

## **U.S. INSIDER TRADING: A DOZEN IMPORTANT QUESTIONS FOR TRADERS OF FINANCIAL PRODUCTS AND TRADITIONAL COMMODITIES AND DERIVATIVES WORLDWIDE**

In 2018, the U.S. Commodity Futures Trading Commission (“CFTC”) announced the creation of a Commodities Insider Trading Task Force. While insider trading cases have historically been confined to the securities markets, the CFTC and the U.S. Department of Justice (“DOJ”) now have the authority to prosecute persons located worldwide who trade on inside information in U.S. commodities and derivatives markets, which are defined to include financial assets like foreign exchange and interest rates as well as traditional commodities such as oil, metals and agricultural. While CFTC has only brought a handful of insider trading cases in the years since, they have increased their efforts to detect and prosecute insider trading following the creation of the Commodities Insider Trading Task Force. Indeed, recent news reports suggest that CFTC and perhaps DOJ are currently investigating potential insider trading in the oil markets, based on non-public information regarding negotiations between Russia and OPEC. CFTC has also increased its market-surveillance capabilities in recent years by using advanced technology to analyze large volumes of trading data to monitor and reconstruct market activity. This increased surveillance heightens CFTC’s ability to detect insider trading (among other types of misconduct).

The current pandemic conditions heighten the risk of insider trading investigations, as volatile markets mean that certain information may have an outsize effect and as work-from-home orders strain compliance and surveillance frameworks. And as decades of insider trading investigations in the securities markets demonstrate,

even a successful defense of an investigation can take years, cost millions of dollars and imperil hard-won reputations. A settlement or finding of guilt will likely carry very large financial penalties and can involve serious criminal sanctions.

In light of this risk, we ask and answer 12 critical questions below, which set forth the basics of the commodities insider trading prohibition and suggest certain risk mitigants.

**1. What products are covered by the commodities insider trading prohibition?**

The commodities insider trading prohibition applies to trading in a very wide range of products. These include futures, options and swaps on agricultural commodities such as corn and sugar, energy commodities such as oil and natural gas, precious and industrial metals, and financial products such as interest rates, broad-based stock indices, currencies and cryptocurrencies. Furthermore, the prohibition applies to trading in wholesale physical markets for each of these products.

**2. Does the prohibition apply to individuals or companies outside the U.S., or information obtained outside the U.S.? Information obtained outside the U.S. not related to a U.S.-produced or merchanted commodity?**

Yes, the prohibition can apply to individuals and to companies outside of the United States. Generally speaking, the U.S. insider trading prohibition will be violated if a person trades in a U.S. market while in possession of material, non-public information (“MNPI”). The trader need not be located in the United States, nor does the MNPI have to have originated in or pass through the U.S. or relate to any physical commodity produced or merchanted in the U.S. For example, a trader sitting outside the U.S. could violate the U.S. insider trading prohibition by trading in U.S. physical oil markets, or trading oil futures on U.S. exchanges, while in possession of non-public information regarding Russia’s negotiations with OPEC, even though that information would not likely have originated in or passed through the U.S.

**3. What are the elements of commodities insider trading?**

The prohibition on commodities insider trading is violated when one trades while in possession of material, non-public information (“MNPI”), where such MNPI was obtained in breach of a duty or through fraud or deception.

**4. What constitutes “material” information?**

Information is generally found to be “material” when a “reasonable investor” would be likely to consider the information important in making an investment decision. When deciding whether a reasonable investor will consider the information important, courts will consider both the reliability of the source of the information, and whether the information is sufficiently specific that an investor could trade based upon it.

**5. What constitutes “non-public” information?**

Information is non-public when it has not been disclosed to the general marketplace. To be public, information must be generally accessible to all

potential investors using ordinary means of discovery. This means that selective disclosure to certain analysts or investors would not typically suffice to render information public. Publication in a widely circulated online or print article will generally suffice to render information public, even if the article is only available to paying subscribers.

## **6. Who can be liable?**

The insider trading prohibition applies to anyone who trades while in possession of MNPI obtained in breach of a duty or through fraud or deception. In addition, one who obtains MNPI (a “tipper”) and passes it to another who intends to trade (a “tippee”) in circumstances involving breach of a duty, fraud or deception can be liable for insider trading. In this scenario, the tipper can typically be liable for insider trading if s/he knew or reasonably should have known that the tippee would trade on the information. The tippee can be liable if s/he knew or reasonably should have known that the tipper breached a duty in providing the information, or committed a fraud or deception in obtaining the information. Finally, any intermediary who receives information from a tipper and passes it along to someone else can be liable for insider trading, provided the intermediary both knew or reasonably should have known that the information was obtained in breach of a duty or through fraud or deception, and also knows or reasonably should know that the tippee to whom the information is being provided will trade on that information.

In addition to individual liability, employers can also be liable for insider trading offenses that are committed by employees within the scope of their employment.

## **7. What sort of information counts as MNPI for purposes of this prohibition?**

As stated above, the MNPI must have been obtained in breach of a duty or through fraud or deception. Many potential duties can arise. For example, traders have a duty not to trade ahead of or against their employers' positions, and portfolio managers have a similar duty not to disadvantage the portfolios they manage by trading ahead of or against them. Market participants can also create duties for themselves by agreeing to treat counterparty information confidentially, or by offering “best execution” or similar assurances.

