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Bridging the Weeks by Gary DeWaal: March 18 – 29 and April 1, 2019 (Programmer’s Trial; Trade Reporting Headaches; Food Giants Settle Manipulation Enforcement Action)

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Not the spoofer, but the person alleged to have developed the computer program used by the spoofer to conduct his illicit futures transactions goes on trial this week in a criminal action brought by the Department of Justice. Last week, the presiding judge declined a motion by the DoJ to lessen the burden of proof it would require to convict the programmer by rejecting the DoJ's argument that the programmer could be found guilty if the jury concluded that he likely suspected the program would be used for spoofing (even if he did not definitely know) but deliberately avoided confirming his suspicion. Separately, two food giants agreed to settle the Commodity Futures Trading Commission’s enforcement action against them alleging manipulation, attempted manipulation and fraud-based manipulation in connection with their 2011 end-of-year trading of wheat futures on the Chicago Board of Trade. No terms have been announced, however. As a result, the following matters are covered in this week’s edition of *Bridging the Weeks*:

- Criminal Trial of Purported Programmer for Convicted Spoofer Begins This Week; Proposed Ostrich Instruction to Jury Rejected by Court (includes **My View**);
- Two Global Investment Banking Groups Substantially Fined by UK FCA for Alleged Reporting Breakdowns (includes **Compliance Weeds**);
- Food Giants Settle CFTC Enforcement Action Alleging Traditional and New Fraud-Based Manipulation (includes **Legal Weeds**); and more, including some important current legal and regulatory developments involving cryptoassets.

Briefly:

- **Criminal Trial of Purported Programmer for Convicted Spoofer Begins This Week; Proposed Ostrich Instruction to Jury Rejected by Court**: Jitesh Thakkar, who was criminally charged in early-2018 with conspiracy to commit spoofing and aiding and abetting spoofing in connection with his alleged development of a computer program – “NavTrader” – used by Navinder Sarao in connection with Mr. Sarao’s spoofing activities will stand trial this

week in a federal district court in Chicago.

The trial will occur after Mr. Thakkar prevailed last week in a motion to preclude the government from suggesting to the jury that they could convict Mr. Thakkar if they found he had a strong suspicion that NavTrader would be used for spoofing, but he purposely avoided confirming that fact. Instead, the government will have to show Mr. Thakkar possessed knowledge of Mr. Sarao's illicit purpose beyond a reasonable doubt. (The instruction proposed by the government is known as an "ostrich instruction.")

According to court papers filed on behalf of Mr. Thakkar, the government first proposed the court's use of an ostrich instruction on March 22, 2019 – six days before jury selection was to commence in connection with the defendant's trial. Mr. Thakkar's court papers alleged this was because of "the government's realization that they don't have sufficient evidence to prove Jitesh's knowledge beyond a reasonable doubt."

Initially, both the government and Mr. Thakkar were required to file proposed jury instructions with the court by December 7, 2018; the jury instructions proposed by the government at the time did not contain the ostrich instruction. Last week, the court rejected the government's proposal for an ostrich instruction without a written decision.

Mr. Sarao pleaded guilty in November 2018 to criminal charges brought against him by the Department of Justice for engaging in manipulative conduct through spoofing-type activity involving E-mini S&P futures contracts traded on the Chicago Mercantile Exchange between April 2010 and April 2015, including illicit trading that allegedly contributed to the May 6, 2010, "Flash Crash." On the same day, the Commodity Futures Trading Commission announced that Mr. Sarao settled civil charges it had brought against him and Nav Sarao Futures Limited PLC, a company he controlled, related to the same essential conduct. (Click here for background regarding Mr. Sarao's settlements and initial charges against him in the article "Alleged Flash Crash Spoofer Pleads Guilty to Criminal Charges and Agrees to Resolve CFTC Civil Complaint by Paying Over $38.6 Million in Penalties" in the November 13, 2016 edition of *Bridging the Week*.)

