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Bridging the Week: Futures Insider Trading, Artificial Prices, Theft by Convention, Whistleblowing [VIDEO]

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Last week, the ***Commodity Futures Trading*** brought and resolved its second enforcement action based on the securities industry's concept of insider trading, while a federal court ruled in response to a motion for partial summary judgment that the CFTC must show that a price was intended to be artificial to ultimately prevail in a lawsuit alleging manipulation and attempted manipulation. In addition, the Securities and Exchange Commission agreed to settle an enforcement action with a publicly-traded company for terminating a whistleblower where an internal investigation found the whistleblower's complaints were unfounded. As a result, the following matters are covered in this week's edition of *Bridging the Week*:

- Ex-Airline Employee Sued by CFTC for Insider Trading of Futures Based on Misappropriated Information (includes **Legal Weeds**);
- Federal Court Holds That CFTC Must Show Artificial Price to Prevail in Traditional Manipulation Lawsuit (includes **My View**);
- Trader Indicted for Exploiting Minimum Futures Pricing Convention to Hide Trading Losses and Causing Firm Collapse; CFTC Also Files Civil Charges;
- Firm Sanctioned by SEC for Firing Whistleblower Who Allegedly Made False Allegations (includes **My View**);
- Brokerage Firm Agrees to Pay US $12.5 Million Fine to SEC for Trading Controls Failure; Six Exchanges to Assess an Additional US $3 Million Penalty (includes **Compliance Weeds**);
- Swap Dealer Settles Enforcement Action by CFTC for Not Filing Daily Large Trader Reports of Commodity Swaps Positions (includes **Compliance Weeds** and **Follow-Up**);
- Introducing Broker and Principal Sued by CFTC for Recordkeeping and Supervision Breakdowns (includes **My View**);
- Hedge Advisor to Retailers of Fuel Products Settles With CFTC Over Charges It Acted as an Unregistered CTA; and more.

Briefly:

- **Ex-Airline Employee Sued by CFTC for Insider Trading of Futures Based on Misappropriated Information**: The Commodity Futures Trading Commission brought and settled charges against Jon Ruggles, a former trader for Delta Airlines, for trading accounts in his wife's name based on his knowledge of trades he anticipated placing for his employer. The CFTC claimed that this constituted trading on illicitly misappropriated information, and based its action, in part, on a theory equivalent to the securities concept of insider trading. According to the CFTC, Mr. Ruggles frequently placed a trade for accounts of his wife, and subsequently placed a limit order to liquidate the position at a price not then currently available in the relevant market but designed to achieve a profit. Mr. Ruggles would then place an order for his employer on the opposite side of the market for the same or greater quantity of the order for his wife's accounts. Either his employer's order would be totally executed against his personal order, or it would induce other traders to trade opposite his personal order. The CFTC said that Mr. Ruggles engaged in this and other types of similar illicit trading activity on 71 days from March 2012 through December 2012, achieving a profit of over US $3.5 million. (He mostly traded energy products listed on the New York Mercantile Exchange.) Mr. Ruggles's conduct was alleged by the CFTC to constitute the employment of a manipulative or deceptive device based on his trading of material, nonpublic information that he inappropriately obtained from his employer, and fraud. To resolve the CFTC's charges, Mr. Ruggles agreed to pay a fine of US $1.75 million; disgorge all trading profits on a specified schedule over 42 months; and never again trade on a market overseen by the CFTC. In June 2016, NYMEX brought and settled a disciplinary action against Mr. Ruggles based on similar allegations. NYMEX imposed a fine of US $500,000 against Mr. Ruggles; ordered disgorgement in excess of US $2.8 million (reduced by any amount disgorged to the CFTC); and imposed a permanent CME Group all-products trading prohibition. (Click here for details of the NYMEX disciplinary action against Mr. Ruggles, as well as an action against his wife.)

