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Bridging the Week by Gary DeWaal: April 8 – 12 and April 15, 2019 (Not In An Empire State Of Mind; Mistrial For Programmer) [VIDEO]

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The New York State Department of Financial Services cancelled the temporary authority of a major cryptocurrency exchange to operate in New York, saying its failure to meet anti-money laundering, AML compliance officer quality and potential capital requirements disqualified it for a BitLicense or a money transmitter license. The firm now has less than 60 days to liquidate or off-load its existing NY customers. Separately, a mistrial was declared in the criminal action against the alleged programmer for the purported flash crash spoofer in connection with two counts of aiding and abetting spoofing. The prosecution has less than two weeks to determine whether to subject the programmer to a second criminal trial. As a result, the following matters are covered in this week's edition of *Bridging the Week*:

- New York State Department of Financial Services Revokes Crypto Exchange's Safe Harbor to Operate Without BitLicense (includes **Memory Lane** and **My View**);
- Mistrial Declared in Prosecution of Purported Programmer for Alleged Flash Crash Spoofer (includes **My View**); and more.

Article Version:

Briefly:

- **New York State Department of Financial Services Revokes Crypto Exchange's Safe Harbor to Operate Without BitLicense**: The New York State Department of Financial Services revoked the authority of Bittrex, Inc. to operate a virtual currency business involving New York or a NY resident effective April 11, 2019. The firm had been conducting business in New York pursuant to a "safe harbor" granted by NYSDFS while its application of August 10, 2015, for a NY BitLicense and its application of July 27, 2018, for a NY money transmitter license were pending.

NYSDFS denied Bittrex's license and revoked its authority to conduct a virtual currency business in New York, saying the firm could not "demonstrate it will conduct its business honestly, fairly, equitably, carefully and efficiently" as required by applicable law and rules.

In response, Bittrex issued a written statement saying it was "saddened and disappointed" by NYSDFS's action.

Under NY law and rules, persons engaging in a virtual currency business involving New York or NY persons must typically have a NY BitLicense and a money transmitter license. The BitLicense requirement was adopted in 2015. In 2018, New York amended its rules for persons engaged in a virtual currency business to require a program for monitoring for fraud, including manipulation. (Click here for background on NY BitLicense requirements in the article "New York BitLicense Regulations Virtually Certain to Significantly Impact Transactions in Virtual Currencies" in a July 8, 2015 *Advisory* by Katten Muchin Rosenman LLP. Click here for additional information on the 2018 augmentation of requirements for persons conducting a NY virtual currency business in the article "NYS Financial Services Regulator Ups the Obligations of State-Licensed Virtual Currency Entities" in the February 11, 2018 edition of *Bridging the Week*.)

According to NYSDFS, Bittrex's current anti-money laundering and economic sanctions compliance program are inadequate; it was not certain that Bittrex followed its own guidelines in approving digital tokens for trading on its own platform; and Bittrex would not commit to comply with NYSDFS's capital requirements. In connection with the firm's AML program, NYSDFS indicated that Bittrex lacked adequate policies and procedures; may not have employed an AML compliance officer with adequate experience who evidenced an appropriate level of authority and effectiveness; did not adequately train employees; and may not have had adequate independent testing of its AML program, all of which are required under applicable rules.

Bittrex vehemently disputed NYSDFS's findings, but acknowledged that it was on a "journey to improving and maturing our compliance function." The firm noted that "[c]orporate responsibility is in our DNA and our commitment to regulatory and compliance guidelines is second to none." In response to NYSDFS's claim that Bittrex was unwilling to commit to meet the Department's financial requirements the firm claimed that "NYDFS imposed capitalization requirements in excess of that of any other state despite Bittrex's industry-leading security and cold storage procedures."

Under NYSDFS's order, in addition to suspending its NY business by last week, Bittrex is required to wind down or transfer existing positions of NY residents by June 9, 2019.

Separately, NYSDFS granted a BitLicense to Bitstamp USA Inc., a subsidiary of Bitstamp Ltd. Under its license, Bitstamp is authorized to enable its customers to buy and sell bitcoin and other designated cryptocurrencies, as well as facilitate transfer of funds onto the Ripple network, issuing Ripple balances in US dollars and select non-US fiat currencies, as well as other virtual currencies. According to a statement by Bitstamp, the firm "has always embraced regulatory efforts which focus on transparency and accountability that help expand the industry." Bitstamp's approval marked the 19th approval by NYSDFS of a company to engage in a virtual currency business in New York.

In other legal and regulatory developments involving cryptoassets:

- Representatives Propose New Legislation to Carve Out Utility Tokens From Application of Securities Laws: Multiple US Congressmen introduced the "Token Taxonomy Act" to exclude from the definition of "security" under US securities laws "digital tokens," namely

cryptoassets that do not constitute a financial interest in a company or partnership. As proposed, the Securities and Exchange Commission and all states would be prohibited from enacting any requirement mandating the registration of digital tokens as securities. The proposed law would also require the SEC to adopt rules to provide for good control locations for any digital token that might be a security, as well as for the Internal Revenue Service to clarify the tax treatment of certain events involving virtual currencies.

