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Bridging the Week: July 24 to 28 and July 31, 2017 (Bitcoin Derivatives Clearinghouse; Digital Tokens for Fund-Raising; Bitcoin Alleged Criminal Activity; Spoofing; Reg MAR) [VIDEO]

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Developments concerning digital tokens highlighted news in financial services this week. For the first time, a derivatives clearing organization – LedgerX – was licensed by the Commodity Futures Trading Commission to clear fully collateralized swaps contracts that could settle in digital currencies including Bitcoin. Separately, the Securities and Exchange Commission ruled that digital tokens issued to raise funds for projects might be securities under US law. Finally, BTC-e, a digital currency exchange, and Alexander Vinnik, who purportedly directed its operations and finances, were indicted for allegedly operating an unlicensed money services business and engaging in money laundering. Additionally, the CFTC brought a me-too enforcement action against a defendant for alleged spoofing trading activity more than two years after two CME Group exchanges resolved disciplinary actions for the same conduct – is this the most meaningful and cost-effective way of prosecuting purported wrongful behavior? As a result, the following matters are covered in this week's edition of *Bridging the Week*:

- LedgerX Approved by CFTC as First Derivatives Clearing Organization for Fully Collateralized Swap Contracts Potentially Settling in Bitcoin (includes **Legal Weeds**);
- SEC Declines to Prosecute Issuer of Digital Tokens That Violated US Securities Laws;
- Bitcoin Exchange and Operator Charged With Money Laundering;
- CFTC Settles With Alleged Spoofer Two Years After CME Group Exchanges First Resolved Disciplinary Actions for Same Conduct (includes **My View**);
- Trader Settles COMEX Disciplinary Actions for Failure to Supervise Employee's Purported Spoofing Activity (includes **Compliance Weeds**);
- Four Broker-Dealers Agree to Pay Aggregate Fine of US $4.75 Million to FINRA and Various Exchanges for Allegedly Violating SEC Market Access Rule (includes **Compliance Weeds**); and more.

Video Version:

Article Version:

Briefly:

- **LedgerX Approved by CFTC as First Derivatives Clearing Organization for Fully Collateralized Swap Contracts Potentially Settling in Bitcoin**: On July 24, LedgerX was approved by the Commodity Futures Trading Commission as a derivatives clearing organization to clear fully collateralized digital currency swaps. The firm was recently approved as a swap execution facility. (Click here for background in the article "LedgerX Approved as SEF by CFTC; Intends to List Bitcoin Options for Trading" in the July 9, 2017 edition of *Bridging the Week*.) To gain registration as a SEF and DCO, LedgerX had to demonstrate how it proposed to comply with core principles applicable to such entities as required by law. (Click here for a summary of core principles applicable to SEFs and here for core principles applicable to DCOs.) However, in connection with its DCO approval, LedgerX was granted exemption from complying with a few specific CFTC requirements because of its fully collateralized model (click here to access the CFTC's exemption letter addressing these requirements). Only institutional clients that qualify as eligible contract participants under applicable law will be eligible to trade through LedgerX and each participant must provide LedgerX with sufficient collateral to cover the maximum potential loss or delivery obligation of a contract prior to a trade being executed. (Click here to access the definition of an eligible contract participant at 7 U.S.C. § 1a(18).) LedgerX anticipates listing options on Bitcoin (click here for specifications) and day ahead swaps (click here for specifications) beginning in September 2017. (Click here for an introduction to LedgerX by Paul Chou, Chief Executive Officer.)

