The CFTC turns to insider trading enforcement

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Abstract

Purpose – *To alert participants in the commodities markets to an important development in the exercise of enforcement authority by the Commodity Futures Trading Commission.*

Design/methodology/approach – *Explains a recent proceeding which resulted in the CFTC's first-ever application of a newly-promulgated regulatory Rule to punish "insider trading" involving the commodities markets.*

Findings – *The CFTC has shown that it intends to apply its new Rule aggressively to address insider trading in the commodities markets.*

Practical implications – *As a result of the CFTC's new enforcement approach to regulating insider trading in the areas under its jurisdiction, all participants in the commodities markets must be attuned to the prohibition on insider trading, familiar with actions that might be deemed unlawful insider trading, and act accordingly to avoid improper trading activities.*

Originality/value – *Practical guidance for participants in the commodities markets from an experienced attorney with expertise in government enforcement matters.*

Keywords *Insider trading, Commodity Futures Trading Commission (CFTC), CFTC Regulation 180.1, Commodities enforcement, Commodities exchange act, Regulatory sanctions*

Paper type *Technical paper*

The US Commodities Futures Trading Commission (CFTC or Commission) recently brought, and settled on consent, its first-ever insider-trading case. The Commission used its new authority under the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) and the Commission's new antifraud regulation promulgated under Dodd-Frank. This action portends a new enforcement priority for the CFTC and more commodities-related insider trading cases in the future.

The CFTC's charges

The CFTC's action was taken in an administrative proceeding, *In the Matter of: Arya Motazedi* (CFTC Docket No. 16-02, Dec. 2, 2015), culminating in an Order entered on consent. As recited in the CFTC's Order, Respondent Motazedi was a gasoline and energy futures proprietary trader at the Chicago office of an unidentified public company. Due to his position, Motazedi received confidential and propriety trading information concerning the times, amounts, and prices at which his company intended to trade energy commodities futures for its account. His employer's internal policies prohibited employees from engaging in personal transactions involving energy contracts and other personal transactions that created a conflict of interest.

The CFTC charged that, from September through November 2013, Motazedi orchestrated 46 fraudulent transactions in futures contracts for oil and gas through the New York Mercantile Exchange using his personal trading accounts and a proprietary account in which he traded for his company. Thirty-four of the transactions were, according to the

CFTC, "fictitious trades" between the company's account and Motazedi's personal accounts "at prices which disadvantaged the company's accounts''; some of these were "roundtrip" transactions in which the same number of contracts was traded back and forth between the accounts at different prices. The other fraudulent transactions involved Motazedi placing orders for his personal accounts ahead of orders he placed for the company, a practice known as "front running." From all the transactions, the CFTC charged, Motazedi generated profits for himself and caused losses (or reduced profits) for his company totaling $216,955.80.

The CFTC's findings and determination

The CFTC based liability on several provisions of the Commodities Exchange Act. It concluded that Motazedi's orchestrating the improper trades by misappropriating confidential information, and his front running trades, violated Section 4b(a), a general antifraud provision. The Commission also found that his prearranged trades between his employer's proprietary account and his personal trading accounts violated Section 4c(a) of the Act, which specifically makes unlawful a transaction that is a "fictitious sale." And it determined that Motazedi's actions in "matching" orders between his personal accounts and his employer's violated Commission Regulation 1.38(a), which requires commodity futures contracts to be executed "openly and competitively" and therefore bars non-competitive trades.

But while these long-standing antifraud provisions were no doubt themselves sufficient to sanction Motazedi, the CFTC went further. It found that Motazedi's conduct violated Section 6(c)(1) of the Commodities Exchange Act (7 USC § 9(1)). That provision – in language largely tracking Section 10(b) of the Securities Exchange Act of 1934 – generally makes it unlawful for "any person, in connection with" any swap or commodities sales contract "to use or employ any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission shall promulgate." Section 753 of Dodd-Frank (Pub. L. No. 111-203, § 753(a), codified at 7 USC §9(1)) provided this statutory authority for the CFTC to promulgate such new antifraud rules and regulations. As a consequence, in 2011 the CFTC adopted Regulation 180.1 (17 C.F.R. § 180.1).

As the Commission described it in *Motazedi*, Regulation 180.1 makes it unlawful to:

> (1) use or employ, or attempt to use or employ, any manipulative device, scheme, or artifice to defraud; (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; or (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.