Duties can also be breached outside of the trading context. For example, U.S. government employees owe a duty to the public not to use non-public information learned in the course of their employment for personal gain or to tip others. Similarly, scientists conducting drug trials owe duties of confidentiality that preclude them from trading on information regarding those trials or tipping others.

## **8. Can one trade based on knowledge of his or her own positions, business strategy or trading intentions?**

Yes. Generally speaking, one can make trades intended to take advantage of one's own future trades, or based on knowledge of one's own business strategy or positions. For example, a trader for an oil company can enter trades in the futures market based on knowledge of his or her employer's oil

supply. Similarly, the trader can make trades in a futures or derivatives market based on knowledge of his or her employer's upcoming purchases or sales of physical oil.

### **9. Can one trade based on knowledge of a counterparty's positions or trading intentions?**

With important exceptions, one can generally trade based on knowledge of an arm's-length counterparty's positions or trading intentions learned in the normal course of business, as arm's-length counterparties typically do not owe duties to each other with respect to their positions or trading intentions. However, as stated above, a counterparty can undertake such duties by giving assurances of confidentiality, "best execution" or similar assurances. Further, intermediaries typically owe duties to customers or clients (as opposed to arm's-length counterparties), which would typically prohibit trading ahead. Finally, industry best-practices documents, including the FX Global Code and similar codes, may suggest that using a counterparty's information to trade ahead of or against the counterparty is inappropriate. While the FX Global Code and similar best-practices documents for some other industries do not themselves create duties, if a trading organization has adopted those provisions into its own policies, then trading ahead of or against a counterparty could constitute a breach of a duty created by that corporate policy, and therefore violate the insider trading prohibition.

### **10. Can one trade based on information received from government officials, researchers or expert networks?**

One can generally trade based on research or information from expert networks. However, a U.S. government official would very likely breach a duty in passing MNPI to a trader, so a trader could not trade while in possession of this information. Likewise, if a trader believes that the researcher or expert has provided MNPI that has been obtained through breach of a duty, fraud or deception (from a government official or otherwise), then trading while in possession of that information would violate the insider trading prohibition. For example, if an expert divulged non-public information regarding Congressional deliberations that was obtained based on a personal relationship with a Congressional staff member, one who learned that information would violate the insider trading prohibition by trading products whose price might be affected by it.

### **11. What steps should businesses take to manage commodities insider trading risk?**

Businesses should focus both on prevention and detection of insider trading. Many businesses have policies, procedures and controls to prohibit and to prevent and detect securities insider trading, but may not have extended these frameworks to commodities trading, and may not otherwise have ensured that these frameworks are sufficient to mitigate insider trading risk for products other than securities. In order to prevent commodities insider trading

to the greatest extent possible, businesses should consider doing the following:

- ensuring that policies adequately explain and prohibit traders from trading products subject to the commodities insider trading prohibition while in possession of MNPI;
- ensuring that procedures and controls will, to the extent possible, prevent traders from receiving MNPI, including by
  - placing limits on the sources of information that traders can access, including, among other things, non-public communications of public officials and persons engaged in scientific research; and
  - establishing information walls around persons whose normal duties likely put them into possession of commodities MNPI;
- ensuring that procedures and controls will limit the risk of receiving MNPI from expert networks, including by
  - ensuring that all agreements with expert networks expressly forbid the provision of MNPI;
  - ensuring that any information divulged by experts can independently be obtained through publicly available sources; and
  - requiring that all communications with expert networks include a statement that the business may trade on any information received and does not wish to receive any non-public information;
- conducting a risk assessment of markets in which the business trades or proposes to trade to identify any particular risks of receiving MNPI and to ensure that proper restrictions are imposed on and proper resources are devoted to any higher-risk markets; and
- conducting periodic training regarding the identification and handling of commodities MNPI.

In order to detect commodities insider trading to the greatest extent possible, businesses should consider doing the following:

- reviewing unexpectedly or uncommonly profitable trades;
- conducting surveillance of trader communications, including communications with expert networks; and
- comparing trading trends or abnormal trading patterns against news releases.

## **12. What steps should businesses take if a trader receives MNPI?**

Most importantly, businesses should ensure that any trader who receives MNPI reports this to compliance and/or to supervisors and does not trade on the information. If a trader is suspected of having traded while in possession of MNPI, the business should prevent that trader from engaging in any further trades while it seeks to verify whether the trader in fact traded while in possession of MNPI. The business should also consider whether it should also prevent other traders from trading during this period, in case the MNPI was shared more widely. If the trader is found to have traded while in possession of MNPI, the business should consider what remedial steps must be taken, including:

- employment consequences for anyone found to have traded while in possession of MNPI;
- unwinding of any affected positions;
- review of policies, procedures, controls and training; and
- potentially, proactive reporting of any violations to appropriate authorities.

Finally, the business should ensure that all steps taken in response are documented, as the timeliness and extent of the business's response will likely factor heavily into any decision by CFTC or DOJ to seek civil or criminal penalties.

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More information on commodities insider trading and other matters of U.S. derivatives and commodities enforcement can be found in Clifford Chance's Guide to United States and United Kingdom Derivative and Commodity Market Enforcement Regimes, which is available upon request.

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