Legal Weeds: The CFTC has broad jurisdiction over commodities and, in particular, derivatives based on commodities. Under applicable law, commodities are defined to include all "goods and articles" (except onions and motion picture box office receipts) and "all services, rights and interests" on which contracts for future delivery might be based. (Click here to access the definition of an eligible contract participant at 7 U.S.C. § 1a(9).) In response, the Commission formally proclaimed its authority over derivatives based on virtual currencies in December 2014 when then Chairman Timothy Massad testified before the US Senate Committee on Agriculture, Nutrition and Forestry. There, Mr. Massad said, "Derivative contracts based on a virtual currency represent one area within our responsibility." (Click here to access a copy of Mr. Massad's testimony.) Previously, in September 2014, TeraExchange self-certified a US dollar-settled Bitcoin swap contract for trading on its SEF and the CFTC did not object. In September 2015, the Commission brought and settled charges against Coinflip, Inc. and its chief executive office for purportedly operating a trading facility for Bitcoin options without being registered as a SEF or a designated contract market. (Click here for details in the article "CFTC Says Virtual Currencies Are a 'Commodity' Under Federal Law, Files Charges Against Coinflip for Operating an Unregistered Bitcoin Options Trading Platform" in the September 20, 2015 edition of *Bridging the Week*.) More recently, in June 2016, the CFTC brought and settled charges against BFXNA Inc., doing business as Bitfinex, for allegedly engaging in prohibited, off-exchange commodity transactions with retail clients and failing to register as a futures commission merchant, as required. (Click here for details in the article "Bitcoin Exchange Sanctioned by CFTC for Not Being Registered" in the June 5, 2016 edition of *Bridging the Week*.)

- **SEC Declines to Prosecute Issuer of Digital Tokens That Violated US Securities Laws**: The Securities and Exchange Commission published a Report of Investigation last week that concluded that digital tokens issued by an entity for the purpose of raising funds for projects – even if using distributed ledger or blockchain technology – may be securities under federal law. If so, such securities must be registered with the Commission or eligible for an exemption from registration requirements. Moreover, the SEC concluded that any person offering trading facilities like an exchange for digital tokens that are securities must be registered as a national securities exchange or be exempt from such registration requirement. The SEC's Report follows an investigation by the SEC's Division of Enforcement which concluded that digital tokens offered and sold during April and May 2016 by DAO, an unincorporated virtual organization created by Slock.it UG, a German corporation, were securities subject to the SEC's registration requirements. Notwithstanding its finding, the SEC determined not to take an enforcement action against the DAO entity, Slock.it, any of the natural person founders of the DAO entity or any entity that offered secondary trading in DAO tokens "based on the conduct and activities known to the Commission at this time." The Commission also declined to take an enforcement action against any intermediary, including any trading facility, involved in the transactions. (Click here for a detailed analysis of the SEC's Report of Investigation and **My View** in a special edition of *Between Bridges* issued on July 26.) In the Report, the SEC raised the possibility that a virtual organization might be required to register as an investment company, but indicated this was beyond the scope of its analysis. The SEC warned, however that, "Those who would use virtual organizations should consider their obligations under the Investment Company Act."

- **Bitcoin Exchange and Operator Charged With Money Laundering**: BTC-e, a digital currency exchange, and Alexander Vinnik, who purportedly directed and supervised BTC-e's finances and operations, were criminally indicted by a federal grand jury in San Francisco for operating an unlicensed money service business, money laundering and other crimes. According to court papers filed by the US Attorneys' Office, from 2011 through the present, BTC-e "was an exchange for cybercriminals worldwide," and allegedly used by criminals to launder and liquidate criminal proceeds from digital currencies, such as Bitcoin, to fiat currencies, including US dollars and EU Euros. Moreover, despite doing "substantial" business in the US, BTC-e did not register with the Financial Crimes Enforcement Network of the US Department of Treasury, as required, and had no "meaningful" anti-money laundering procedures in place, claimed the indictment. According to the indictment, BTC-e, through the relevant time, received criminal proceeds from numerous computer hacking events and ransomware scams, including the well-publicized hacking of the digital currency online market Mt. Gox in June 2011. Among other things, said the indictment, BTC-e users were not required to provide any meaningful identifying information to conduct transactions on the exchange. Mr. Vinnik was arrested in Greece on July 25 in connection with his indictment. If

convicted, Mr. Vinnik could be subject to a substantial time of imprisonment and fines. Separately, FinCEN assessed a monetary penalty of over US $110 million against BTC-e and US $12 million against Mr. Vinnik for not registering BTC-e as a money service business and violating AML program requirements.