Legal Weeds: This is the second time the CFTC has brought and settled an enforcement action that sounds in the securities concept of insider trading, relying on the relatively new provision of law and CFTC rule that prohibits employment of a manipulative or deceptive device or contrivance in connection with futures or swaps trading. (Click here to access Commodity Exchange Act Section 6(c)(1), US Code § 9(1), and here to access CFTC Rule 180.1.) In the first action brought in 2015, the CFTC alleged that Arya Motazedi, a gasoline trader for an unnamed large, publicly traded corporation, similarly misappropriated trading information of his employer for his own benefit. The CFTC charged that Mr. Motazedi breached his duty of confidentiality to his employer by trading opposite the firm on 34 occasions to effectively transfer funds from his employer to himself, and in front of his employer's orders on 12 other occasions. The CFTC has used its manipulative or deceptive device or contrivance authority in a wide range of enforcement actions stemming from its first use in the JP Morgan "London Whale" episode to subsequent allegations of illegal off-exchange metals transactions, claims of more traditional manipulation of wheat, allegations of spoofing and insider trading. The CFTC has made clear it sees its new authority "as a broad, catch-all provision reaching fraud in all its forms – that is, intentional or reckless conduct that deceives or defrauds market participants" and will use it whenever possible – including for allegations of trading on the basis of material nonpublic information obtained as a result of a breach of a duty of confidentiality, or through fraud or deception. (Click here to access the CFTC's views on the reach its authority under CFTC Rule 180.1 in the *Federal Register* adopting release for this provision.)

- **Federal Court Holds That CFTC Must Show Artificial Price to Prevail in Traditional Manipulation Lawsuit**: In connection with a motion for partial summary judgment brought by the Commodity Futures Trading Commission, Donald Wilson and DRW Investments LLC prevailed in their argument to a federal court in New York that the CFTC must prove that they had "the specific intent to affect market prices that 'did not reflect the legitimate forces of supply and demand'" in connection with the Commission's enforcement action against the defendants alleging manipulation and attempted manipulation. The CFTC initially filed a lawsuit in 2013, claiming the defendants manipulated and attempted to manipulate the settlement prices of the IDEX USD Three-Month Interest Rate Swap Futures contract on numerous occasions in 2011. (Click here for a copy of the CFTC's complaint.) Respondents generally denied the CFTC's allegations. (Click here for a copy of respondents' answer.) In November 2015, the CFTC moved for partial summary judgment on its attempted manipulation charge based on, among other matters, the purported "undisputed material facts" that the defendants, through their conduct, evidenced "an intent to affect price." Defendants opposed the CFTC's motion, and their legal views were echoed by five industry organizations who appeared as friends of the court and claimed that the CFTC was applying the wrong standard. They all argued that the CFTC should be required to prove—consistent with prior case law—that the defendants intended to create an artificial price not solely to affect price, a much lesser burden, as the CFTC charged. (Click here for details of the five industry organizations' arguments.) The court rejected the CFTC's view of its legal requirements, and rejected both the CFTC's motion for partial summary judgment and the defendants' motion for summary judgment related to this matter overall.

My View: As I observed earlier this year, the CFTC defines manipulation as "[a]ny planned operation, transaction, or practice that causes or maintains an artificial price" on its own website (emphasis added). (Click here to access CFTC definitions on its website.) As the CFTC recently acknowledged in adopting its new anti-manipulation and anti-fraud rules, one of the cornerstones for proving manipulation or attempted manipulation is "that the accused specifically intended to create or effect a price or price trend that does not reflect legitimate forces of supply and demand" to wit, an artificial price. (Click here to access the *CFTC Fact Sheet* related to its anti-manipulation and anti-fraud rules, Rule 180.1 and 180.2.) Setting aside the long-established case law as capsulized in the decisions cited in the five organizations' friends of the court brief and the court's decision in this matter, it was very surprising that the CFTC argued that an attempted manipulation could be an attempt to cause anything less than an artificial price in light of the agency's own published plain words.

