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CFTC Seeks Comments Regarding ICE Futures U.S. Rules Governing Trading on Non-Public Information After ICE and NYMEX Interpretations Differ on "Pre-Hedging" Block Trades

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The ***Commodity Futures Trading Commission's ("CFTC")*** is seeking comments regarding an amendment (Submission No. 16-67) ICE Futures U.S. ("ICE") has proposed to its ***Block Trade Frequently Asked Questions*** ("Block Trade FAQ") to clarify "the extent to which parties may engage in pre-hedging or anticipatory hedging related to the consummation of a block trade." Specifically, the amendment clarifies that, as a general matter, "Parties to a block trade may engage in pre-hedging or anticipatory hedging of the position that they believe in good faith will result from the consummation of the block trade, except for an intermediary that takes the opposite side of its own Customer order."

The CFTC's Division of Market Oversight decided to stay the effective date of the amendment "because the submission presents novel or complex issues that require additional time to analyze and may be inconsistent with the CEA or CFTC regulations." The CFTC has established a review period ending on September 13, 2016. The deadline for comments is July 14, 2016.

Although the CFTC provided no specifics as to its concerns, ICE's clarification regarding non-intermediaries is in contrast to CME Group's (CME, CBOT, NYMEX & COMEX) July 8, 2015 Market Regulation Advisory Notice RA1510-5, which prohibits "[p]re-hedging or anticipatory hedging of any portion of a block trade in the same product or a closely-related product based upon a solicitation to participate in a block trade" without respect to the entity's status as an intermediary. The CME Group's interpretation was highlighted in an August 2015 NYMEX disciplinary notice against a non-intermediary entity for engaging in pre-hedging of a block trade. Specifically, after receiving a solicitation to enter a block trade, but prior to consummation, the non-intermediary entity entered into a separate hedge transaction in the same product on the opposite side of the market, thus guaranteeing itself a profit upon subsequent execution of the block trade. In that instance, both the company and the individual trader were penalized by NYMEX.

The new guidance from ICE Futures U.S., unlike the CME Group interpretation, draws a longstanding

distinction between the fiduciary responsibilities of intermediaries compared to the duties of arms-length counterparties. With respect to intermediaries, the amended Block Trade FAQ would provide, "prior to the consummation of the block trade the *intermediary* is prohibited from offsetting the position established by the block trade in any account which is owned or controlled, or in which an ownership interest is held, or for the proprietary account of the employer of such intermediary." (*emphasis added*)

Trading on Non-Public Information

Notwithstanding the above clarification regarding non-intermediaries, the proposed Block Trade FAQ goes on to explain that it is a violation of Exchange Rule 4.02(h) for any market participant to engage in "front running of a block trade when acting on material non-public information regarding an impending transaction by another person, acting on non-public information obtained through a confidential employee/employer relationship, broker/customer relationship, or in breach of a fiduciary duty." Finally, ICE Futures U.S. warns "[t]he Exchange may proceed with enforcement action when the facts and circumstances of pre-hedging suggest deceptive or manipulative conduct by any of the involved parties, including when an intermediary handling a Customer order acts against its Customer's best interests."

This connection between market manipulation and trading on non-public information in breach of a duty of confidentiality or loyalty is also an emphasis at the CFTC. In December 2015, the CFTC entered into a settlement to resolve allegations of "fraud by misappropriating non-public, confidential and material information" against a gasoline futures trader employed by a large, publicly-traded corporation. The CFTC charged the trader with violations of the Commodity Exchange Act's ("CEA") fraud and anti-manipulation provisions for engaging in fraudulent transactions between his personal accounts and the proprietary account he traded on behalf of his employer, with the intention of generating profits for his personal accounts. The CFTC noted that the trader and his employer "shared a relationship of trust and confidence that gave rise to a duty of confidentiality." Specifically, the trader had access to "information concerning the times, volume and prices at which his employer intended to trade energy commodity futures for its proprietary account"—information that was material and non-public and which the CFTC deemed the trader to have "misappropriated." In a May 2016 interview with POLITICO, the CFTC's head of enforcement, Aitan Goelman, alluded to an intent to continue to bring new insider trading cases under its anti-manipulation authority.

The limited application of the anti-manipulation provisions of the CEA to trading on non-public information was addressed in the CFTC's order adopting Rule 180.1 (anti-manipulation). The CFTC recognized "that unlike securities markets, derivatives markets have long operated in a way that allows for market participants to trade on the basis of lawfully obtained material nonpublic information," and concluded, "[t]his final rule does not prohibit trading on the basis of material nonpublic information except as provided in the following paragraph or otherwise prohibited by law."

"Depending on the facts and circumstances, a person who engages in deceptive or manipulative conduct in connection with any swap, or contract of sale of any commodity in interstate commerce, or contract for future delivery on or subject to the rules of any registered entity, for example by trading on the basis of material nonpublic information in breach of a pre-existing duty (established by another law or rule, or agreement, understanding, or some other source), or by trading on the basis of material nonpublic information that was obtained through fraud or deception, may be in violation of final Rule 180.1. The Commission believes that this application of the final Rule would be consistent with our responsibility to protect market participants and promote market integrity and with our statement in the NOPR that section 6(c)(1) is a broad catch-all provision, reaching any manipulative

or deceptive device or contrivance."

Because ICE's proposed amendment is consistent with the CFTC's interpretation of its own anti-manipulation rule (i.e., "[t]he Exchange may proceed with enforcement action when the facts and circumstances of pre-hedging suggest deceptive or manipulative conduct by any of the involved parties), the CFTC is likely to focus on whether a non-intermediary, prospective counterparty to a block trade owes any duty to the other prospective counterparty to refrain from trading ahead of the trade based on its knowledge of the potential block trade. Absent such a duty, the question will turn not on whether such trading might constitute market manipulation but rather whether the CFTC considers such trading inconsistent with the CFTC's core principles applicable to designated contract markets such as ICE.

Regardless of the fate of ICE's proposed Block Trade FAQ, market participants should be carefully considering their use of non-public information to ensure their compliance with their contractual obligations, the CFTC's anti-manipulation rule, and any other laws impacting their ability to use the information.

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