Mr. Thakkar, along with Edge Financial Technologies, Inc. – a company Mr. Thakkar founded and for which he served as president – was also civilly charged by the CFTC with spoofing and engaging in a manipulative and deceptive scheme for designing software that was used by Mr. Sarao to engage in spoofing activities. This case was stayed in December 2018 pending resolution of Mr. Thakkar's criminal case. (Click here for more details regarding the criminal and civil complaints involving Mr. Thakkar in the article "CFTC Names Four Banking Organization Companies, a Trading Software Design Company and Six Individuals in Spoofing-Related Cases; the Same Six Individuals Criminally Charged Plus Two More" in the February 4, 2018 edition of *Bridging the Week*.)

Mr. Thakkar made a motion to dismiss the criminal complaint against him in May 2018. This motion was denied in August 2018 in a summary order. (Click here for additional information regarding Mr. Thakkar's motion to dismiss in the article "Programmer Moves to Dismiss Criminal Charges for Allegedly Aiding and Abetting Trader's Spoofing Violations" in the June 3, 2018 edition of *Bridging the Week*.)

In other legal developments involving allegations of spoofing:

- **Department of Justice Rejects Amicus Claims That Spoofing Can't Be Prosecuted**

Alleging Wire Fraud: The Department of Justice urged a court to reject arguments that wire fraud charges were inappropriate substitutes for allegations of express spoofing law violations. These positions had been taken in two friends of the court briefs filed in connection with the criminal case against James Vorley and Cedric Chanu related to the defendants' purported spoofing. The two amicus briefs – one filed by FIA and the other collectively by the US Chamber of Commerce, the Bank Policy Institute and the Securities Industry and Financial Markets Association – argued that charges against the defendants for wire fraud (and not spoofing) prompted concern by the business community because they implied that orders entered without an intent of execution for any reason constituted fraudulent statements to the marketplace. However, the DoJ said the amicus' arguments were "meritless," because whether the fraudulent orders were materially false or fraudulent is "a question properly reserved for resolution by a jury after the presentation of evidence." Moreover, noted the DoJ, the amicus' position is inconsistent with a prior federal appeals court decision that rejected a convicted spoofer's view that "because his orders were fully executable and subject to legitimate market risk, they were not, as a matter of law, fraudulent."

Mr. Vorley and Mr. Chanu were named in criminal complaints filed in a US federal court in Chicago related to alleged spoofing trading activities on the Commodity Exchange, Inc. from at least December 2009 through November 2011. (Click here for details regarding the charges against Mr. Vorley and Mr. Chanu in the article "Alleged Spoofer Exonerated in Criminal Trial Agrees in Principle to CFTC Settlement; Two More Purported Spoofers Criminally Charged" in the August 5, 2018 edition of *Bridging the Week*. Click here for background regarding the two amicus briefs filed on behalf of the defendants in the article "Government Argues New Trial for Convicted Spoofer Not Justified by Data Available Before Trial End" in the February 24, 2019 edition of *Bridging the Week*.)

- Broker-Dealer Loses Effort to Dismiss Cross-Market Spoofing Charge: A federal court in New York rejected a motion for summary judgment by Lek Securities Corp. and Samuel Lek in connection with a Securities and Exchange Commission enforcement action against them for purportedly facilitating manipulative trading activity by a customer, Avalon FA Ltd, a non-US entity, and its two control persons. At the time of the lawsuit, Mr. Lek was the chief executive officer and a 70 percent owner of Lek Securities.

According to the SEC's complaint filed in March 2017, Avalon engaged in two types of manipulative conduct: layering and cross-market manipulation involving equities and related options from December 2010 through at least September 2016.

The Lek defendants principally argued that the record failed to provide sufficient evidence supporting a violation by the Avalon defendants, and that, in any case, there was not sufficient evidence to show they aided and abetted Avalon's alleged violations. The court rejected these positions, ruling they were "material factual disputes that are inappropriate for resolution on summary judgment." (Click here for background regarding the SEC's enforcement action against the Lek defendants in the article "US Broker-Dealer, Its CEO and a Non-US Client Sued by SEC for Layering and Other Manipulative Schemes" in the March 12, 2017 edition of *Bridging the Week*.)