- **Trader Indicted for Exploiting Minimum Futures Pricing Convention to Hide Trading Losses and Causing Firm Collapse; CFTC Also Files Civil Charges**: Tom Lindstrom was indicated by a federal grand jury in Chicago, and also sued civilly by the Commodity Futures Trading Commission in a federal court in Chicago, for hiding trading losses from his employer and causing the firm's financial collapse. According to the CFTC's complaint, Mr. Lindstrom was formerly employed by Rock Capital Markets LLC, a proprietary trading firm, where he engaged in trading of options on 10-year US Treasury note futures listed on the Chicago Board of Trade. In order to disguise his trading losses, alleged the CFTC, between January 1, 2014, and January 27, 2015, Mr. Lindstrom purchased "hundreds of thousands" of deep out of the money options for a very nominal price. He did this, said the CFTC, to take advantage of a CBOT pricing convention in effect at the time that priced each option for settlement purposes at a minimum of US $15.63/option. As a result, claimed the CFTC, Mr. Lindstrom was able to show his employer that he had "millions of dollars of phony profits" in his account as opposed to losses. After the CME Group questioned Rock Capital about its large option positions on January 27, 2015, the firm recognized that the purported value of Mr. Lindstrom's account was false by more than US $15 million, said the CFTC. In fact, the CFTC alleged, Mr. Lindstrom had sustained trading losses in excess of US $13.9 million over the life of his account, "and caused the collapse of Rock Capital." In the indictment, Mr. Lindstrom was charged with four counts of commodities fraud and four counts of wire fraud. The CFTC seeks an injunction, the imposition of a fine and disgorgement, among other remedies, against Mr. Lindstrom. Since February 29, 2016, all deep out of the money options at the Chicago Mercantile Exchange and the CBOT are settled at $1 (click here to access details of the exchanges' revised practice).

- **Firm Sanctioned by SEC for Firing Whistleblower Who Allegedly Made False Allegations**: International Game Technology, a publicly traded company, agreed to pay a fine of US $500,000 to the Securities and Exchange Commission for terminating an employee who raised certain concerns regarding accounting practices with management and filed a complaint on the company's internal whistleblower hotline. According to the SEC, from 2008 through October 30, 2014, while employed at IGT, the employee consistently received very favorable reviews and was promoted to be director of a division with 11 direct reports and a spending budget of over US $700 million. In July 2014, the employee raised concerns to his two supervisors, including his executive supervisor, regarding how certain costs were accounted for in the company's financial statement; he believed the costs were overstated. According to the SEC, the employee "had a heated disagreement with [his] executive supervisor on the issue." In response, the executive supervisor advised IGT's chief executive officer that he would terminate the employee. However, shortly afterwards, the employee submitted his complaint on IGT's whistleblower hotline. In response, the company conducted a formal investigation utilizing outside counsel that concluded that the firm's accounting practices were appropriate. Following completion of the investigation, the employee was terminated. The SEC charged that this termination violated the employee's anti-retaliation rights for whistleblowing under applicable law (click here to access the Securities Exchange Act Section 21F(h)).

My View: From the SEC's Order in this matter, it is not clear how reasonable were the complaining employee's allegations, or in what manner he presented his concerns, other than to note that he and his executive supervisor had a "heated disagreement" on the issue. Apparently, the executive supervisor considered a slide the employee had prepared stating his views to be "inflammatory" and was concerned his statements had "no basis in fact." An internal investigation helped by outside counsel appeared to confirm the executive supervisor's view. Although whistleblowing is and should be protected, all complaints should have some legitimate basis, and companies should not be penalized for terminating employees who abuse a whistleblowing process for illegitimate purposes or who engage in improper conduct even in connection with a legitimate complaint. Otherwise employees are empowered to extort their employers for their own inappropriate actions or conduct. It's a fine line. (Click here for background on the SEC's whistleblower protections.)

- **Brokerage Firm Agrees to Pay US $12.5 Million Fine to SEC for Trading Controls Failure; Six Exchanges to Assess an Additional US $3 Million Penalty**: Merrill Lynch, Pierce, Fenner & Smith Incorporated agreed to pay a fine of US $12.5 million to resolve an enforcement action brought by the Securities and Exchange Commission claiming that, from July 14, 2011, through December 2014, the firm failed to have adequate risk management controls reasonably designed to prevent the entry of erroneous orders or orders that exceeded preset credit or capital controls for several of its trading desks. During the relevant period (as is the case now), such controls were mandatory, said the SEC, for all broker-dealers, such as ML, that had direct access to trading in securities on an exchange or through an alternative trading system under the SEC's market access rule (click here to access SEC's Market Access Rule, its Rule 15c3-5). According to the SEC, during the relevant time, ML utilized maximum share quantity and maximum notional value controls as its principal means to control trading access. However, charged the SEC, "because the thresholds were set at such high levels, the controls were not reasonably designed to prevent erroneous orders from entering the market." As a result, said the SEC, during the relevant time, ML sent many erroneous orders to marketplaces, causing multiple sudden increases and decreases in the prices of stocks and exchange-traded funds – in some cases, short-term price swings of 10 percent or more. The SEC claimed that ML did not begin to address its market access controls until May 2013, after some erroneous orders caused a 99-percent decline in one stock's price. Separately, six exchanges also announced a settlement with ML related to the firm's alleged violation of Regulation MAR during the same approximate time period as well as the exchanges' own supervision requirements. ML agreed to pay, in aggregate, US $3 million to resolve disciplinary actions brought by Bats BZX Exchange, Bats BYX Exchange, Bats EDGX Exchange, the New York Stock Exchange, NYSE Arca and the NASDAQ Stock Market.

