Special Derivatives Insider Trading Considerations and Risk Reduction Techniques During a Pandemic

Clifford Chance US LLP

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Overview

- Increased Potential for Insider Trading Liability
- U.S. Enforcement Fundamentals – Insider Trading and Related Laws
- Hypothetical Scenarios
- Risk Mitigants
- Responding to Investigations

Enforcement Focus During the Pandemic

"U.S. Probes Whether Traders Profited Off Tips on Russia at OPEC+: CFTC said to examine suspicious wagers involving oil future."
BLOOMBERG, APRIL 22, 2020

CFTC Forms Insider Trading Task Force
CFTC PRESS RELEASE, SEPTEMBER 28, 2018

"Given these unique circumstances, a greater number of people may have access to material nonpublic information than in less challenging times."
STEPHANIE AVAKIAN AND STEVEN PEIKIN, CO-DIRECTORS OF THE SEC DIVISION OF ENFORCEMENT, MARCH 23, 2020

"Every U.S. Attorney's Office is . . . directed to prioritize the detection, investigation, and prosecution of all criminal conduct related to the current pandemic."
WILLIAM BARR, UNITED STATES ATTORNEY GENERAL, MARCH 16, 2020

FIA

Heightened Insider Trading Risk

Greater potential for receiving inside information

- New sources of price-sensitive information
- Increased criticality of information and increased volatility result in large price effects
- New sources of information may not be accustomed to handling confidential, price-sensitive information

Insider-trading controls are strained

- Work-from-home orders make Compliance's job harder
- New information sources need to be vetted

Easing of regulatory requirements also heightens risk

- CFTC has eased voice-recording requirements for FCMs and other registrants
- SEC has relaxed certain reporting and blackout requirements

Heighted Enforcement Risk

Expansion of Scope of Insider Trading Liability since 2008

New statutes have expanded the scope of insider-trading liability

- Commodity Exchange Act – Dodd-Frank revisions make insider trading prohibitions directly applicable to markets for futures, derivatives and other commodities **(7 U.S.C. § 1, et seq.)**
- STOCK Act – Prohibits employees of the executive and legislative branches from trading on inside government information, regardless of market **(*See, e.g.*, 7 U.S.C. § 6c(a)(3); 15 U.S.C. § 78(u)-1 (g), (h))**

Old statutes are being applied to insider trading in novel ways

- Wire fraud and Criminal Conversion – Criminal prohibitions provide potential insider trading liability with less stringent proof requirements **(18 U.S.C. §§ 1343, 641)**
- New York State Martin Act – State commodities and securities anti-fraud law used to push the boundaries of insider-trading liability **(N.Y. Gen. Bus. L. §§ 352–53)**

Enforcement Fundamentals

Insider Trading
(15 U.S.C. § 78j; 7 U.S.C. § 9; SEC Rules 10b-5; 10b5-1 and 10b5-2; CFTC Rule 180.1)

Traditionally a fraud-based offense

Elements:

- Trading on the basis of material non-public information
- Obtained in breach of a duty, or via deception or other fraud

Potentially applies to:

- Any person located in the U.S.;
- Any person anywhere in the world involved with trading on U.S. markets
- Traders, "Tippers," "Tippees," and Intermediaries

Covered Instruments	
Commodities Laws	Securities Laws
• Futures (including Treasury futures) • Swaps • Broad-based stock indices • Commodities in interstate commerce	• Securities • Government securities • Single-stock futures • Narrow-basket indices

Material Non-Public Information (MNPI)

Material:

- There must be a substantial likelihood that a reasonable investor would consider the information important in making an investment decision
- Reliability of source and specificity of information both impact materiality

Non-public:

- Not generally accessible to all potential investors using ordinary means of discovery
- Selective disclosure (i.e. to market analysts on conference call or e-mail) may not render information public.