- Japanese Regulator Recommends Sanctioning Global Investment Bank for Spoofing: The Securities and Exchange Surveillance Commission of Japan recommended that Citigroup Global Markets Limited be fined Japanese ¥133.4 million (approximately US $1.2 million) for purportedly engaging in spoofing-type trading activities involving December 2018 Government

Bond Futures on the Osaka Exchange during two time periods in October 2018. According to SESC, the firm allegedly entered orders for a large quantity of the relevant futures contracts on one side of the market without the intent to achieve execution to induce other market participants to place same direction orders. This would help the firm execute its smaller quantity of resting orders on the other side of the market, said SESC. The SESC claimed that once the firm's small quantity orders were executed, it cancelled its larger orders. SESC's recommendation was to the Financial Services Agency.

My View: The Thakkar case is important because it represents an attempted extension of both the DOJ's and CFTC's reach in spoofing cases to the alleged provider of programming used by the primary person accused of spoofing. Potentially, it is relevant to all third-party vendors whose services or devices may be utilized by lawbreakers. In this case, Mr. Thakkar claims that not only was he not the person who developed the NavTrader program used by Mr. Sarao, but he never was aware of the purpose for which Mr. Sarao proposed to use NavTrader. Instead, he claims he took Mr. Sarao's order to develop NavTrader and passed it along to three programmers – none of whom have been sued by the DoJ or the CFTC. Moreover, Mr. Thakkar said that Mr. Sarao never explained his strategy, which Mr. Thakkar did not consider atypical, because it was part of Mr. Sarao's "secret sauce" for trading.

The court's rejection of the ostrich instruction proposed by DoJ indicates that the government will have to show that Mr. Thakkar had actual knowledge of Mr. Sarao's illicit purpose for using NavTrader. A suspicion or a conjecture of potential wrongful use by Mr. Sarao will not be enough. This outcome should provide some interim comfort to programmers whose software may later be used by a trader without their knowledge for illicit purposes. However, it will be important to see how the facts play out in this case and the ultimate outcome before coming to any final conclusions. A principle of absolute liability should not be applied against programmers if their algorithmic creations are intended to be used by traders and are, in fact, actually used for illegal purposes without their actual knowledge a planned illicit use.

- **Two Global Investment Banking Groups Substantially Fined by UK FCA for Alleged Reporting Breakdowns**: UBS AG and Goldman Sachs International were fined a collective £61.3 million (approximately US $80 million) by the UK Financial Conduct Authority for transaction reporting failures over a multi-year period.

GSI was sanctioned £34.3 million for problematic transaction reporting from November 2007 through March 2017, while UBS was penalized £27.6 million for transaction reporting issues from November 2017 through May 2017. New reporting requirements across Europe went into effect on November 1, 2017, as a result of the implementation of Markets in Financial Instruments Directive that changed the list of transactions that needed to be reported and standardized the type of information that was required to be included in reports.

According to FCA, both firms failed to accurately report a large number of transactions during the relevant times, failed to report other transactions that should have been reported, and inadvertently reported some transactions that should not have been reported at all.

FCA said that GSI sustained issues in reporting because, at various times, it purportedly did not ensure it had sufficient change management procedures and controls "to manage the impact of business or upstream systems changes on transaction reporting"; did not have sufficient processes

to detect transaction reporting errors on a timely basis; and did not have adequate systems and controls to accurately reflect counterparty reference data used for transaction reporting. FCA alleged that UBS also had breakdowns in change management controls and the maintenance of static data, as well as errors in its systems, technology logic and reporting processes.

Both firms benefitted from 30 percent discounts to potential penalties under the FCA sanctioning regime because, among other reasons, FCA recognized they identified many of their own errors and proactively took steps to correct their reporting breakdowns.

Compliance Weeds: Although reporting obligations are more extensive for European-based financial institutions under MiFID, the Commodity Futures Trading Commission also imposes substantial reporting obligations on US swap dealers.

