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# CFTC Enters the Insider Trading Enforcement Arena

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Since the passage of the Dodd-Frank Act, the Commodity Futures Trading Commission has stepped up its profile on the financial regulatory landscape. Dodd-Frank not only expanded the CFTC's jurisdiction by handing it the multi-hundred trillion dollar swaps market to regulate, it also enlarged the agency's enforcement tool box by, among other things, enacting forceful anti-fraud legislation. On Dec. 2, 2015, the CFTC used that new tool to charge the misappropriation theory of insider trading liability for the first time in the agency's history. This action demonstrates the CFTC's willingness to enter a territory previously held exclusively by securities regulators, albeit at a time when shifts in the legal landscape have narrowed what constitutes culpable insider trading in the securities arena, a narrowing that surely will impact the CFTC as well. The history of CFTC insider trading enforcement and what the future may hold follows.

In the past, the CFTC was a reluctant actor in insider trading enforcement. After all, the futures markets were founded in part upon the notion that the nation's producers—such as farmers and ranchers—should have a regulated platform to trade on their own "inside" information concerning their crops and herds, to hedge their risks and lock in prices.[1] In other words, the futures (and other derivatives) markets exist, at least in part, to *promote* lawful "insider trading." There is no general obligation for a farmer to disclose to futures traders material information about his crops before he trades on that information. On the other hand, the securities markets, which are used for capital formation, exalt principles of disclosure. Securities investors own shares in companies that are obligated to regularly disclose accurate information about how the company is doing; corporate insiders are forbidden from trading on material information unless they first disclose that information.[2]

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For many years, the Commodity Exchange Act's (CEA) primary prohibition against insider trading applied solely to insiders of the Commission, registered futures exchanges and registered futures associations, and their tippees.[3] This prohibition did not reach certain forms of misappropriation-based insider trading, such as where employees of private companies holding material corporate information traded in breach of duties owed to their employers.

Also for many years, certain market voices have urged the CFTC to more aggressively police insider trading. For example, Congress, in the early 1990s, attempted to pass a bill to prohibit employees from personally using nonpublic information about their employers' cash market positions.[4] However, perhaps wary that futures market insider trading prosecutions might erode the fundamental futures market principle that one should be able to hedge based on one's own inside information (think farmer and his crops), the CFTC opposed this theory of liability, noting that while "employees should not misuse their firms' information for personal gain" in the futures or options markets, "more information regarding the nature and magnitude of th[e] problem [was] needed" in order to justify the bill.[5]

In the wake of Dodd-Frank, proponents of insider trading enforcement have won the debate. The CFTC, aiming to protect market integrity, reversed course and demonstrated a newfound enthusiasm for pursuing misappropriation-based insider trading actions. For the first time, Dodd-Frank made it unlawful for any person, in connection with any contract of sale of any commodity for future delivery, to use or employ any manipulative or deceptive device or contrivance in contravention of Commission rules.[6] Under that authority, the Commission promulgated CFTC Rule 180.1, which largely tracked the well-known securities law provision, Rule 10b-5, in making it unlawful to: "use or employ … any manipulative device, scheme or artifice to defraud" or "engage … in any act, practice, or course of business, which operates or would operate as a fraud or deceit upon any person."[7] In the release adopting Rule 180.1, the Commission sent the clear message that prosecuting traders using misappropriated material nonpublic information was not inconsistent with its core mission of protecting the hedging opportunities provided by the derivatives markets. The Commission observed that the label "'insider trading' can mean different things in different contexts," and gave an explicit nod to key principles of CFTC-regulated markets: "[U]nlike securities markets, derivatives markets have long operated in a way that allows for market participants to trade on the basis of lawfully obtained material nonpublic information. [Rule 180.1] does not prohibit trading on the basis of material nonpublic information except as provided in the following paragraph or otherwise prohibited by law."[8] The following paragraph of the release then spelled out the theory: "Depending on the facts and circumstances, a 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 on or subject to the rules of any registered entity, *for example by 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*, may be in violation of final Rule 180.1."[9] The Commission emphasized that the Rule was consistent with its "responsibility to protect market participants and promote market integrity" and with its view that the Dodd-Frank anti-fraud provision "is a broad catch-all provision, reaching any manipulative or deceptive device or contrivance."[10]