Under traditional theories, disclosure of material, non-public information will be insider trading only IF accompanied by…

Breach of Duty in Respect of MNPI

Breach of duty to the source of the information:

- <u>**Misappropriation Theory**</u>: Expands insider trading liability to non-insiders, who traded with knowing possession of material non-public information in breach of a fiduciary or similar *duty of trust and confidence. e.g.*,
  - Duty owed by law, regulation or self-regulatory rule, including
    - Non-disclosure duties owed by government employees under the STOCK Act
    - Duties imposed by fiduciary or similar relationships
  - Ad hoc duties created by contract, employment policies, statements, conduct, etc.
  - Possibly extending to duties created by industry best-practices documents, such as the FX Global Code, to which an organization has subscribed

Breach of duty to shareholders (generally inapplicable to commodities markets):

- <u>**Classical Theory**</u>**:** Focuses on trading by true corporate insiders or temporary/constructive insiders (*e.g.*, underwriters, lawyers, accountants).

Case Highlight – Dr. Sidney Gilman

- Dr. Sidney Gilman, a renowned neurologist and Alzheimer's expert, settled SEC charges for insider trading as a tipper for passing information about an Alzheimer's drug trial to hedge fund trader Matthew Martoma
- Dr. Gilman consulted for the financial and pharmaceuticals industries through an expert network, and was also the chair of the Safety Monitoring Committee for an Alzheimer's drug trial
- Dr. Gilman settled charges that he passed information about the drug trial to Mr. Martoma, whom he met through the expert network
- The SEC's complaint alleged that Dr. Gilman's tips violated duties of confidence that he owed the pharmaceuticals companies that were running the drug trial
- As part of his settlement, Dr. Gilman was required to pay over $200,000 in disgorgement and to testify in Mr. Martoma's trial

Case Highlight – Johnson and Scott

- The DOJ charged UK citizens Mark Johnson and Stuart Scott with wire fraud for front-running a customer while employed by HSBC
- An HSBC customer asked HSBC to execute a foreign exchange transaction in connection with the sale of a subsidiary, exchanging approximately $3.5 billion into British Pound Sterling
- Johnson and Scott purchased pounds for an HSBC proprietary account in advance of the customer transaction, yielding a profit of approximately $8 million
- Johnson was arrested in July 2016 when he entered the United States on vacation, unaware that he had been charged in a sealed indictment
- Johnson was convicted on nine of ten counts on October 23, 2017 and sentenced to two years imprisonment
- Stuart Scott fought and avoided extradition to the United States

Other Relevant Laws

Different Legal Theories May Require Proof of Fewer Elements

Trading on MNPI can violate other federal criminal statutes with less stringent elements

- Wire fraud **(18 U.S.C. § 1343)**
- Conversion **(18 U.S.C. § 641)**
- Sarbanes-Oxley insider trading **(18 U.S.C. § 1348)**

New York's Martin Act - (N.Y. Gen. Bus. L. §§ 352–53)

- Applies to anyone transacting in securities or commodities in New York, or with a counterparty in New York
- "Insider Trading 2.0" may require those with superior information to disclose the information or abstain from trading

Case Highlight

United States v. *Blaszczak*, 947 F.3d 19 (2d Cir. 2019)

- Appellate decision upholding convictions for trading on non-public Medicare reimbursement rates under theories of Wire Fraud, Conversion and Sarbanes-Oxley Securities Fraud
- The defendants included an employee at the Center for Medicare & Medicaid Services (the tipper), a political consultant (an intermediate tipper), and two hedge fund traders (the ultimate tippees of the intermediate, who traded on the information)
- The defendants were acquitted of securities insider trading (but convicted of the other charges), on the apparent basis that the government had failed to prove that the Center for Medicare & Medicaid Services provided the information in exchange for a personal benefit
- The appellate court held that conviction under the wire fraud, conversion and Sarbanes-Oxley securities fraud statutes did not require proof of a personal benefit

Scenario

FX Sales Trader

Jane is a sales trader employed by a swap dealer and FX market maker. She receives an order from a counterparty for a large CHF swap. Jane intends to lay off the risk of the swap in the spot market, and she expects this will impact the price of spot CHF.