Compliance Weeds: In April 2014, the Securities and Exchange Commission's Division of Trading and Markets issued helpful answers to frequently asked questions related to Regulation MAR (click here to access). This regulation, adopted in 2010, generally requires a broker or dealer with access to trading securities directly on an exchange or alternative trading system to have procedures and controls that limit their financial exposure as a result of such access, and ensure compliance with all applicable regulatory requirements. In its Q&As, the SEC provides a concise summary of the relevant regulation as well as answers to 19 questions regarding it. These questions include: does MAR apply to quotes (yes, MAR applies to all orders, including market maker quotes); and security futures products (yes, for broker-dealers that trade security futures on an exchange or alternative trading system but not for Notice-registered futures broker-dealers); and may a broker-dealer that provides access to an affiliate broker-dealer grant the affiliate control over its risk management controls and supervisory procedures (no).

- **Swap Dealer Settles Enforcement Action by CFTC for Not Filing Daily Large Trader Reports of Commodity Swaps Positions**: Wells Fargo Bank NA agreed to pay a fine of US $400,000 to the Commodity Futures Trading Commission to resolve charges that it failed to comply with the CFTC's requirements that it submit accurate large trader reports to it related to its physical swaps commodity positions. The CFTC claimed that from March 1, 2013, through November 13, 2015, every LTR submitted by Wells contained one or more errors. This is the fourth action the CFTC has now brought alleging violations of a swaps dealer's obligations to provide it accurate LTR data regarding physical swaps commodity positions. (Click here to access information regarding one recent CFTC enforcement action regarding LTR breakdowns.)

Compliance Weeds: The CFTC maintains an extensive large trader reporting program that must be strictly complied with by reporting entities. For futures and related options, large trader data must be provided to the Commission by futures commission merchants and foreign brokers. Generally, if at the end of a day a reporting firm has a customer with a position at or exceeding the Commission's reporting level in any single futures or options expiration month, the firm must report all of the customer's positions in futures and options in that commodity no matter the size positions in the other months. (Click here for current CFTC reporting levels for futures.) Rules related to large trader reports were amended in 2013 and some changes were effective last week for the first time. (Click here for details) Similarly, clearing members and swap dealers are required to file daily with the CFTC large trader reports for physical commodity swaps and swaptions when their positions exceed the equivalent of 50 related futures contracts (such swaps and swaptions must relate to certain covered agricultural and exempt futures contracts; click here to access a list of relevant covered contracts). The report must include certain required information in a format mandated by the Commission – including converting swap positions to futures contracts equivalent levels. (Click here to access the helpful CFTC publication "Large Trader Reporting for Physical Commodity Swaps: Division of Market Oversight Guidebook for Part 20 Reports" published June 22, 2015.)

Follow-Up: In August, the CFTC filed charges in a federal court in New York City against Deutsche Bank AG, a registered swap dealer, for its alleged failure to accurately report information regarding its swap transactions, as required by law, from April 16, 2016, through the current time. (Click here for details regarding the CFTC's enforcement action against Deutsche Bank) In conjunction with the CFTC's enforcement action, the CFTC and Deutsche Bank filed a joint motion seeking the appointment of a monitor to help ensure the bank's ongoing compliance with its swaps reporting requirements. However, on September 22, the federal court hearing the CFTC's enforcement action unexpectedly declined to automatically approve and enter a proposed consent order appointing a monitor, finding that the "CFTC's application is bereft of any authorities explaining why the proposed Consent Order is 'fair, reasonable, adequate, and in the public interest'." Last week the CFTC submitted a memorandum of points and authorities in support of its motion for entry of the proposed consent order that endavored to address the court's concerns. A hearing on the Commission's application is scheduled for October 6.