- Developer of Decentralized Computing Network Files Reg A+ Offering for SEC Approval: Blockstack Token LLC filed an offering statement with the SEC related to its proposed offering of up to 295 million Stacks Tokens. Through this offering, the firm hopes to raise up to US $50 million to further the development of the Blockstack decentralized computer network and decentralized applications. Blockstack filed its offering statement pursuant to Regulation A+, which provides an exemption from SEC and state registration requirements for smaller companies that meet certain eligibility, disclosure and reporting requirements. (Click here for details regarding Reg A+.) Blockstack expects that, if approved, its offering will be "the first SEC-qualified token offering of its kind" to rely on Reg A+.

- Coordinator of National Financial Regulators Publishes Directory of International Crypto Regulators: The Financial Stability Board published a list of national regulators of cryptoassets worldwide and briefly described how each overseer interfaces with digital assets. Last year, the FSB published a report concluding that cryptoassets do not currently pose any material risks to global financial stability, but should be monitored vigilantly in light of the speed of market developments. (Click here for background in the article "International Financial Regulator Coordinator Says Crypto-Assets Currently Pose No Threat to Financial Stability" in the October 14, 2018 edition of *Bridging the Week*.) Established in 2009, the FSB is an international organization comprising representatives of national authorities responsible for financial stability in material international financial centers. The FSB monitors and makes recommendations about the global financial system.

Memory Lane and **My View**: In September 2018, the New York Attorney General issued a report claiming that trading platforms for cryptocurrencies often (1) engaged in several lines of business that may pose conflicts of interest; (2) have not implemented "serious efforts to impede abusive trading activity"; and (3) have "limited or illusory" protection for customer positions. Moreover, the report named three cryptocurrency platforms that it alleged might have been operating unlawfully in New York at the time, and said it referred these platforms to the NYSDFS for possible further action. However, no public enforcement or other action by the NYSDFS has been announced against any identified firm since the NY AG report.

The NY AG's report followed a voluntary request for information sent to 13 cryptocurrency platforms earlier last year.

Just as the NY AG report appeared at the time to be a damning public indictment of multiple cryptoasset exchanges without the ordinary protection afforded defendants in judicial processes, NYSDFS denial of Bittrex's license transformed what should be private interactions into public theater. It may well be that NYSDFS was justified in its bottom-line determination, but the public way it excoriated Bittrex seems inappropriate.

That being said, a fundamental flaw of founders and promoters of both permissioned and permissionless blockchain networks is they all presume their system design is the best. Although

such persons may, for permissionless systems, espouse the benefit of peer-to-peer non-intermediated transactions through “disruptive” decentralized, cryptographically secure networks, such a benefit only exists for transactions on a specific blockchain. They do not exist for transactions across blockchains, such as exchanges of one digital asset for another or for interactions involving the real world, such as exchanges of fiat currency for a digital asset. These cross-blockchain network transactions today require third-party intermediation as different digital networks are generally not natively interoperable.

As a consequence, it is not unexpected that regulators seek to impose minimum qualifications on such intermediaries to protect customers, and it is equally not unexpected that many of such intermediaries in the relatively new cryptoasset industry have little or no experience dealing with experienced financial regulators. As Bittrex acknowledged about its own situation, “[We are] a young innovative company that believes in the future of blockchain technology. Bittrex will continue to mature its compliance program because we believe in being good corporate citizens, and because we believe in the rule of law. We will continue to work with the many other regulators, and we will continue to take constructive feedback to improve our ability to be the corporate citizens we have set out and committed to be.”

Hopefully, as the cryptoasset industry continues to evolve, regulators and legitimate industry participants will continue to work together to ensure an appropriate environment for customers without resorting to inflammatory front page headlines and public shaming absent fraud or other purposely nefarious conduct.

(Click here for additional information regarding the AG’s findings in the article “NY Attorney General Says Investors Risk Abusive Trading and More on Crypto Platforms” in the September 23, 2018 edition of *Bridging the Week*.)

- **Mistrial Declared in Prosecution of Purported Programmer for Alleged Flash Crash Spoofer** A mistrial was declared by the judge presiding over the criminal trial of Jitesh Thakkar, the alleged programmer of the software used by purported “Flash Crash” spoofer Navinder Sarao. The declaration followed the failure of the jury hearing the case to reach an unanimous verdict; the jury voted 10 – 2 in favor of acquitting Mr. Thakkar of two counts of aiding and abetting spoofing. Previously, the judge – the Hon. Robert Gettleman of the US District Court of the Northern District of Illinois – had acquitted Mr. Thakkar of the criminal charge of conspiracy to commit spoofing. The judge instructed the Department of Justice to determine whether it wanted to proceed with another trial of Mr. Thakkar or forego prosecution within two weeks. (Clickhere for additional background regarding this criminal prosecution in the article “Alleged Programmer for Flash Crash Spoofer Acquitted of Criminal Conspiracy Charge; Aiding and Abetting Allegations Pending” in the April 7, 2018 edition of *Bridging the Week*.)