- **CFTC Settles With Alleged Spoofer Two Years After CME Group Exchanges First Resolved Disciplinary Actions for Same Conduct**: Simon Posen agreed to pay a fine of US $635,000 and never to trade on markets overseen by the Commodity Futures Trading Commission to resolve CFTC charges that he engaged in spoofing-type conduct from December 2011 through March 2015. According to the CFTC, during this time, on multiple occasions, Mr. Posen would enter one or more large orders or a series of layered orders on one side of Copper, Crude Oil, Silver or Copper Futures markets in order to suggest increasing or decreasing market price interest, and one or more similar small orders on the other side of the same market (or an iceberg order for a larger quantity but with only a small quantity publicly visible). After the smaller-sized orders were executed, Mr. Posen would cancel the larger-sized orders. The CFTC said that Mr. Posen typically traded during off-peak hours when markets were less liquid. After executing a trade, Mr. Posen would often repeat his process to liquidate the transaction, claimed the Commission. Mr. Posen's transactions occurred on the Commodity Exchange, Inc. and New York Mercantile Exchange. In 2015 business conduct committees of both exchanges resolved disciplinary actions with Mr. Posen related to the same conduct, albeit for a shorter period of time – September 2013 through February 2014. Mr. Posen agreed to settle his two exchange matters by payment of an aggregate US $75,000 fine and a CME Group-product five-week trading ban. (Click here for details in the article "Causing 'Atypical Price Activity' in Gold Futures Results in US $200,000 Fine by COMEX" in the June 21, 2015 edition of *Bridging the Week*.) Mr. Posen also settled another disciplinary action in November 2016 with COMEX for overlapping conduct from November 2014 through March 2015. In connection with this more recent disciplinary action, Mr. Posen agreed to pay a fine of US $90,000 and incur a four-week CME Group trading suspension. (Click here for background in the article "COMEX Member Settles Disciplinary Action Alleging Spoofing-Type Activities; ICE Futures Trader Agrees to Settle Alleged Position Limits Violation" in the December 4, 2016 edition of *Bridging the Week*.)

My View: The CFTC's enforcement action in this matter appears unwise particularly in light of the agency's precarious financial circumstances and limited resources. Unless self-regulatory organizations have insufficient jurisdiction to address trading-based infractions on their facilities that span other exchanges or involve extraordinary wrongdoing, it's not clear what the marginal benefit is of the CFTC bringing a me-too enforcement action. Here, where Mr. Posen was subject to hefty CME Group exchanges' sanctions for alleged spoofing-type conduct, an additional CFTC action appears unwarranted. If the CFTC is dissatisfied with the way an SRO handles infractions, the more appropriate forum to address this is through periodic rule reviews. (Click here for background on the CFTC's FY 2018 budget request and current financial circumstances in the article "Commissioner Bowen Votes to Process CFTC 2018 Budget Proposed by Acting Chairman Despite Disapproval" in the June 4, 2017 edition of *Bridging the Week*.) The CFTC's enforcement action a few weeks ago in light of a disciplinary action this week by the CME against Rosenthal Collins Capital Markets LLC raises similar concerns. (For background on this matter check the article "Trader Settles COMEX Disciplinary Actions for Failure to Supervise for Employee's Alleged Spoofing Activity" in this week's edition of *Bridging the Week*.)

- **Trader Settles COMEX Disciplinary Actions for Failure to Supervise Employee's Purported Spoofing Activity**: Focus and Vision General Trading LLC and a trader it

employed, Vivek Jain, agreed to resolve a disciplinary action brought by the Commodity Exchange, Inc. related to alleged spoofing-type trading activities from January to June 2015. According to COMEX, during this time, Mr. Jain on multiple occasion entered layering orders involving gold futures on one side of the market to encourage market participants to trade against his smaller order resting on the other side of the market. To resolve this matter Mr. Jain, who was charged with violating COMEX's prohibition against disruptive trading practices, agreed to pay a fine of US $25,000 and not trade on any CME Group exchange market for 20 business days. Focus, which was charged with failure to supervise, consented to pay a fine of US $30,000.

