CFTC Asserts Its Broader Fraud Jurisdiction and Steps Into the World of Insider Trading

On December 2, 2015, the Commodity Futures Trading Commission (CFTC) announced the filing and simultaneous settlement of an administrative proceeding captioned *In the Matter of Arya Motazedi*, CFTC Docket No. 16-02. The matter involved trading by Arya Motazedi, identified as a proprietary trader in the Chicago office of "a large, publicly traded corporation." Apparently he traded gas futures for the company and also placed orders for other energy futures for his employer. The CFTC found that he misused the proprietary and confidential information he had about the prices, amounts and times at which the company intended to trade oil and gas futures, both to place trades between his personal accounts and the company's accounts at prices favorable to himself and to trade ahead of his company's orders. The settlement order requires Motazedi to pay restitution of approximately $217, 000 to his former employer and a civil monetary penalty of $100,000, and permanently bars him from registration in any capacity with the CFTC and from trading on any CFTC-regulated futures exchange, clearinghouse or swap execution facility, as well as from transacting in any "commodity interest" as defined in the Commission regulations.[1]

In many ways, this settlement is not particularly noteworthy. Its findings of illegal fictitious and non-competitive sales based on the fact that Motazedi executed trades between his personal accounts and company's accounts in a manner designed to ensure they matched and avoided competitive execution and negated market risk, and to ensure his personal accounts would profit (by exactly what manner he accomplished these ends remains unexplained in the settlement order) is not unusual. Finding fraud violations under Section 4b of the Commodity Exchange Act (CEA) for front-running is also a long-standing practice. [2] Indeed, bringing charges for front-running orders of one's employer is not a new phenomenon.[3]

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[1] *See* 17 C.F.R. §1.3(yy).

[2] Section 4b provides in relevant part that it is unlawful:

> **(1)** for any person, in or in connection with any order to make, or the making of, any contract of sale of any commodity in interstate commerce or for future delivery that is made, or to be made, on or subject to the rules of a designated contract market, for or on behalf of any other person; or
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> **(2)** for any person, in or in connection with any order to make, or the making of, any contract of sale of any commodity for future delivery, or swap, that is made, or to be made, for or on behalf of, or with, any other person, other than on or subject to the rules of a designated contract market –
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> > **(a)** to cheat or defraud or attempt to cheat or defraud the other person;

However, there are three very important aspects of this settlement, worthy of careful consideration:

1) *The Commission eliminates any remaining doubt that it intends to use its broad, new authority under Section 6(c)(1), as added by the Dodd-Frank Act, to go after fraud, not just manipulation.*

Congress added Section 6(c)(1) to the CEA[4] in response to concerns that the CFTC's existing provisions addressing manipulation created too high a hurdle of proof for the government.[5] Congress added the provision in a section of Dodd-Frank entitled "Anti-Manipulation Authority." The heading written into the provision itself reads "Prohibition Against Manipulation." And the CEA already has a provision that addresses fraud and deception, the aforementioned Section 4b, which Dodd-Frank did not amend.

However, the actual language used in the statute was drawn from and mimics Section 10(b) of the Securities Exchange Act of 1934, which covers both fraud and manipulation. The CFTC rule promulgated to implement this provision, Rule 180.1 similarly mimics Rule 10b-5 of the Securities and Exchange Commission, which is generally recognized as a broad fraud rule.[6] The CFTC said at the time that it promulgated rule 180.1 that, "given

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> **(b)** willfully to make or cause to be made to the other person any false report or statement or willfully to enter or cause to be entered for the other person any false record;
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> **(c)** willfully to deceive or attempt to deceive the other person by any means whatsoever in regard to any order or contract or the disposition or execution of any order or contract, or in regard to any act of agency performed, with respect to any order or contract for or, in the case of paragraph (2), with the other person.

[3] *See,* e.g., *Commodity Futures Trading Commission v. Kelly, et al.,* 98 Civ. 5270(JSR) (S.D.N.Y., filed July 23, 1998) (complaint alleging employee used employer's trading information to frontrun its trades); and *In re Sitzmann,* CFTC Docket No. 96-5, 1997 WL 82610 (CFTC February 27, 1997) (consent order finding that vice president of commodity trading of meat processer used his employer's nonpublic and proprietary information about large orders to frontrun those trades in a proprietary trading account).

[4] Section 6(c)(1) of the CEA provides, in relevant part:

> **(1) Prohibition against manipulation**
> It shall be unlawful for any person, directly or indirectly, to use or employ, or attempt to use or employ, 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, any manipulative or deceptive device or contrivance, in contravention of such rules and regulations as the Commission shall promulgate by not later than 1 year after July 21, 2010, provided no rule or regulation promulgated by the Commission shall require any person to disclose to another 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 made to the other person in or in connection with the transaction not misleading in any material respect.

