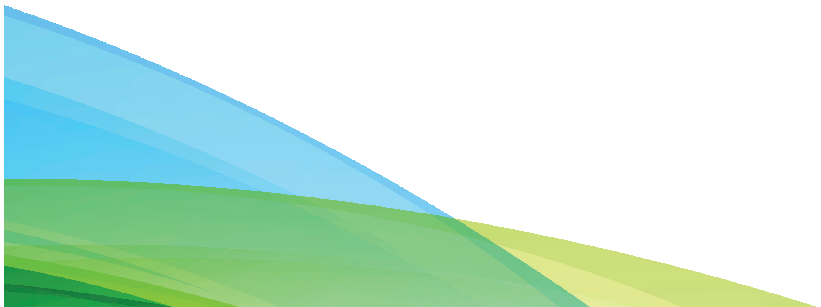
- *Statement from a broker to a bank market-maker: “European banks are currently bidding for 1-month at-the-money USD/JPY volatility in size.”*
- *Statement from an asset manager to bank market-maker: “Bank ABC just called me with an axe to buy EUR/SEK. Are you seeing buying as well?”*
- *Bank market-maker to another bank market-maker: “I’m being asked to quote a two way price in USD 150m in USD/MXN. What spread does your bank's pricing matrix show?”*



June 1, 2016

ICE Guidance on Pre-Hedging Block Futures Trades

- ICE proposed rules to permit parties (not intermediaries) to an anticipated block trade to **pre-hedge positions** they believe in good faith will result from the trade
 - However, it is a **violation** of exchange rules for a person **to front run a block trade when acting on material non-public information** regarding an impending transaction by another person, if done based upon non-public information obtained through a confidential employer/employee relationship broker/customer relationship, or in breach of a fiduciary responsibility
 - The exchange may take enforcement action when the facts and circumstances suggest **deceptive or manipulative conduct** by any of the persons involved
- Since October 2012, CME has prohibited pre-hedging block trades more broadly
 - No trading in the same or a closely-related product (including physical commodities) for the purpose of taking advantage of “actionable non-public information regarding an imminent block trade” prior to the public report
 - Parties to a block trade may hedge the trade only after it is consummated



EU Directives Regarding Insider Trading

European Insider Trading Restrictions

- Historically, EU-wide insider trading rules under 2003 Market Abuse Directive applied only to financial instruments traded on **regulated markets**
- UK had additional offences under the 1993 Criminal Justice Act which applied to **securities** (defined as shares, debt securities, warrants, depositary receipts, security options, futures and contracts for differences), again, where traded on a regulated market
- **Physical commodity markets** have been in scope in only a limited capacity
- Since original rules were enacted, financial instruments have increasingly been traded on new trading venues or OTC, making it more difficult for regulators to monitor for market abuse
- New Market Abuse Regulation 2015 (MAR) and Regulation on Wholesale Energy Markets Integrity and Transparency 2011 (REMIT) expanded insider trading to all trading venues (not just regulated markets) and OTC transactions that impact contracts traded on those venues – physical commodity markets are now fully in scope



Conclusion

Thank you for your attention.

Please use the “question” function on your webinar control panel to ask a question to the moderator or speakers.

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