The CFTC noted that regulation-enabling Section 6(c)(1) is "virtually identical" to Section 10(b) of the Securities Exchange Act and, thus, the CFTC had found it appropriate and in the public interest "to model final Rule 180.1 on SEC Rule 10b-5." As a result, the CFTC noted in *Motazedi* that Section 10(b) and Rule 10b-5 case law would be "instructive" in construing these counterparts in the Commodities Exchange Act. However, the CFTC left itself an out, stating that because of differences between the securities and derivatives markets, the CFTC "will be guided, but not controlled," by judicial precedent under Rule 10b-5.

The Commission also noted in *Motazedi* that in adopting Regulation 180.1, it had opined that Section 6(c)(1) and the regulation "augment the Commission's existing authority to prohibit fraud and manipulation"; and that in this rule-making process, the Commission made clear its intent to interpret 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." Thus, the CFTC plainly stated the prohibition on insider trading in commodities transactions under its new authority: "Trading on material non-public information in breach of a pre-existing duty may constitute a violation of Regulation 180.1."

And the CFTC invoked the misappropriation theory of misuse of confidential information – one of the theories often used in securities insider trading cases – explaining that the deception necessary under the theory occurs "because the source of the information (principal) is entitled to 'the exclusive use of the information.'"

In applying these principles, the CFTC characterized Motazedi's fraud in the familiar language of securities law insider trading. It found that:

- Motazedi was privy to material, non-public trading information of his employer;
- he held a relationship of trust and confidence with his employer and owed it a duty not to misuse the information;
- he was prohibited under his company's internal policies from trading energy commodities in his personal accounts and from engaging in transactions that created a conflict of interest with his employer; and
- he nonetheless "knowingly or recklessly used his employer's trading information to trade for his own benefit and failed to disclose his plans to his employer."

The CFTC therefore concluded that Motazedi breached his duty to his employer in violation of both Section 6(c)(1) and Rule 180.1.

Based on the findings of violation, and on Motazedi's offer of settlement, the CFTC imposed significant sanctions. Specifically, the Order requires Motazedi to cease and desist from violating the statutes and regulations at issue in the proceeding, pay restitution in the amount of $216,955.80, and pay a civil monetary penalty of $100,000. Significantly, the Order also permanently prohibits Motazedi from trading in commodities interests and permanently bars him from applying for registration with the CFTC.

Implications

The implications of *Motazedi* are significant. Simply put, the CFTC now has begun using its newly given enforcement muscle to address insider trading in the commodities markets. More investigations involving transactions of commodities traders and other participants in the commodities markets are sure to follow. And, no doubt, this will lead to CFTC enforcement actions charging unlawful insider trading under Regulation 180.1. Furthermore, regulatory investigations of fraud often implicate criminal liability. It is likely that the CFTC will coordinate more with criminal authorities, so more parallel criminal cases for insider trading in commodities should also be expected.

Significantly, the scope of Regulation 180.1 is broad. "[A]ny person," whether acting "directly or indirectly" and "in connection with" commodities transactions in interstate commerce, is subject to the prohibitions. Thus, the regulation goes beyond registered traders or managers. It is also noteworthy, but not surprising, that a reckless state of mind, not just intentional conduct, can give rise to a violation. Furthermore, the CFTC has indicated that it will construe Regulation 180.1 based on case law interpretation of Rule 10b-5, providing a ready body of law to be applied in particular cases. However, the CFTC also indicated it might deviate from the securities law cases if a case presents differences arising from the commodities markets, so there remains an as-yet unknown possible expansion on the CFTC's future application of Regulation 180.1. In addition, the possibility exists that "tipping" cases – where inside information is conveyed down a chain for trading purposes – might arise in future commodities cases; these cases often present additional issues on the misuse of and benefit from nonpublic information. It is also noteworthy that harsh sanctions can be applied for insider trading in commodities transactions, such as the lifetime trading ban meted out to Motazedi.

In short, all participants in commodities transactions and markets need to be cognizant of the CFTC's new attention to insider trading. In particular, investment fund managers who trade in commodities contracts need to be attuned to whether trading and market

information is confidential and proprietary to their firm, and to be aware that their activities might be under the microscope of whether information was used in violation of their fund's guidelines and their duties owed to the fund and its managing entity. The net result is that compliance procedures to deter and detect insider trading long prevalent on the securities side of a business must now be considered for commodities trading as well.

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