[5] *See.,* e.g., http://www.cantwell.senate.gov/news/record.cfm?id=324761 (Press Release of Senator Maria Cantwell, May 6, 2010) ("Under current law, the standard the CFTC must meet to prove market manipulation is so high that there has only been one successful prosecution in the past 35 years.")

[6] Rule 180.1 states:

> (a) It shall be unlawful for any person, directly or indirectly, 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, to intentionally or recklessly:
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> (1) Use or employ, or attempt to use or employ, any manipulative device, scheme, or artifice to defraud;
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> (2) Make, or attempt to make, any untrue or misleading statement of a material fact or to omit to state a material fact necessary in order to make the statements made not untrue or misleading;
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> (3) Engage, or attempt to engage, in any act, practice, or course of business, which operates or would operate as a fraud or deceit upon any person; or,
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> (4) Deliver or cause to be delivered, or attempt to deliver or cause to be delivered, for transmission through the mails or interstate commerce, by any means of communication whatsoever, a false or misleading or inaccurate report concerning crop or market information or conditions that affect or tend to affect the price of any commodity in interstate commerce, knowing, or acting in reckless disregard of the fact that such report is false, misleading or inaccurate.
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> Notwithstanding the foregoing, no violation of this subsection shall exist where the person mistakenly transmits, in good faith, false or misleading or inaccurate information to a price reporting service.

the similarities between CEA section 6(c)(1) and Exchange Act section 10(b), the Commission deems it appropriate and in the public interest to model [the new rule] on SEC rule 10b-5."[7] It also said it would "be guided, but not controlled by, the substantial body of judicial precedent applying the comparable language of SEC Rule 10b-5."[8] Indeed, CFTC Rule 180.1 goes beyond SEC Rule 10b-5, by explicitly including a "recklessness" standard and expressly covering any "attempt" to violate any of its provisions.

It was not entirely clear, therefore, in the wake of the passage of Dodd-Frank and the promulgation of Rule 180.1, whether the Commission would feel at all confined by the purpose behind the new provision—to address the Commission's anti-manipulation authority—to limit its use of the new provision to those purposes, or whether it would feel free to use the new provision broadly to go after any fraud in market transactions.

This case makes it crystal clear that the CFTC intends to use it as a sweeping fraud provision. There is no suggestion that this matter had any manipulative element to it. Rather, the facts are described solely in terms of the fraud and deceit operated upon Motazedi's employer. Moreover, in the body of the order, the Commission quotes its own statement in the Notice of Proposed Rulemaking relating to Rule 180.1, that it intended "to interpret CEA section 6(c)(1) as a broad, catch-all provision reaching fraud in all its forms—that is, intentional or reckless conduct that deceives or defrauds market participants."[9]

What is most interesting about this decision to apply Section 6(c)(1) broadly is that, unlike the SEC's provision, which is tied specifically to securities transactions, the CFTC provision allows it to bring cases for fraud and deception arising from "a contract for sale of any commodity in interstate commerce." The implementing rule repeats this language. In other words, it is *not* limited to futures, swaps or other derivatives, or even for that matter, to cash commodities tied in some way to futures, swaps or other derivatives. In theory, the CFTC, if it chose to do so, could turn itself into an enforcer against fraud and deception in virtually any commercial transaction. While there is no reason to think it will do so, it is far from clear what self-imposed limits it intends to follow.

2) *The Commission has embraced the language of insider-trading law, although not the terminology "insider trading" itself.*

In *Motazedi*, the CFTC adopts and embraces the language of SEC insider trading law. Motazedi's fraud is described as "misappropriating non-public, confidential and material information." It relies in part on the fact that "Motazedi and his employer shared a relationship of trust and confidence that gave rise to a duty of confidentiality." The Order indicates that Motazedi routinely had access to the times, volume and prices at which his employer intended to trade energy futures for its proprietary accounts, all of which the CFTC labeled as "material, non-public information." The CFTC cites the seminal SEC insider trading case, *U.S. v. O'Hagan*, 521 U.S. 642 (1997), in its legal analysis. It concludes that Motazedi committed fraud by his "knowing or reckless

(b) Nothing in this section shall be construed to require any person to disclose to another 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 made to the other person in or in connection with the transaction not misleading in any material respect.

(c) Nothing in this section shall affect, or be construed to affect, the applicability of Commodity Exchange Act section 9(a)(2).

[7] 76 Fed. Reg. at 41,399.

[8] *Id.*

[9] 75 Fed. 67,657, 67,658 (CFTC November 3, 2010).

misappropriation and misuse of his employer's material nonpublic trading information to trade in personal trading account, [which] breached his duty to his employer."