On Dec. 2, 2015, the CFTC demonstrated just how committed it is to the misappropriation theory. On that day, the Commission announced the settlement of an enforcement action against a gasoline trader, Arya Motazedi, whom it found had traded on information he misappropriated from his employer.[11] According to the CFTC's order, as a trader for a company that traded gasoline futures contracts, Motazedi both was privy to material nonpublic information regarding his employer's intention to trade those contracts and owed his employer a duty not to use the company's proprietary information for his own benefit. Despite this duty, which was created by the company's written prohibitions against personal trading, Motazedi placed orders for gas and oil futures contracts in his own personal accounts immediately before placing orders for his employer. The CFTC found that Motazedi engaged in this practice a dozen times in the hope that his personal orders would benefit from any price movement that resulted from the subsequent execution of his employer's orders. According to the CFTC, Motazedi violated Rule 180.1, marking the first time the CFTC had used the Rule to enforce a misappropriation-based insider trading theory.

By bringing the Motazedi action, the CFTC has confirmed that it will use its new "insider trading" powers notwithstanding prior misgivings about pushing forth into insider trading enforcement. But what if the CFTC seeks to take the theory to the next logical step, to charge tippers and tippees of misappropriated information? If the trader in Motazedi had tipped an investment adviser, or a swap dealer, who then traded on that information, would the adviser or dealer be liable? If, as we predict, the CFTC seeks to take the theory to the next logical step, against tippers and tippees of misappropriated information, it will have to grapple with the latest shifts in insider trading theory, particularly the Second Circuit's landmark decision in *U.S. v. Newman*.[12]

Although the CFTC's action against Motazedi did not involve his "tipping"—i.e., providing material nonpublic information to others to trade on—such a practice is a common basis for insider trading liability. In *U.S. v. Newman*, the Second Circuit clarified that there is a higher bar to establish liability for such cases than the government had proposed in its prosecution. In interpreting *S.E.C. v. Dirks*—the Supreme Court case that dictates that the initial tipper must have received a "personal benefit" from tipping inside information before liability can attach to either that tipper or his tippees—the Second Circuit in *Newman* made clear that such a "personal benefit" is not so easily proven. The court found that the reputational benefit that may redound to a tipper from tipping inside information to a casual friend was insufficient to satisfy the "personal benefit" requirement.[13] Rather, in order to meet this requirement, the government must prove "a meaningfully close personal relationship that generates an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature."[14]

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Although *Newman* was based on the classical theory of insider trading (i.e. where, by sharing corporate information with others, tippers violate a duty to shareholders, rather than to the source of their information), it is likely that *Newman*'s "personal benefit" requirement applies to misappropriation-based insider trading actions, such as those contemplated under Regulation 180.1.[15] Indeed, in interpreting *Newman*, Judges Rakoff and Carter of the Southern District of New York and one of the SEC's own Administrative Law Judges have all found that the opinion's "personal benefit" holding applies to misappropriation cases.[16]

The CFTC's misappropriation theory for insider trading liability will be "guided" by the "substantial body of judicial precedent applying the comparable language of SEC Rule 10b-5."[17] Accordingly, the limits that *Newman* imposed on securities tipper-tippee liability theories will presumably apply to the CFTC as well. Although *Newman* will not prevent the CFTC from continuing to use its new authority to bring misappropriation-based insider trading cases against individuals like Motazedi, who directly trade on their employer's information for their own benefit, this new precedent will limit the CFTC's ability to bring charges against tippers and tippees where, like in *Newman*, the benefit to the tipper is not so clear or easy to prove. To be sure, by insisting that the equivalent of a quid-pro-quo between the tipper and tippee be shown, the court in *Newman* imposed an evidentiary burden that CFTC enforcement attorneys will have to carefully consider before bringing a misappropriation-based action against tippees.[18] Nonetheless, whatever the impact of *Newman*, the CFTC has staked out new ground as the derivatives market insider trading enforcer.