My View: The outcome of a hung jury, in this case, was surprising, but the failure of 10 jurors to vote for Mr. Thakkar’s conviction for aiding and abetting Mr. Sarao’s spoofing is significant. Clearly, for the 10 jurors, the DOJ did not provide sufficient proof beyond a reasonable doubt that Mr. Thakkar programmed software with knowledge that Mr. Sarao intended to use such software for illicit spoofing purposes. Previously, the government had endeavored to have the jury convict Mr. Thakkar on a lesser standard – i.e., if they found he had a strong suspicion that the relevant software would be used for spoofing, but he purposely avoided confirming that fact. However, the judge rejected this “Ostrich Instruction.”

Given the apparent weakness of the DOJ's evidence and the challenge of flipping 10 jurors, it seems an inappropriate use of the public purse to retry Mr. Thakkar.

More Briefly:

- **Multinational Bank Resolves Purported Breaches of US Sanctions Program and AML Breakdowns by Paying Over US $1.1 Billion to Multiple Government Overseers**: Standard Chartered Bank, a multinational bank headquartered in the United Kingdom, agreed to pay sanctions (including fines and forfeiture) in excess of US $1.1. billion to resolve US federal, state and local charges, as well as charges by the UK Financial Conduct Authority, for violating various US government sanctions programs, as well as for poor anti-money laundering controls. Among other matters, SCB was alleged to have violated sanctions programs administered by the Office of Foreign Assets Control of the US Department of Treasury against Burma, Cuba, Iran, Sudan and Syria. This happened when SCB purportedly processed over 9,300 transactions to or through the United States from June 2009 through May 2014 totaling in excess of US $437 million involving expressly sanctioned persons or countries. Most of the allegedly problematic conduct involved Iran-related accounts maintained at SCB's Dubai branch. In addition to paying sanctions, SCB agreed to "sustain its commitment" to having robust compliance procedures, including having a management team that "is committed to a culture of compliance." In addition to the FCA allegations, SCB also settled allegations with the US Department of Justice's Money Laundering and Asset Recovery Section and the US Attorney's Office for the District of Columbia; the Board of Governors of the Federal Reserve System; the Office of Foreign Assets Control of the US Department of Treasury; the New York State Department of Financial Services; and the New York County District Attorney's Office.

- **CME Group Consolidates Guidances Regarding Prohibited Activities During Pre-Opening Sessions**: CME Group exchanges proposed adoption of a new Market Regulation Advisory Notice to consolidate prior guidance related to all prohibited activities, including disruptive practices and wash trades, during pre-opening periods on the CME Globex electronic trading platform. The Advisory generally prohibits market activity from engaging in disruptive practices to manipulate or otherwise cause artificial fluctuations in the indicative opening price provided by Globex. Expressly prohibited conduct includes placing orders to detect stop or iceberg orders, or market depth, without the intent to execute such orders, or to purposely manipulate the IOP. Absent CFTC objection, the proposed Advisory is scheduled to be effective April 25. Separately, Denis Pospelov, a non-member, agreed to resolve allegations by the Chicago Mercantile Exchange that, from December 1, 2017, through April 30, 2018, he entered orders without an intent to execute for various E-mini S&P futures and options contracts. He also purportedly used other persons' Tag 50 identification, and let other persons use his identification to execute trades. Mr. Pospelov agreed to pay a fine of US $40,000 and be subject to a 30-day all CME Group exchanges' trading prohibition to resolve this disciplinary action.

- **SEC Commissioner Criticizes Regulation by No Action**: In a speech at SEC Speaks 2019, Securities and Exchange Commission Commissioner Hester Peirce bemoaned the practice of SEC staff issuing guidance in the form of guidance or relief to industry participants that creates a "secret garden" of law, outside the requirements of transparency and fairness mandated for the SEC in connection with the promulgation of new or amended rules. Although she expressed sympathy for the need of industry participants to acquire quicker clarifications, she said that "[the] practices I worry about are almost always the product of

good intentions and diligence." According to Ms. Peirce, “I have grown increasingly concerned that this … guidance – due to a lack of transparency and accountability – may have turned into a body of secret law.” Separately, the Executive Office of the President issued a reminder to the heads of all US government executive departments and federal agencies to submit all proposed rules to Congress for evaluation prior to their rollout. All proposed rules that might constitute “significant regulatory action” cannot be implemented prior to 60 days after finalization, in order to give Congress an opportunity to disapprove a rule. These obligations are mandated by the Congressional Review Act of 1996 (click here to access).

- **For Departing Registered Reps, Tell Customers How Accounts Will Be Handled Says FINRA in Reg Notice**: The Financial Industry Regulatory Authority adopted guidance that obligates members to advise customers “promptly and clearly” how their accounts will be handled after their registered representatives leave the firm. The guidance also requires members to provide customers with timely and complete answers when they ask questions about a departed RR.

Video Version:

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