- **Introducing Broker and Principal Sued by CFTC for Recordkeeping and Supervision Breakdowns**: The Commodity Futures Trading Commission filed an enforcement action against eFloor Trade LLC (EFT) and John Moore, for various recordkeeping and supervision failures, and Mr. Moore with making false statements to the Commission. EFT is registered with the CFTC as an introducing broker, while Mr. Moore is a registered associated person of EFT whom the CFTC claimed was responsible for supervising all of the firm's employees and agents in all "aspects of their business." According to the CFTC's complaint filed in a federal court in New York, the majority of EFT's business involved receiving trading instructions from third-party trading systems and placing orders for its customers who subscribed to the systems with future commission merchants for execution. The CFTC claimed that EFT failed to maintain and produce to the CFTC on request the trading instructions it received from the systems or records of orders it placed on behalf of its customers. The CFTC charged that EFT also failed to keep emails relating to its business, and that EFT and Moore failed to supervise the handling of its customers' trading accounts. Among the evidence the CFTC cited is claiming that EFT and Moore failed to supervise was "EFT's failure to adopt written procedures governing the handling of routine margin calls which occur when the carrying FCM demands additional funds or securities to be deposited in a trading account because the value of equity in the account has fallen below a required minimum." Finally, the CFTC claimed that Mr. Moore testified falsely to the Commission when he advised the CFTC under oath that ETF maintained a spreadsheet that reflected customer orders, when it did not. The CFTC seeks an injunction, a fine and a permanent revocation of the registrations of defendants.

My View: CFTC Regulation 166.3 is a broadly drafted provision that has been used by the Commission in diverse circumstances (click here to access CFTC Rule 166.3). However, in this complaint is a worrisome suggestion that the CFTC may also consider it a failure to supervise trading accounts if a registrant does not memorialize in a written procedure an obligation imposed on it by contract or otherwise by a third party that is not grounded in a law or regulation. This is suggested by the CFTC's EFT enforcement action because there is no existing regulation requiring introducing brokers to make margin calls on customers they introduce to futures commission merchants. Indeed, some FCMs preclude their IBs from making margin calls at all. Although a requirement that an IB call customers introduced to an FCM for margin under certain circumstances may be a measure imposed by a particular FCM, it seems a stretch to argue that the failure to memorialize that obligation into a procedure constitutes a violation of a registrant's duty to supervise.

- **Hedge Advisor to Retailers of Fuel Products Settles With CFTC Over Charges It Acted as an Unregistered CTA**: Angus Partners, LLC d/b/a Angus Energy settled charges brought by the Commodity Futures Trading that it acted as an unregistered commodity trading advisor when it advised its energy clients on hedging strategies involving over-the-counter commodity options and swaps. The Commission also claimed that the firm never provided a required disclosure document to its clients that revealed that it sold its clients OTC options that included a markup that it retained. The CFTC charged that Angus has engaged in its wrongful conduct since October 2012. According to the CFTC, during the relevant time, Angus Energy promoted itself as an expert in devising hedging strategies, using promotional literature that "gave clients the clear impression that Angus [Energy] would act in its clients best interest." Angus's clients were mostly retailers of heating oil and other fuel products. To resolve this matter, Angus Energy agreed to pay a fine of US $250,000.

And more briefly:

- **Hedge Fund Resolves SEC Charges That It Impermissibly Bribed Foreign Governments to Obtain and Retain Business; Owner of King of Beers Also Sanctioned**: Och-Ziff Capital Management Corporation and one of its subsidiaries agreed to pay total penalties of approximately $412 million to resolve criminal charges brought by the US Department of Justice and civil charges brought by the Securities and Exchange Commission related to its alleged bribery of government officials in various African countries in order to make investments at favorable terms and to obtain and retain investments from one sovereign wealth fund. Daniel Och, Och-Ziff's chief executive officer, and Joel Frank, its chief financial officer, also agreed to resolve related SEC charges brought against them personally. Mr. Och agreed to pay a penalty in excess of $2.1 million, while Mr. Frank's penalty will be determined later. Separately, Anheuser-Busch InBev, the purveyors of Budweiser – the advertised "King of Beers" – agreed to pay penalties totaling US $6 million to the SEC for alleged improper payments to government officials in India as well as its entry into a separation agreement with an employee that prevented the individual from communicating to the SEC about his bribery concerns.