Separately, Gyuris Zoltan agreed to pay an aggregate fine of US $20,000 and serve a 10-business-day trading suspension from all CME Group exchanges to resolve disciplinary actions brought by the Chicago Board of Trade and the Chicago Mercantile Exchange that, on one or more occasions from August 2015 through December 2015, he placed orders during pre-opening sessions to test the connectivity and latency of his front-end trading sessions and not to execute bona fide orders. Similarly, Kyu-Sung Kim agreed to pay a fine of US $15,000 and serve a 15-business-day trading suspension from all CME Group exchanges to settle charges that he entered orders on various occasions between July and December 2015 to assess market depth without the intent to consummate trades. Mr. Zoltan and Mr. Kim were charged with engaging in disruptive trading practices.

Finally, Rosenthal Collins Capital Markets LLC consented to pay a fine of US $250,000 and disgorgement of US $467,555 to resolve charges by CME that its traders engaged in wash sales in order to obtain monthly trade-fee credits in connection with a CME market maker program for Eurodollar Pack and Bundle futures in 2014 and 2015. The Commodity Futures Trading Commission resolved an enforcement action against Rosenthal Collins for the same infraction earlier this month. To settle that matter, the firm agreed to pay a fine of US $5 million. (Click here for details of this action in the article "Trading Firm and Individual Trader Settle CFTC Allegations of Engaging in Wash Sales to Obtain Exchange Fee Rebates" in the July 9, 2017 edition of *Bridging the Week*.)

Compliance Weeds: Last year, CME Group exchanges brought and settled disciplinary actions against Geneva Trading USA, LLC and two of its employees – Krzysztof Marzec and Robert Kimmons – for engaging in alleged spoofing-type activities on the New York Mercantile Exchange, Inc. and the Commodity Exchange, Inc. from March 2013 through July 2013. To resolve the matter, Geneva Trading agreed to disgorge aggregated COMEX and NYMEX trading profits of US $91,241. For the actions of its two traders, Geneva Trading was charged by the CME Group exchanges with violating just and equitable principles of trades and related violations, but solely on a strict liability basis. The firm was not charged with failure to supervise, and it was not assessed a fine. The disciplinary actions against Focus and General Trading and Geneva Trading suggest that, although a firm may be held strictly liable for the allegedly wrongful acts of its employees under CME Group rules, where the firm has and enforces robust policies and procedures governing the conduct, CME Group might consider it appropriate solely to require the firm to return any profits attributable to employees' improper conduct. In such instances, the firm should not necessarily be charged with failure to supervise and subject to a fine or other sanctions. This would be the case despite the employees not following such policies and procedures! If a firm does not have or does not enforce robust policies, however, a fine should not be unexpected. (Click here for background on the disciplinary action against Geneva Trading in the article "CME Group Settles With Trading Firm for Spoofing-Type Offenses, Holding It Strictly Liable for Acts of Agents; Orders Disgorgement of Profits" in the October

9, 2016 edition of *Bridging the Week*.)

- **Four Broker-Dealers Agree to Pay Aggregate Fine of US $4.75 Million to FINRA and Various Exchanges for Allegedly Violating SEC Market Access Rule**: Four broker-dealers agreed to pay an aggregate fine of US $4.75 million to resolve charges brought by the Financial Industry Regulatory Authority and various securities exchanges for violating the Securities and Exchange Commission's market access rule (Click here to access SEC Rule 15c3-5.) According to FINRA and the exchanges, the firms failed to comply with one or more provisions of Reg MAR, including not implementing controls to prevent the entry of mistaken or duplicate orders, orders that were in excess of pre-set credit or capital limits or orders that might constitute potentially violative or manipulative orders. The four broker-dealers and the amounts of their fines were: Deutsche Bank Securities Inc. (US $2.5 million); Citigroup Global Markets Inc. (US $1 million); JP Morgan Securities LLC (US $800,000); and Interactive Brokers LLC (US $450,000).

