

CLIENT ALERT

# Good News and Bad News: CFTC Misappropriation Enforcement Action Signals Move Away from “Insider Trading,” but Includes Inequitable Remedies

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On September 30, 2019, the CFTC issued an Order making findings of violations and imposing remedial sanctions against a CFTC-registered introducing broker (Classic Energy) and an affiliated/associated person of the IB (Matthew Webb) for the misappropriation of their customers’ material nonpublic information. Webb executed customer orders for block trades against an account that he owned and controlled without disclosing that he was the principal on the other side of the trades. The Order also made findings that the IB failed to supervise its brokers and failed to maintain adequate records of block trades.

This Order highlights the CFTC’s continued push to investigate and pursue the misappropriation of material nonpublic information. Notably, the Order relies on both written agreements between the IB and its customers and a CFTC rule imposing trading standards for IBs to establish the IB’s duty not to trade for its own benefit based upon misappropriated confidential information. The Order does not refer to “insider” trading which suggests that maybe the CFTC is being responsive to industry criticism of its failure in prior orders to distinguish between misappropriation and “insider” trading, the latter of which only applies to CFTC and exchange officials.

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### The Relationship Between the IB and its Customers

According to the Order, “Classic is a ‘voice broker’ that solicits and receives requests from its customers to enter into block trades via phone or instant message. Classic then locates potential counterparties for the requested block trades either from among Classic’s other customers or the customers of another voice broker. *Classic’s customers consider their block trade requests and other information they provide to voice brokers regarding their trading intentions to be confidential and nonpublic*, and they provide this information to Classic brokers with the expectation that Classic brokers will only use that information to locate potential block trade counterparties. When locating potential counterparties for requested block trades, Classic brokers necessarily disclose to other market participants the existence of a potential buyer or seller of a particular contract, as well as price and quantity information, *but they do not disclose the identity of the customer making the block trade request.*” (Emphasis added).

Importantly, Classic had written agreements with its customers that included a provision requiring “Classic keep confidential its customers’ confidential and proprietary information.” The agreements also precluded Classic from acting as a principal in natural gas futures contracts or any other transactions for which Classic provides brokerage services. In addition to the written agreements requiring Classic to keep its customers’ proprietary information confidential, CFTC Rule 155.4(b)(2)(i) provides that no IB or any of its affiliated persons shall:

knowingly take, directly or indirectly, the other side of any order of another person revealed to the introducing broker or any of its affiliated persons by reason of their relationship to such other person, except with such other person’s prior consent and in conformity with contract market rules approved by or certified to the Commission.

Thus, Classic had both a contractual and a regulatory obligation to keep confidential its customers’ proprietary information and not use it to trade for Classic’s benefit in violation of that duty.

### Misappropriation of Customer Material Nonpublic Information

In the Order, the Commission found that on 63 instances between April 30, 2014 and September 3, 2015, Webb received requests from Classic’s customers for block trades in certain natural gas futures contracts. Rather than locate a counterparty, as his customers expected, Webb executed a block trade between the customer and an account that he owned and controlled. Furthermore, Webb never disclosed to his customers that he was taking the other side of their requested block trade. The CFTC found that, by trading opposite Classic’s customers based upon their misappropriated material nonpublic information, Webb earned illicit profits of \$413,065 in his account.

### Violations of the Commodity Exchange Act and CFTC Rules

The Order found that Classic and Webb violated numerous provisions of the Commodity Exchange Act and the CFTC’s regulations.

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### ***Misappropriation and Fraud***

CEA Section 6(c)(1) and CFTC Rule 180.1 make it “unlawful for any person, directly or indirectly, to intentionally or recklessly: (1) use or employ, or attempt to use or employ, any manipulative device, scheme, or artifice to defraud; [ . . . ] (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.” According to the CFTC, “[t]rading on material, nonpublic information in breach of a pre-existing duty may violate CEA Section 6(c)(1) and Regulation 180.1.” The pre-existing duty may be “established by another law or rule, or agreement, understanding, or some other source.”

According to the Order, Webb intentionally or recklessly misappropriated his customers’ material nonpublic information in violation of a pre-existing duty to keep the information confidential as described in Classic’s account documentation with its customers. Furthermore, Webb’s conduct violated a pre-existing duty under CFTC Rule 155.4 not to take the other side of a customer order without the consent of the customer. Finally, Webb created the “false impression” for Classic’s customers that he was acting as a broker, not a counterparty. The Order held Classic liable for violations of CEA Section 6(c)(1) and CFTC Rules 180.1 and 155.4 on the basis that Webb acted as an agent for Classic.

### ***Recordkeeping***

The Order found that Classic failed to retain records of oral communications beyond the one-year retention period applicable to IBs as specified in CFTC Rules 1.31 and 1.35.

### ***Failure to Supervise***

Pursuant to CFTC Rule 166.3, CFTC registrants “must diligently supervise the handling of its partners, officers, employees and agents [...] of all commodity interest accounts [...] introduced by the registrant and all other activities of its partners, officers, employees and agents [...] relating to its business as a Commission registrant.” Both Classic and Webb were CFTC-registrants during the relevant period of the Order and, therefore, subject to the duty to supervise. According to the Order, the following deficiencies established a violation of the duty to supervise:

- The lack of an adequate system of oversight sufficient to detect or prevent misappropriation of material, nonpublic information from Classic’s customers.
- The failure to establish written policies or procedures that set forth broker standards of conduct or prohibited practices.
- The fact that Classic’s compliance group did not review or monitor broker activity to detect instances of brokers trading opposite customer orders.

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- An independent trader was allowed to sit on Classic’s trading floor and was able to hear customer material nonpublic information. Furthermore, there were no safeguards put in place to prevent the independent trader from trading based upon customer material nonpublic information.

### Appropriate and Inequitable Sanctions

Some of the sanctions imposed by the CFTC are reasonably related to the violations. The Order requires Classic and Webb to cease and desist from violating the CEA and CFTC regulatory provisions cited in the Order and to pay, jointly and severally, a \$1.5 million civil monetary penalty. In addition, the Order imposes a broad trading and registration ban on Webb related to trading in commodity interest transactions (futures, swaps, and commodity options), or having commodity interests traded on his behalf, until January 3, 2022.

Significantly, however, the disgorgement sanction imposed by the CFTC is inequitable because the payment is not provided to Classic’s injured customers. Rather, the Order requires Webb to pay \$413,065 in disgorgement to the U.S. Treasury. Section 6c(d)(3) of the CEA authorizes the CFTC to seek a court order imposing equitable remedies on any person who violates the CEA or CFTC regulations, including “restitution to persons who have sustained losses proximately caused by such violation (in the amount of such losses).” Here, the CFTC found that Webb (and Classic through vicarious liability) defrauded Classic’s customers by trading opposite their accounts based upon misappropriated material non-public information at other than the best available bids and offers and still charging broker commissions. Despite the fact that Classic’s and Webb’s conduct caused the losses incurred by the defrauded customers, the CFTC effectively transferred the customers’ lost funds to the U.S. Treasury rather than returning them to the injured parties.

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If you have any questions regarding this client alert, please contact the following attorneys or the Willkie attorney with whom you regularly work.

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