- **SEC Adopts Enhanced Regulatory Framework for Systemically Important Clearing**

Agencies: The Securities and Exchange Commission approved rules to enhance the operations and governance of systemically important clearing agencies as well as of clearing agencies that handle complex products such as security-based swaps. The SEC also proposed that its new rules apply to certain other clearing agencies, including SEC-registered central counterparties, such as the Options Clearing Corporation. Among other measures, the adopted rules will require clearing agencies to maintain liquid net assets equal to at least six months of current operating expenses. The SEC's new rules will be effective 60 days after their publication in the *Federal Register* and must be complied with by 120 days afterwards. The agency will accept comments on the proposed rules for 60 days after their publication in the *Federal Register*. Approval of the SEC's rules is expected to assist OCC and other SEC-supervised CCPs be recognized as so-called "qualified CCPs" by the European Commission and enable European Union-based banks and their affiliates to have exposure to such entities without incurring a penalty capital charge.

- **SEC Calls for T+2 Securities Transactions Settlement**: The Securities and Exchange Commission proposed to reduce the standard settlement cycle for most broker-dealer transactions involving the purchases and sales of securities from three business days (T+3) to two business days (T+2). The SEC has maintained the T+3 settlement cycle since 1993. The Commission will accept comments on its rule proposal for 60 days following its publication in the *Federal Register*.

- **UK FCA Considers Regulatory Obligations of Head of Legal Function at Investment Firms**: The UK Financial Conduct Authority sought views on proposed new elements of its recently implemented Senior Managers' and Certification Regime, including guidance for senior managers at investment firms on their "Duty of Responsibility" and a requirement that UK branches of overseas banks advise their employees of FCA and Prudential Regulatory Authority whistleblowing provisions. The FCA is also seeking input on whether the legal function should fall within the Senior Managers' Regime, including regarding the obligations of the head of the legal function. Comments on the legal function will be accepted through January 9, 2017.

- **CFTC Mandates More Interest Rate Swaps to Be Centrally Cleared**: The Commodity Futures Trading Commission approved expanding its mandatory clearing requirement to certain new categories of interest rate swaps. These new categories are fixed-to-floating IRS and forward rate agreements denominated in certain enumerated foreign currencies; basis swaps denominated in Australian dollars; and overnight index swaps denominated in Australian and Canadian dollars and overnight index swaps enumerated in US and certain foreign currencies with up to three years' termination dates. The clearing requirement for these products will be phased in over a maximum of two years depending on equivalent phase-in schedules in non-US jurisdictions.

- **NFA Amends Form PQRs Again, and Reminds CTAs and CPOs Regarding Late Fees**: The National Futures Association made a minor change to its Form PQR for commodity pool operators that is required beginning for the quarter ending September 30. The change relates to the date of each participant disclosure regarding redemption halts, material limitations on redemptions and the termination of halts or limitations. NFA also reminded CPOs and commodity trading advisors that, effective for reports dated September 30, it will assess a $200/business day late fee for each day a Form PQR or PR is filed tardy.

- **SGX Encourages Collaboration to Address Market Misconduct**: The Singapore Exchange announced two measures to assist member firms detect and halt market misconduct. It issued a handbook that describes prohibited market disruption activities such as spoofing and layering and will issue to members on a quarterly basis a surveillance dashboard that will include the number of alerts triggered by SGX's real-time surveillance system. The report will identify the date and time an alert was generated, the relevant security identification of futures contract and the code of the relevant trader. The first report was issued to members last week.

- **ICE Futures U.S. Traders Barred for Prearranging Trades to Transfer Funds Between Accounts**: Yang Fan, Haibang Huang and Jiaoqing Zhang were permanently barred from trading on ICE Futures U.S. for engaging in prearranged trades from June 2012 through September 2012 to transfer funds between their accounts. Mr. Fan was also ordered to pay a fine of US $100,000, while Mr. Huang and Mr. Zhang were each ordered to pay a fine of US $25,000. Similarly, Lei Wei and Chen Yun Zhen were also found to have engaged in similar prearranged transactions in October and December 2013 for the purpose of transferring funds to Mr. Zhen's account. Mr. Wei and Mr. Zhen were also permanently barred from trading on IFUS.

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