In December 2015, the CFTC's Division of Swap Dealer and Intermediary Oversight published a *Staff Advisory* reminding swap dealers and major swap participants of their obligation to report certain swap data timely and accurately. Staff noted "diverse reporting issues and failure," with certain types of errors occurring "with some frequency": readily apparent errors; incomplete reporting; duplicative swap reporting; calculation errors; and reporting delays. Staff recommended utilizing certain measures or processes to enhance reporting quality: data gatekeepers; automated review of reported data; erroneous record checks; and improved changed management practices. Staff also reminded SDs and MSPs that if they utilize third-party service providers to report swap data, they still remain responsible for complying with applicable requirements. (Click here to access the CFTC staff's advisory.)

The consequences of faulty reporting can be expensive, and the CFTC has sought high sanctions against what it considers to be recidivist violators. (Click here for background in the article "Swap Dealer Settles Enforcement Action by CFTC for Not Filing Daily Large Trader Reports of Commodity Swaps Positions" in the October 2, 2016 edition of *Bridging the Week*.)

- **Food Giants Settle CFTC Enforcement Action Alleging Traditional and New Fraud-Based Manipulation:**Kraft Foods Group, Inc. and Mondelez Global LLC entered into a "binding agreement" with the Commodity Futures Trading Commission to settle the CFTC's 2015 lawsuit against them which claimed that wheat futures trades the defendants entered into during November 2011 on the Chicago Board of Trade for the alleged purpose of hedging were in fact entered for the purpose of artificially lowering prices in the related cash market. This activity, charged the CFTC, was a violation of federal law and the Commission's rules prohibiting manipulation, attempted manipulation and fraud-based manipulation. The CFTC also charged the defendants with violating speculative position limits, as well noncompetitive trading in connection with multiple transfers of positions between different accounts that were executed as exchanges for related positions (instead of as transfer trades). (Clickherefor more background on the CFTC's enforcement action in the article "Manipulation Is Not Hedging Says CFTC in Federal Court Lawsuit Against Kraft Foods Group and Mondelez Global" in the April 5, 2015 edition of Bridging the Week.)

No terms of the settlement were announced. The parties are obligated to report back to the federal court in Chicago hearing this case for a status update on May 28, 2019.

Previously, the defendants sought to dismiss the CFTC's charges related to traditional and the new fraud-based manipulation. The district court rejected the defendants' motion. (Click here for details in

the article “Global Food Merchant’s Motion to Dismiss CFTC’s Enforcement Action for Alleged Manipulation Denied” in the December 20, 2015 edition of *Bridging the Week*.) The court later declined to allow the defendants to appeal their loss (click here for details).

Legal Weeds: In December 2018, a US federal court in New York City ruled that the CFTC did not meet its burden of proof in its enforcement action against DRW Investments, LLC and Don Wilson, its chief executive officer. The CFTC had charged the defendants with manipulation and attempted manipulation of the IDEX USD Three-Month Interest Rate Swap Futures Contract from January 24 through August 12, 2011. Because of the timing of the alleged wrongful conduct, the CFTC did not charge defendants with violating the CFTC’s new fraud-based manipulation authority.

The court held that the defendants’ trading activities were legitimate and were consistent with their view that the futures contract’s design was flawed and that the futures instrument was inherently more valuable than a comparable over-the-counter contract. According to the court, “[i]t is not illegal to be smarter than your counterparties in a swap transaction, nor is it improper to understand a financial product better than the people who invented that product.” (Click here for background in the article “Being Smarter Than Your Counterparties Is Not Manipulation Rules Judge in CFTC Enforcement Action” in the December 9, 2019 edition of *Bridging the Week*.) The CFTC subsequently determined not to appeal this decision.

The reach of the CFTC’s fraud-based manipulation authority is currently being considered by a federal appeals court in California. Recently, a federal district court in California held that the CFTC cannot use the prohibition against persons engaging in any manipulative or deceptive device or contrivance in connection with the sale of any commodity in interstate commerce enacted as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act to prosecute acts of purported fraud except in instances of fraud?based market manipulation. The CFTC claimed in its appeals court argument that the district court misread and misapplied the plain language of the relevant statute. (Click here for details in the article “CFTC Asks Appeals Court to 'End the Confusion' Regarding Clarity of Law Regarding Actual Delivery and Fraud-Based Manipulation” in the March 17, 2019 edition of *Bridging the Week*.)