1. See U.S. Commodities Futures Trading Comm'n, "A Study of the Nature, Extent and Effects of Futures Trading by Persons Possessing Material, Nonpublic Information" at 54 n.10 (September 1984) ("[F]utures markets have as a basic function facilitating risk shifting, certain information cannot be equally accessible to all. Otherwise, a firm that is hedging its cash market risk would be disadvantaged in making those transactions, or, were its cash market operations or the full extent of its risk publicly disclosed, might have its ability to shift that risk impaired.").

2. See *Chiarella v. United States*, 445 U.S. 222, 227 (1980) ("[A] corporate insider must abstain from trading in the shares of his corporation unless he has first disclosed all material inside information known to him.").

3. See 7 U.S.C. §13(c), (d) (2006).

4. See H.R. Rep. No. 6, 101st Cong., 2d Sess. 11 (1991).

5. H.R. Rep. No. 6, 101st Cong., 2d Sess. 59 (1991).

6. 7 U.S.C. §9(1) (2012).

7. 17 C.F.R. §180.1 (2014).

8. Prohibition on the Employment, or Attempted Employment, of Manipulative and Deceptive Devices and Prohibition on Price Manipulation 76 F.R. 41398, 41403 (July 14, 2011).

9. Id. (emphasis added).

10. Id. Dodd-Frank also provided a separate basis for insider trading liability, which the former CFTC Chairman referred to as the "Eddie Murphy Rule" in a reference to the 1983 movie where an unpublished U.S. Department of Agriculture orange crop report was passed on to traders who attempted to profit from that information by trading frozen concentrated orange juice futures contracts. See "First The Volcker Rule, Now The Eddie Murphy Rule!", MarketBeat, The Wall Street Journal (March 4, 2010). The "Eddie Murphy Rule" prohibits *all* federal employees from imparting non-public information to assist others in a futures, options or swap transactions. 7 U.S.C. §6c(a)(4)(A)-(B).

11. Order Instituting Proceedings, *In re Arya Motazedi*, CFTC Docket No. 16-02 (Dec. 2, 2015).

12. *U.S. v. Newman*, 773 F.3d 438 (2d. Cir.), cert. den., 136 S.Ct. 242 (2015).

13. *Newman*, 773 F.3d at 452.

14. Id.

15. See *U.S. v. O'Hagan*, 521 U.S. 642, 652-54 (1997) (misappropriation theory emanates from a fiduciary's "self serving use" of that information, involving conversion of information "for personal gain"); *S.E.C. v. Obus*, 693 F.3d 276, 289 (2d Cir. 2012) (tipper must have received a personal benefit from the tip to establish liability under the misappropriation theory); *Newman*, 773 F.3d at 446 ("The elements of tipping liability are the same, regardless of whether the tipper's duty arises under the 'classical' or the 'misappropriation' theory.").

16. See *S.E.C. v. Payton*, 14 Civ. 4644, slip op. at 9-10 (S.D.N.Y. April 6, 2015) (Rakoff, J.) (finding that, under *Newman*, the "personal benefit" requirement applied to the misappropriation theory of insider trading in addition to the classic theory); *U.S. v. Conradt, et al.*, No. 12-cr-887, slip op. at 3 (S.D.N.Y. Jan. 22, 2015) (Carter, J.) (same); *In the Matter of Gregory T. Bolan, Jr. and Joseph C. Ruggieri*, File No. 3-16178, SEC Release No. 2309, at 1-2 (Feb. 12, 2015). Moreover, at least one other circuit court has reached the same conclusion. See, e.g., *SEC v. Yun*, 327 F.3d 1263, 1275 (11th Cir. 2003) ("[M]ust prove that a misappropriator expected to benefit from the tip.").

17. 76 F.R. at 41399.

18. At least for the time being, *Newman* will be the primary case the CFTC must consider in bringing a tip-based insider trading case. However, the Supreme Court recently granted a petition for certiorari in a criminal insider trading action from the Ninth Circuit that also turns on the scope and meaning of the "personal benefit" requirement. See *Salman v. U.S.*, —S.Ct.—, 2016 WL 207256 (Mem) (Jan. 19, 2016). Depending on whether and how the Supreme Court reformulates the standard, this case could affect how the "personal benefit" element is analyzed in the future and should be closely monitored by those interested in this issue.