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# INSIDER-TRADING RISKS FOR SWAPS, FX, INTEREST RATES, CRYPTOCURRENCIES TRADERS UNDERSCORED BY RECENT CFTC SETTLEMENT

A recent CFTC settlement order underscores the risks posed by commodities insider-trading prosecutions, even where the defendant may have reasonable arguments against a finding of guilt. Indeed, defendants' decision to settle this matter rather than litigate may have reflected their determination that the cost of trial and the risk of an adverse jury verdict were unjustifiably high. Businesses worldwide that trade commodities (which are broadly defined to include swaps, FX, interest rates, cryptocurrencies, energy and more traditional commodities in U.S. derivatives and physical markets) should take note of this result, especially as CFTC now has the authority to prosecute insider trading by virtually all participants in U.S. commodities markets. Given the very high costs associated with even a successful defense of an insider-trading prosecution, businesses should take steps to assess and mitigate any insider trading risks related to their operations to ensure, to the greatest extent possible, that their practices do not come close to the line dividing permissible and insider trading. More information on the subject can be found at Clifford Chance's U.S. Insider Trading Q & A.[1]

The settlement arose from the unauthorized sharing by two employees of a futures exchange with a commodities broker who was seeking customers, of the identities and trading information

[1] A Dozen Important Questions For Traders Of Financial Products And Traditional Commodities And Derivatives Worldwide. More information can also be found at Clifford Chance's Guide to United States and United Kingdom Derivative and Commodity Market Enforcement Regimes, which is available upon request.

of certain traders on NYMEX. CFTC alleged that this information was material, such that its sharing constituted a violation of an insider-trading prohibition, even though it is not immediately apparent that such information would be considered material (that is, relevant by other market participants in making their trading decisions) and even though it is not apparent that any party ever traded while in possession of the information. Further, CFTC alleged that NYMEX was vicariously liable for insider trading as a result of the actions of its employees, even though they acted contrary to NYMEX policy, and even though their actions do not necessarily appear to have benefited NYMEX. However, after the trial court ruled that key questions regarding materiality and vicarious liability should be determined by a jury following trial, NYMEX and its employees chose to settle the matter for $4 million.

## Background

On August 3, 2020, the U.S Commodity Futures Trading Commission (CFTC) entered into a $4 million joint settlement with the New York Mercantile Exchange, Inc. ("NYMEX") and two of its former employees. The two employees were charged with improper disclosure of material nonpublic information (MNPI) to a broker in violation of Section 9(e)(1) of the Commodity Exchange Act (CEA). NYMEX was charged under the vicarious liability provision of the CEA, Section 2(a)(1)(B). CFTC alleged that over a period of several years from 2008 to 2010, two NYMEX employees divulged confidential information regarding NYMEX traders to a commodities broker.[2] (The broker is also a defendant in this case, but did not join NYMEX and its two employees in settling.) CFTC alleged that the NYMEX employees divulged, among other things, the identities of the parties to specific trades, the identities of the brokers involved in certain trades, the structure of particular transactions, and the trading strategies of market participants.[3]

As noted above, CFTC alleged that this conduct violation Section 9(e)(1)[4] of the CEA, which is a longstanding prohibition against insider trading that applies to certain registrants and their employees, and CFTC Regulation 1.59(d),[5] an insider-trading rule applicable to self-regulatory organizations and their

2 Amended Complaint for Injunctive and Other Equitable Relief and Civil Monetary Penalties under the Commodity Exchange Act (Am. Compl.) at ¶¶ 1-9, *United States CFTC v. Byrnes*, 13-CIV-1174 (S.D.N.Y.)

3 Am. Compl. at ¶ 6, *United States CFTC v. Byrnes*, 13-CIV-1174 (S.D.N.Y.)

4 Section 9(e)(1) of the Act provides, in pertinent part, that it shall be a felony for any person: who is an employee ... of a board of trade, registered entity, or registered futures association, in violation of a regulation issued by the Commission ... willfully and knowingly to disclose for any purpose inconsistent with the performance of ·such person's official duties as an employee ... any material nonpublic information obtained through special access related to the performance of such duties. 7 U.S.C. § 13(e)(1).

5 Pursuant to Section 9(e)(1) of the Act, the Commission promulgated Commission Regulation 1.59(d)(1)(ii) which provides, in pertinent part: No employee ... [of a self-regulatory organization ("SRO")] shall ... disclose for any purpose inconsistent with the performance of such person's official duties as an employee ... any material, nonpublic information obtained through special access related to the performance of such duties. 17 C.F.R. § 1.59(d)(ii).

employees. While this matter was charged under CEA Section 9(e), which applies only to a relatively narrow swath of market participants, CFTC now has the authority to pursue insider-trading violations against anyone based on trading in U.S. commodities markets. This broadened authority was granted by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (DFA).[6] DFA created a new anti-fraud provision, CEA Section 6(c), similar in language to the statute giving rising to securities insider trading, Section 10(b) of the Securities Exchange Act of 1934.[7] Following the DFA Amendments, CFTC finalized its new Rule 180.1, which is modeled after the language of SEC Rule 10b-5 and broadly prohibits "intentionally or recklessly" using or attempting to use any manipulative device, scheme, or artifice to defraud.[8] Together, Section 6(c) and Rule 180.1 give CFTC jurisdiction to pursue insider trading in the commodities markets analogous to SEC's jurisdiction over securities insider trading. In other words, CFTC can bring an insider trading action against anyone who trades while in possession of material, non-public information that was obtained in breach of a duty or through fraud or deception, as well as against anyone who knowingly provides such information to someone else with the expectation that that person will trade.