Compliance Weeds: Reg MAR generally requires brokers and dealers with access (or providing access) to trade securities directly on an exchange or alternative trading system to have procedures and processes and controls that limit their financial exposure as a result of such access, and ensure compliance with all applicable regulatory requirements. 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). In its Q&As, the SEC provides a concise summary of the relevant regulation as well as answers to 19 questions regarding it. The SEC and FINRA have applied Reg MAR broadly. In 2015, for example, the Securities and Exchange Commission settled an enforcement action against Latour Trading LLC, a proprietary trading firm, for allegedly violating Reg MAR and other SEC rules in connection with a breakdown in its electronic trading infrastructure that resulted in approximately 12.6 million orders for over 4.6 billion shares being sent to stock exchanges that did not comply with requirements of the SEC aimed to help ensure competition among US securities markets and fair prices – "Regulation NMS" (National Market System). The SEC claimed that Latour violated Reg MAR because it did not "appropriately" control market access so as not to jeopardize its "own financial condition, that of other market participants, the integrity of trading on the securities markets, and the stability of the financial system." The SEC said that Latour violated Reg MAR because the developer who changed software, purportedly causing the trading infrastructure breakdown, was not under Latour's exclusive control. Latour settled this matter by payment of a fine of more than US $8 million. (Click here for background on this matter in the article "Proprietary Trading Firm Agrees to Pay More Than US $8 Million to SEC to Resolve Market Access Charges Emanating From Faulty Software" in the October 4, 2015 edition of *Bridging the Week*.)

More briefly:

- **Broker-Dealer Settles FINRA Charges That It Failed to File Suspicious Activity Reports in Response to Red Flags**: Electronic Transaction Clearing, Inc., a registered broker-dealer, agreed to settle charges brought by the Financial Industry Regulatory Authority that it failed to consider whether to file suspicious activity reports, as required, in response to red flags of possible suspicious conduct as well as for other violations. According to FINRA, ETC did not file such reports even after it restricted trading by certain of its customers after 30 instances where the firm identified problematic conduct, including prearranged trades or trading without an apparent economic reason. (Click here for background regarding FINRA's charges and Compliance Weeds in the article "Clearing Firm's Failure to File Suspicious Activity Reports in Response to Red Flags Charged as Violation of FINRA Requirements" in the March 26, 2017 edition of *Bridging the Week*.)

- **SEC Grants Two Whistleblower Awards Totaling US $4.2 Million; One to Government Agency Employee**: The Securities and Exchange Commission announced two whistleblowing awards totaling US $4.2 million. One award for US $2.5 million was approved for an employee of an unspecified government agency. The SEC said such an award was authorized despite there being a prohibition under applicable law from providing such awards to "a law enforcement organization" (Click here to access SEC Rule 21-F-8(c)(1).) The SEC said it was proper to interpret this rule as applying "only to employees of a clearly separate agency component that performs law enforcement functions, rather than to all employees of an entire agency that happens to have been granted law enforcement powers among its many other separate responsibilities and powers."

- **NFA Ends Swap Dealer Filing Requirement, Substitutes Attestation Process**: Effective immediately, the National Futures Association is ending its requirement that an applicant for swap dealer registration must submit a copy of all of its policies and procedures evidencing compliance with each obligation of a swap dealer under applicable law and CFTC rule

(click here to access a list of such obligations). Instead, applicants will only need to submit an attestation that it has adopted policies and procedures or other appropriate documentation reasonably designed to comply with CFTC requirements. (An applicant will continue to be required to submit certain documents related to its risk management program.) NFA intends to review relevant policies and procedures as part of examinations and other regulatory oversight processes.

- **LIBOR to End in 2021**: In a speech last week at Bloomberg, London, Andrew Bailey, Chief Executive of the UK Financial Conduct Authority indicated that the regulator will cease supporting the London Interbank Offer Rate benchmark at the end of 2021. By that time, said Mr. Bailey, FCA intends not to "persuade, or compel, banks to submit to LIBOR." According to Mr. Bailey, LIBOR is no longer sustainable because "the underlying market that LIBOR seeks to measure – the market for unsecured wholesale term lending to banks – is no longer sufficiently active." Mr. Bailey says that to address legacy contracts that reference LIBOR, it will have to be decided whether it is better to amend such contracts or amend the definition of LIBOR. FCA has regulated LIBOR since 2013.

- **FCA Makes No Promises to Firms That Missed the July 3 Deadline for Requesting MiFID II Permissions**: The UK Financial Conduct Authority reminded financial service firms that they may only carry on activities that require authorization under the Markets in Financial Instruments Directive II after January 3, 2018, if they have required permissions. To assure this, such firms should have applied for necessary authorizations or variations of existing permissions by July 3. If they did not do so by then, they should apply as quickly as possible. FCA commits to reviewing such applications within six months but "cannot guarantee" to do so by January 3. FCA encourages firms that have not yet applied for necessary authorizations to begin considering contingency plans.