More Briefly:

- **CFTC Kisses on Regulatory Burdens and Excludes on Swap Dealer De Minimis Exception**: The Commodity Futures Trading Commission issued final amendments to two existing rules under its Project KISS initiative, designed to holistically review the Commission’s rules, regulations and practices to make them simpler, less burdensome and less expensive, where possible.

Under one set of amendments, the CFTC will require swap dealers and major swap participants to notify certain counterparties of their right to require segregation at the initiation of a relationship and not prior to each transaction (or at least annually). In addition, the SD or MSP can give such notice to an appropriate person at the counterparty, not solely to persons with designated titles. Under another set of amendments, the scope of existing requirements related to third-party experts’ evaluation of self-regulatory organization’s financial surveillance program of futures commission merchants will be modified and only required once every five years (not three years as currently mandated). Both sets of amendments lessen existing burdens on applicable parties without diminishing important protections, claimed the CFTC.

(Click here for more information regarding Project KISS in the article "CFTC Chairman Nominee Warns of Tough Love to Come: KISS But Also Aggressive and Assertive Enforcement" in the March 19, 2017 edition of *Bridging the Week*.)

Separately, the CFTC excluded from the calculation of swaps that would cause an entity to be registered as a swap dealer (i.e., the "de minimis exception" – a rolling annual amount equal to US $8 billion), swaps entered into by Insured Depository Institutions to hedge loans with customers. Two commissioners – Dan Berkovitz and Rostin Behnam – objected to the manner in which the Commission created this exclusion – by purportedly revising "the scope of activity that constitutes swap dealing." According to Mr. Berkovitz, "[i]n the guise of helping small and mid-size banks, [the amendments] ope[n] the door for large banks to undertake an unlimited amount of swap dealing with loan customers without registering as swap dealers" However, Brian Quintenz, another commissioner, disagreed with this assessment, saying that "the preamble of today's rule makes absolutely clear that if an IDI entered into a swap with an end-user for the end user's speculative purposes, that transaction would not qualify for the de minimis exception."

Unrelatedly, the Senate Committee on Agriculture, Nutrition and Forestry will vote on the nomination of Heath Tarbert as the next CFTC Chairman on April 1 (click here for details).

- **Supreme Court Rules Employee Potentially Liable for Federal Securities Law Fraud When Providing False Promotional Literature Drafted by Boss**: The US Supreme Court ruled that an individual may be found liable for fraud under applicable securities laws when he knowingly disseminates false or misleading statements to potential investors even though he did not compose the false statements. The decision stems from an SEC enforcement action against Francis Lorenzo, an investment banker who was sanctioned by the agency for violating its anti-fraud rule. According to the SEC, Mr. Lorenzo, at the direction of his boss, knowingly sent emails drafted by his boss to potential investors that contained false information about the worth of an investment banking client's assets. Mr. Lorenzo disputed the SEC's action, claiming that he was not liable for fraud under the SEC's anti-fraud rule because he was not the author of the false statement. Justice Stephen Breyer, writing the opinion, stated that it didn't matter whether Mr. Lorenzo was responsible for drafting the false information; what mattered was that Mr. Lorenzo knew that he was sending false information to potential investors.

- **Subject of Early CFTC Enforcement Action for Cryptocurrency Scam Criminally Indicted for Same Offense**: Patrick McDonnell was charged with nine counts of wire fraud in a federal court in Brooklyn for conducting a purportedly fraudulent virtual currency scheme from November 2014 through January 2018.