These are all concepts rooted in the SEC's insider trading precedent. In that regard, it is the confirmation of an evolution in CFTC thinking over the last several years. For most of its existence, the CFTC had shunned the concept of insider trading as relevant to the futures markets. To the contrary, it has long been a premise of futures and derivative regulation that the use of what might in the securities world be thought of as "insider information" for trading was a central element of the markets' price discovery function. In the classic example, a large agricultural processor knows that it has made a material sale of grain. It goes into the market to hedge that sale. The hedging trades communicate to the market critical information about supply and demand. Thus, the company used "inside information" about its material sales to trade, and that use of the information is beneficial, not detrimental, to the market. Indeed, this distinction between the overall view of the use of inside information between the securities and the derivatives worlds caused some people to worry about how the SEC would address its responsibilities for overseeing certain derivatives products.[10]

Nonetheless, in recent years, more discussion about potential concerns with certain forms of "insider trading" has crept into the CFTC's public discussions; certainly the theft of confidential information that is then used to trade in the markets has been viewed as improper.[11] Now, with *Motazedi*, the CFTC has presented the most explicit exposition of how it sees "misappropriation" of "confidential, material and non-public" information as providing a foundation for a charge of fraud under its own statute.

The open issue is where the Commission is prepared to go with this theory of liability. On the one hand, it does not seem to require that the misuse of the information cause harm to the person to whom the duty of trust and loyalty was owed. While the Commission notes that Matazedi's employer *may* have gotten poorer executions for its own trades because of the front-running, it does not make a definitive finding in that regard, and it does not rely at all on the possible harm to the employer in its analysis of fraud under the Section 6(c)(1). Rather, the fraud is tied solely to the fact that Matazedi used the information to trade for his own benefit without disclosing his plans to do so to his employer. That fraud provided a sufficient basis for the Commission to act, without regard to any evidence of actual harm to the market or to any participant in the market.

On the other hand, the Commission is careful to state that the problem is with "the misuse" of confidential, material, nonpublic information to trade, not its use at all. In that regard, the CFTC has stated that rule 180.1 and does not impose any new affirmative duties of inquiry, diligence, or disclosure. The failure to disclose material nonpublic information prior to entering into a transaction, either exchange transactions or in bilateral negotiations, will not constitute a violation.

However, depending on all of the facts and circumstances, trading or engaging in a transaction on the basis of material nonpublic information in breach of a pre-existing duty (established by another law or rule, agreement,

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[10]*See* A Joint Report of the SEC and the CFTC on Harmonization of Regulation at 6 (October 16, 2009) (The approaches of the securities and futures laws also diverge on the issue of insider trading. . . . The difference between the two regimes is attributable, first, to the historical functions of the futures markets. These markets permit hedgers to use their non-public material information to protect themselves against risks to their commodity positions. Though counterparties to these kinds of transactions may not have access to the same nonpublic information, corporate officials and personnel generally do not have a similar fiduciary duty with respect to those counterparties; indeed, their duties are to ensure that the company properly manages its risks by trading on the best available information.") *found at*: http://www.cftc.gov/stellent/groups/public/@otherif/documents/ifdocs/opacftc-secfinaljointreport101.pdf.

[11]*See id.* at 7("Some extension of insider trading prohibition under the futures laws would be appropriate since current laws would not prohibit, for example, misappropriation of non-public government information for trading purposes").

understanding, or some other source), or on the basis of material nonpublic information that was obtained through fraud or deception, may violate final Rule 180.1. Similarly, fraud or deception by the partial omission of material nonpublic information could violate Rule 180.1.

In sum, the open question is what other types of use of inside information the Commission is prepared to label as "misuse."

3) *While the Order clearly foretells of serious consequences of the misappropriation of inside information, it is unclear what the compliance and supervision implications might be for employers.*

The Order bars Motazedi permanently from registration and trading. It portrays his employer clearly and exclusively as a victim. But it leaves unanswered what the supervision and compliance obligations may now follow from the clear message that there are "misuses" of inside information, aside from outright theft, that constitute violations of the CEA, misuses that can arise from the violations of "duties" to others. Companies now need to consider carefully what kinds of information their employees deal with, both from internal and external sources, and what kinds of policies, procedures, and oversight need to be put in place to seek to prevent any misuse of that information, in violation of duties owed, in the course of trading. While the *Motazedi* Order is solely focused on the individual, one can foresee that failures by companies to police for this type of misconduct could cause liability to land on them in the future. Such liability could be in the form of a CFTC enforcement action alleging principal-agent liability, secondary liability or failure to supervise. It could also trigger a private cause of action against the employer by other traders alleging harm to market prices, based on the "recklessness" of the employer in not adopting appropriate procedures to prevent employees from trading in commodities based on the employer's material nonpublic information.

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The *Motazedi* case is simply another indication of the CFTC desire to flex its enforcement muscles provided by its expanded jurisdiction and expanded powers provided by the Dodd-Frank Act. It is another cautionary tale that those who may find themselves swept into the CFTC's reach by the changes in the statute need to be mindful of the various ways that they can be ensnared in an enforcement matter and take what steps they can to mitigate those risks.

If you have any questions regarding this Sidley Update, please contact the Sidley lawyer with whom you usually work, or

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