For further information:

Bitcoin Exchange and Operator Charged with Money Laundering:

- Department of Justice: https://www.justice.gov/usao-ndca/press-release/file/984661/download
- FinCEN: https://www.fincen.gov/sites/default/files/enforcement_action/2017-07-26/Assessment%20for%20BTCeVinnik%20FINAL%20SignDate%2007.26.17.pdf

Broker-Dealer Settles FINRA Charges That It Failed to File Suspicious Activity Reports in Response to Red Flags:
/ckfinder/userfiles/files/Electronic%20Transaction%20Clearing.pdf

CFTC Settles With Alleged Spoofer Two Years After CME Group Exchanges First Resolved Disciplinary Actions for Same Conduct:
http://www.cftc.gov/idc/groups/public/@lrenforcementactions/documents/legalpleading/enfposenorder072617.pdf

FCA Makes No Promises to Firms That Missed the July 3 Deadline for Requesting MiFID II Permissions:
https://www.fca.org.uk/news/news-stories/mifid-ii-applications-received-after-3-july-2017

Four Broker-Dealers Agree to Pay Aggregate Fine of US $4.75 Million to FINRA and Various Exchanges for Allegedly Violating SEC Market Access Rule:

- Deutsche Bank: http://www.finra.org/sites/default/files/DBAB_action_documents_072617.pdf
- Citigroup Global Markets: http://www.finra.org/sites/default/files/CGMI_action_documents_072617.pdf
- Interactive Brokers: http://www.finra.org/sites/default/files/IBKR_action_documents_072617.pdf
- JP Morgan Securities: http://www.finra.org/sites/default/files/BEST_action_documents_072617.pdf

LedgerX Approved by CFTC as First Derivatives Clearing Organization for Fully Collateralized Swap Contracts Potentially Settling in Bitcoin:
http://www.cftc.gov/idc/groups/public/@otherif/documents/ifdocs/ledgerxdcoregorder72417.pdf

LIBOR to End in 2021:
https://www.fca.org.uk/news/speeches/the-future-of-libor

NFA Ends Swap Dealer Filing Requirement, Substitutes Attestation Process:
https://www.nfa.futures.org/news/newsNotice.asp?ArticleID=4828

SEC Declines to Prosecute Issuer of Digital Tokens That Violated US Securities Laws:
https://www.sec.gov/litigation/investreport/34-81207.pdf
https://www.sec.gov/news/public-statement/corpfin-enforcement-statement-report-investigation-dao
https://www.investor.gov/additional-resources/news-alerts/alerts-bulletins/investor-bulletin-initial-coin-offerings

SEC Grants Two Whistleblower Awards Totaling US $4.2 Million; One to Government Agency Employee:
https://www.sec.gov/news/press-release/2017-130
https://www.sec.gov/rules/other/2017/34-81227.pdf

Trader Settles COMEX Disciplinary Actions for Failure to Supervise Employee's Purported Spoofing Activity:

- Focus and Vision General Trading LLC: http://www.cmegroup.com/notices/disciplinary/2017/07/COMEX-15-0180-BC-1-FOCUS-AND-VISION-GENERAL-TRADING-LL.html#pageNumber=1
- Kyu-Sung Kim: http://www.cmegroup.com/notices/disciplinary/2017/07/NYMEX-15-0330-BC-KYU-SUNG-KIM.html#pageNumber=1
- Rosenthal Collins Capital Markets LLC: http://www.cmegroup.com/notices/disciplinary/2017/07/CME-13-9575-BC.html#pageNumber=1
- Jain Vivek: http://www.cmegroup.com/notices/disciplinary/2017/07/COMEX-15-0180-BC-2-VIVEK-JAIN.html#pageNumber=1
- Gyuris Zoltan: http://www.cmegroup.com/notices/disciplinary/2017/07/CBOT-16-0400-BC.html#pageNumber

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http://www.cmegroup.com/notices/disciplinary/2017/07/CME-16-0400-BC.html#pageNumber=1

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