Last summer, a federal court in Brooklyn, New York, entered an order of permanent injunction, imposed a civil penalty of approximately US $871,000, and ordered restitution of approximately US $290,000 against Mr. McDonnell, and a company he owned and controlled— Cabbagetech Corp. – in connection with a lawsuit brought by the Commodity Futures Trading Commission that charged the defendants with unlawfully soliciting customers to send money and virtual currencies for virtual currency trading advice and for the discretionary trading of virtual currencies. However, alleged the CFTC, the defendants did not provide the promised services and misappropriated their customers' funds. In its decision, the district court upheld the authority of the CFTC to prosecute cases involving allegations of fraud in connection with cryptocurrencies. (Click here for details in the article "Federal Court Enters Final Judgment Against Alleged Virtual Currency Fraudster; Confirms CFTC Authority to

Bring Enforcement Action" in the August 26, 2018 edition of *Bridging the Week*.)

The criminal indictment against Mr. McDonnell parallels the CFTC enforcement action.

In other legal and regulatory developments involving cryptoassets:

- **Ex-CFTC Head Calls for Congress to Close Gaps in Cryptoasset Regulation**: Former CFTC Chairman Timothy Massad published a working paper under the auspices of the Brookings Institute calling for Congress to appoint the Securities and Exchange Commission – or alternatively the CFTC – as the national watchdog of all cryptoassets and related activities. Mr. Massad argued that such action was necessary to close a gap in cryptoasset regulation that is creating "broader societal risks with respect to cyber security and illicit payments." In his paper, Mr. Massad also recommended that, while new legislation is pending, the Financial Stability Oversight Council or the US Department of Treasury should issue a report recommending how Congress might "strengthen and clarify" relevant regulation and that the cryptoasset industry should develop its own self-regulation standards.

- **Japanese Advisory Group Urges Regulation Enhancements For Cryptoasset Businesses:** Japan's Financial Services Agency published an English-language version of a report composed by leading Japanese academicians, attorneys, and business persons, among others, that made recommendations to enhance the regulatory framework regarding cryptoassets in Japan. Among other things, regulations should address unfair acts in virtual currency spot trading; custodial services for virtual currencies; the security of virtual currencies by depositories; disclosure requirements for initial coin offerings; registration requirements for services providers offering contracts for differences involving virtual currencies; and mandatory risk disclosures by offerors of virtual currencies. The report also recommends that companies involved in ICOs should be regulated like ordinary securities companies.

- **Another Day, Another BitLicense:** Tagomi Trading LLC, a subsidiary of Tagomi Holdings Inc., obtained a BitLicense and a money transmission license from the New York State Department of Financial Services. According to the DFS, Tagomi Trading, an institutional-grade aggregation platform, was approved to offer services in money transmission, trade routing and order execution for virtual currencies that include, bitcoin, ether, bitcoin cash and litecoin. New York's BitLicense was introduced in 2015 to establish minimum standards to help ensure customer protection, cybersecurity and anti-money laundering compliance by persons involved in a virtual currency business involving New York or a NY resident. NYDFS has approved 18 BitLicenses to date. (Click here for background on NY's Bitlicense in the article "NYDFS Issues BitLicense Framework for Regulating Virtual Currency Firm" in the June 5, 2015 edition of *Bridging the Week*.)

- **Cryptoassets Among IOSCO's 2019 Priorities:** The International Organization of Securities Commissions indicated that, among its priorities in 2019, it will consider the trading, custody and settlement, and exposure of investments funds to cryptoassets. IOSCO will specifically consider the regulation of cryptoasset trading platforms and investment funds with cryptoasset exposure. IOSCO also indicated that, in 2019, it will focus on artificial intelligence and machine learning; passive investing and index providers; retail distribution and digitalization; sustainable finance; outsourcing and third-party providers; and market fragmentation in derivatives and securities markets, among other priorities.

- **Two Whistleblowers Net US $50 Million in SEC Awards for Top-Notch Information**: The Securities and Exchange Commission awarded US $50 million in total to two separate whistleblowers with one receiving US $37 million, the third largest reward given by the SEC, and the other getting US $13 million. According to a heavily redacted SEC release, the whistleblower who received the highest award did so because he/she provided information that was of “significantly high quality and critically important” to the staff that was the nature of a “smoking gun.” The SEC also disclosed that two whistleblowers were not rewarded for their efforts because their information did not open, assist, or contribute to the success of an investigation.

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