- Can Jane "pre-hedge" by trading in the spot market in advance of executing the swap?
  - *Yes, Jane can likely pre-hedge by trading in the spot market ahead of executing the counterparty's swap. CFTC Rule 23.410 prohibits swap dealers from using a counterparty's non-public trade information to the detriment of the counterparty. However, it does not appear likely that Jane's trade would have a detrimental impact on the counterparty, and in any event, CFTC Rule 23.410 allows the use of counterparty information for hedging.*
- Can Jane trade additional spot CHF for a proprietary account in advance of the swap, in order to profit from the spot price change that she expects the hedge will cause?
  - *Jane will risk a front-running / insider trading charge by trading ahead of the swap counterparty's trade. If Jane's spot trades impact the execution of the counterparty's spot trade or otherwise are detrimental to the counterparty, then Jane's trading will violate CFTC Rule 23.410.*
- Counterparty A and Counterparty B both ask Jane to make a large CHF spot trade. She knows that whichever trade she makes first will impact the price of the trade for the other counterparty. Can she make both trades?
  - *Jane can make both trades, but she should trade in line with disclosures made to both counterparties.*
- Is the analysis of any of the above different if Jane works for a Futures Commission Merchant?
  - *If Jane works for a futures commission order, she would be forbidden, including by CFTC Rule 155.3 from trading for a proprietary account ahead of any executable customer order. FCM disclosure requirements would also very likely include disclosures regarding allocation and execution of multiple customer orders. Jane would need to trade in line with these disclosures.*

Scenario

Reduced Oil Production

Rebecca is an energy trader whose firm subscribes to an energy market intelligence service, which distributes articles to its premium subscribers. She receives an article suggesting that oil producers are cutting production drastically because of reduced demand. Rebecca believes that the production cuts will cause the price of crude futures, which had been falling, to increase.

- Can Rebecca buy crude futures to take advantage of this expected price increase?
  - *In order to answer this question, we need to understand how "publicized" the information is. Has it been made available to the trading public? Moreover, is there any reason to believe that it was obtained in breach of a duty? Even if not obtained in breach of a duty, there could be a potential Martin Act issue if Rebecca is trading on the basis of selectively or preferentially disclosed information.*

- Assume that instead of learning about the production cuts from a published article, Rebecca instead learns about them from a swap counterparty who works at a large oil producer. Can she trade on that information?
  - *In order to answer this question, we need to understand how Jane learned about the information. Did the counterparty tell her, or did she deduce it based on her knowledge of the counterparty's trades. If the counterparty told her, there is a risk that in telling her, the counterparty breached a duty, in which case her trading could violate the commodities insider trading prohibition. If Jane is a swap dealer, her trading could also violate CFTC Rule 23.410, which prohibits swap dealers from using counterparty confidential information to the detriment of the counterparty.*

Scenario
Political Intelligence

Bob trades at InvestCo, an asset manager / CTA. InvestCo has recently engaged ABC, a political intelligence company, to provide information regarding government stimulus efforts. Bob receives an e-mail from an ABC analyst regarding a stimulus bill being debated in Congress. The e-mail predicts that Congress will pass a much larger stimulus package than had previously been reported. Bob believes that the analyst's information is likely accurate.

- Can Bob trade on this information?
  - *We need to understand where the information came from in order to determine whether Bob can trade. Has the ABC analyst revealed his or her sources? Can Bob verify that the information came from a publicly available source? Does InvestCo's engagement with ABC specify that InvestCo may base trading decisions on information received and therefore does not want to receive confidential information?*
- Bob learns that the analyst's husband is an aide to Senate Majority Leader Mitch McConnell. What should Bob ask the ABC analyst to determine whether or not he can trade?
  - *This raises the risk that the information is non-public and has been obtained in breach of a duty. Bob is therefore at serious risk of insider trading if he trades on this information. Bob / InvestCo should verify that the information is publicly available. If it is not, Bob will need to clear any trading with InvestCo compliance until the information becomes publicly available or until the stimulus vote happens. InvestCo should ensure that others do not receive the information that Bob has received.*

Risk Mitigants

Reducing Likelihood of Investigation

Conduct MNPI-related risk assessment

- Are new trading strategies / new markets being vetted?
- Do MNPI policies cover all sources of COVID-relevant information?
- Are existing information barriers sufficient?

Conduct assessment of documentation policies and procedures

Assess risk from expert networks

- Do the agreements prohibit confidential information?
- Are your communications controls sufficient?
- Are experts appropriately vetted?