## CFTC's view of "Materiality"

While the defendants did not dispute that the information allegedly shared was confidential,[9] they argued in an earlier phase of the litigation that it was not material.[10] CFTC Regulation 1.59 provides the relevant standard for materiality:

> Material information means information which, if such information were publicly known, would be considered important by a reasonable person in deciding whether to trade a particular commodity interest on a contract market or a swap execution facility, or to clear a swap contract through a derivatives clearing organization. As used in this section, "material information" includes, but is not limited to, information relating to present or anticipated cash positions, commodity interests, trading strategies, the financial condition of members of self-regulatory organizations or members of linked exchanges or their customers, or the regulatory actions or proposed regulatory actions of a self-regulatory organization or a linked exchange. [11]

This "reasonable person" standard of materiality in Regulation 1.59(d) is the same standard that the Supreme Court propounded in the securities context in

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6 Pub. L. No. 111-203, 124 Stat. 1376 (2010)

7 The new Section 6(c)(1) provides:
"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." 7. U.S.C. § 9(1).

8 CFTC Prohibition on the Employment, or Attempted Employment, of Manipulative and Deceptive Devices and Prohibition on Price Manipulation, 17 C.F.R. § 108.1

9 Ans. of NYMEX at ¶ 2, Byrnes' Mot. for Summ. J.at 7, *United States CFTC v. Byrnes,* 13-CIV-1174 (S.D.N.Y.)

10 Byrnes' Mot. for Summ. J.at 7-15, Curtin' Mot. for Summ. J.at 4-8, *United States CFTC v. Byrnes,* 13-CIV-1174 (S.D.N.Y.)

11 17 C.F.R. § 1.59(a)(5).

*Basic Inc. v. Levinson*,[12] , and is the standard that will likely apply to commodities insider trading cases under Section 6(c).

Interestingly, unlike in the vast majority of insider trading cases, there was no allegation in the case that the broker who received the confidential information ever used it to trade, or that the NYMEX employees who passed along the information expected the broker to use it to trade. It is also not immediately evident why the information would have been relevant to the trading decisions of a reasonable commodities trader. The information relayed appeared to relate only to trades that had already been executed, not to any open positions.[13] It is not clear how such information would be useful in making a trading decision, without knowing anything about the disclosed party's open trading interest, anticipated positions or trading strategies.

Following a motion for summary judgment by the defendants, the trial court held that the question of materiality should be answered by the jury following trial.[14] While the defendants may have had good arguments against materiality, they may have concluded that settlement was preferable to the expense and uncertainty of trial.

## CFTC's Power to Charge the Employer

As with the question of materiality, NYMEX may also have had reasonable arguments against being held vicarious liable for the acts of its employees. Under the vicarious liability section of the CEA, Section 2(a)(1)(B), NYMEX would be liable only if the employees' illegal actions were undertaken "within the scope of [their] employment." CFTC alleged in response to NYMEX's motion for summary judgment on this point that the NYMEX employees were "motivated, at least in part, to serve a purpose or confer a benefit on NYMEX." It is not immediately evident, however, how NYMEX could benefit from the disclosure of confidential information to a broker, or what purpose of NYMEX such disclosure would serve. Indeed, it appears that the disclosures violated NYMEX policies, suggesting that NYMEX did not consider such disclosures beneficial.

However, as with the question of materiality, the trial court found after a motion for summary judgment that a jury should determine whether or not the employees' actions were undertaken within the scope of their employment. As with the question of materiality, NYMEX may have concluded that a settlement was preferable to the expense and uncertainty of trial.

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The settlement underscores the risk that an insider trading prosecution can pose, even in cases where the defendants may have arguments against the charges. Even strong arguments can take many years and significant expense to assert, and may ultimately be subject to a jury determination, which injects a significant degree of uncertainty. With CFTC's insider-trading mandate having been expanded by Dodd-Frank to cover all commodities trading in U.S. markets, the risk of such prosecution must now be considered by a much broader range of

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12 485 U.S. 224, 240 (1988) ("As we clarify today, materiality depends on the significance the reasonable investor would place on the withheld or misrepresented information.")
13 Am. Compl. at ¶ 6, *United States CFTC v. Byrnes,* 13-CIV-1174 (S.D.N.Y.)
14 *United States CFTC v. Byrnes*, No. 13-CV-1174 (VSB), 2019 U.S. Dist. LEXIS 160254, at *17 (S.D.N.Y. Sep. 19, 2019)

market participants.  Businesses that trade commodities would be well advised to ensure that their policies and control frameworks will, to the extent possible, keep them far outside of the "zone of allegation" of insider trading.

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