Consider need for supplemental training on insider-trading risk

Ensure whistleblower portals are fully accessible online

Responding to Investigation

Understand focus of inquiry

Conduct internal investigation
- Be quick and be thorough
- Preserve attorney-client privilege

Corporate Charging Consideration

Avoid “process” violations
- Assume the regulator knows more than you
- Vet responses provided by the business
- Be precise and be accurate

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Steve Gatti is a partner in Clifford Chance's Financial Services Regulatory Group and head of the US securities regulation practice. His practice concentrates on securities enforcement and counseling, with a focus on broker-dealer and investment management regulation, and issues unique to cross-border, multi-national financial services clients.

Steve represents US and international financial institutions, including broker-dealers, banks, and investment advisers in regulatory, enforcement, and commercial matters.

Steve's practice includes strategic counseling on financial markets and trading regulation, anti-money laundering compliance, investment management compliance, broker-dealer regulation, trading systems, distribution and marketing issues, new products, privacy, transactions in the financial institutions sector, and Dodd-Frank. He also represents institutions and individuals in examinations, investigations, and enforcement matters before the U.S. Securities and Exchange Commission (SEC), the Financial Industry Regulatory Authority (FINRA), the US Commodity Futures Trading Commission (CFTC) and other self-regulatory organizations as well as state regulatory authorities. Steve also has years of experience conducting internal investigations involving potential securities law violations and financial fraud, and in conducting internal compliance audits.

Steve received a BA in 1990 from The College of William & Mary and a JD *with honors* in 1995 from The George Washington University Law School. Prior to attending law school, Steve was an exchange floor clerk with an NYSE specialist trading unit. He has recently been named one of Washington's Top Securities Lawyers by *The Washingtonian* magazine and is recognized as a leading regulatory enforcement lawyer in Chambers USA and Legal 500 USA 2018.

Steve is resident in the firm's Washington, DC office and is a member of the District of Columbia Bar, the State of New Jersey Bar and the State of Maryland Bar.

Representative engagements include:

- Conducted comprehensive internal compliance reviews of the extraterritorial application of U.S. financial regulation to non-U.S. business of major multi-national banks
- Established U.S.-registered investment adviser and broker-dealer subsidiaries for leading international financial services providers, including drafting relevant policies, procedures, and manuals
- Advised international banks on restructuring prime brokerage, ISDA, and securities lending arrangements
- Represented US and non-US financial services companies in connection with acquisitions and sales of US regulated institutions
- Represented leading Asian, Nordic, and European investment banks in SEC and FINRA investigations of their cross-border trading and compliance practices
- Advised leading international bank on privacy and data protection law requirements under regulations implementing the Gramm Leach Bliley Act, the Red Flag rules and other applicable state and federal laws
- Conducted global internal compliance audit, including insider trading review, of leading multi-national hedge fund manager
- Represented leading online broker-dealer in FINRA OATS and DMA enforcement actions
- Represented leading broker-dealer market intermediary in SEC short sale enforcement action
- Advised several leading financial institutions on privacy and data protection requirements applicable to asset sales and restructuring
- Represented bulge-bracket firm in connection with FINRA investigation of mutual fund sales and distribution practices

Robert E. Rice

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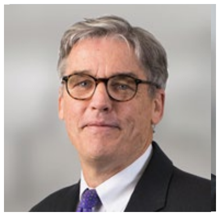

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Robert E. Rice, a partner in Clifford Chance's Litigation & Dispute Resolution practice, has 25 years of white-collar experience in Government and the private sector. Over the course of his career, Bob, a seasoned trial and appellate lawyer, has been at the forefront of many high-stakes regulatory enforcement matters and criminal prosecutions.

Bob represents financial institutions, asset management firms, public companies and individual clients in regulatory and criminal matters as well as in parallel civil litigation and internal investigations.

Before joining Clifford Chance, Bob's prior roles included serving as Chief Counsel to United States Securities and Exchange Commission Chair Mary Jo White, as Head of the Litigation and Regulatory Investigations Practice Group at a major global financial institution, and as an Assistant United States Attorney in the United States Attorney's Office for the Southern District of New York.

As Chief Counsel to SEC Chair White from 2013 to 2015, Bob provided advice and counsel on a broad range of regulatory matters across the SEC's divisions and offices, focusing on enforcement actions, policy and strategy; compliance examinations and inspections of broker-dealers, investment advisers and other SEC registrants; and cross-border coordination with regulatory agencies around the world.

Before his time at the SEC, Bob was, from 2004 to 2013, a Managing Director and senior in-house lawyer at a global financial institution.

While there, he led a team of in-house lawyers in developing and implementing strategies to manage legal and reputational risk associated with a global docket of complex regulatory investigations and enforcement actions, criminal investigations and prosecutions, litigation and corporate governance matters. Bob also served for almost a decade as a federal prosecutor in the United States Attorney's Office for the Southern District of New York, ultimately becoming a Deputy Chief of its Criminal Division. During his tenure in that office, Bob investigated and prosecuted a broad range of federal crimes, including bank fraud, money laundering, public corruption, RICO and securities fraud.

Bob is a JD graduate of St. John's University School of Law, where he was the Managing Editor of the Law Review.

David Yeres

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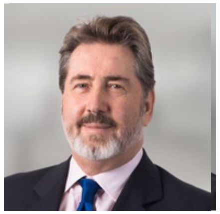

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David Yeres, who has over 35 years experience in government and private practice with Commodity Exchange Act matters, heads the Clifford Chance US commodities and derivatives enforcement practice.

David was counsel to the Chairman of the Commodity Futures Trading Commission, the federal regulatory agency for commodity futures and options trading, and served on the Commission's Financial Products Advisory Committee. He was also the Deputy Associate Attorney General of the United States as well as a federal criminal prosecutor. He is the former chairman of the New York State Bar Association Committee on Commodities Law.

David, who has been in private practice since 1983, has represented, among others, trading companies, banks, and funds with regard to related internal investigations and contentious matters, as well as the dealing or trading in a wide range of physical and financial commodities transactions. He has advised domestic and international clients on the development and operation of various financial products including funds and other structured vehicles that utilize derivative transactions, securities and foreign exchange as well as commodities. David served as an adjunct professor of Commodity Exchange Act regulation at the Fordham Law School and is widely acknowledged as expert in the Commodity Futures Trading Commission's regulation and enforcement program.

Representative experience includes:

- Representing a Canada-based international financial institution in class action lawsuit alleging manipulation of the $12 trillion market for debt securities issued by the US Treasury
- Representing a Chinese multinational banking company in a class action lawsuit alleging manipulation of platinum and palladium futures and options prices
- Representing a major financial institution in connection with numerous class actions and regulatory investigations alleging manipulation of LIBOR
- Representing a major US financial institution in connection with remediation of certain foreign exchange trading practices
- Representing a major international trading organization in connection with an investigation of alleged unlawful trading of energy futures contracts
- Representing a joint venture in connection with investigations by CFTC and NYAG of foreign exchange market-related misconduct
- Representing a Middle Eastern bank in connection with a CFTC investigation of certain financial futures and swaps trading activities
- Representing a Latin American bank in connection with an investigation of a US futures exchange into alleged "spoofing" of an energy market

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Benjamin Peacock is a senior associate in Clifford Chance's Litigation & Dispute Resolution practice in New York. He represents clients in cross-border criminal and regulatory investigations and complex commercial litigation and arbitration.

Prior to joining Clifford Chance, Benjamin interned at the New England Legal Foundation, where he assisted in authoring briefs for the United States Court of Appeals for the First Circuit and the Supreme Courts of Massachusetts, New Hampshire and Maine.

Benjamin received a JD from the New York University School of Law and a BA in philosophy from the University of Georgia. He is admitted to practice in New York.

Recent experience includes:

- Defeated all DOJ FCPA charges against Lawrence Hoskins at trial, with remaining money laundering counts resulting in a 15-month sentence that is currently under appeal
- Representing a financial institution in connection with an investigation by the CME into its trading of energy futures
- Representing a major US financial institution in connection with remediation of its foreign exchange trading practices
- Representing a joint venture in connection with investigations by CFTC and NYAG of foreign exchange market-related misconduct
- Representing a major financial institution in regulatory investigations alleging manipulation of LIBOR, and in subsequent implementation of settlement undertakings

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