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Bridging the Week: March 12 to 16 and 19, 2018 (Swaps De Minimis Level; SLR; SEFs; Insider Trading; ICOs) [VIDEO]

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J. Christopher Giancarlo, Chairman of the Commodity Futures Trading Commission, laid out his priorities for the remainder of 2018 in a speech before the FIA at its annual conference last week. Unrelatedly, the Securities and Exchange Commission filed suit against the former chief information officer of a division of a major company that was hacked and sustained a substantial data breach last year for trading on knowledge of the breach prior to public disclosure of the incident. He was also criminally indicted for his actions. As a result, the following matters are covered in this week's edition of *Bridging the Week*:

- CFTC Chairman Reveals Key Priorities Before Florida Industry Conference (includes **My View**);
- Former Company Unit CIO Sued by SEC for Insider Trading Based on Knowledge of Cybersecurity Breach (includes **Legal Weeds**);
- Gibraltar Suggests Many ICO-Issued Digital Tokens Are Commercial Products, Not Securities (includes **My View**); and more.

Video Version:

Article Version:

Briefly:

- **CFTC Chairman Reveals Key Priorities Before Florida Industry Conference** : In a speech last week before the annual FIA industry gathering in Boca Raton, Florida, Commodity Futures Trading Commission Chairman J. Christopher Giancarlo suggested that finalizing the swap dealer *de minimis* level, proposing a rule to better align current swaps trading rules with legislative intent, and working with other financial regulators to help ensure that the supplemental leverage ratio better reflects clearing members' true exposure to customers' cleared derivatives would be key priorities for the Commission this year.

Separately, in their own speeches in Florida last week, CFTC Commissioners Rostin Behnam and Brian Quintenz each criticized the potential extension of the supervisory authority of the European Securities and Markets Authority over both EU and third-country clearinghouses, including the Chicago Mercantile Exchange and ICE Clear US. (Click here for background in the article "EC Proposes Two-Tier System for Classifying Third-Country CCPs; Certain Systemically Important CCPs May Be Required to Relocate to the EU" in the June 18, 2017 edition of *Bridging the Week*.) Mr. Behnam indicated that any change to the existing EU-CFTC practice of recognizing host regulator equivalence oversight "is unacceptable." Mr. Quintenz said that the CFTC should retaliate against the European Union should it adopt the proposal, including beginning now by not granting requests for no-action relief by European national market regulators from various CFTC rules and orders.

In his presentation, Mr. Giancarlo also indicated that while he is committed to "moving forward" on a final position limits rule, he would not finalize rulemaking until it could be done "properly" by a full Commission of five commissioners. There are currently only three CFTC commissioners. The CFTC last proposed amendments to its position limits regime in May 2016. (Click here for background in the article "CFTC Proposes to Authorize Exchanges to Grant Physical Commodity Users Non-Enumerated Hedging Exemptions and Other Relief Related to Speculative Position Limits" in the May 27, 2016 version of *Bridging the Week*.)

Mr. Giancarlo – who voted against the last proposed iteration of Regulation Automated Trading – also indicated that he was "open" to considering whether there are parts of Reg AT that might serve as the foundation for a "new and truly effective rule." However, he said that the goal "must be an effective rule, not just any rule," and suggested no timeline for rolling out a new version of Reg AT. The CFTC last proposed a version of Reg AT in November 2016. (Click here for background in the article "Proposed Regulation AT Amended by CFTC; Attempts to Reduce Universe of Most Affected to No More Than 120 Persons" in the November 6, 2016 edition of *Bridging the Week*.)

The CFTC issued an order in October 2017 extending until December 29, 2019, the aggregate gross notional amount level of swaps activity an entity must exceed during the prior 12 months to require registration as a swap dealer to US $8 billion (click here to access the relevant CFTC order). Absent the order, the threshold would have decreased to US $3 billion. In his speech before the FIA, Mr. Giancarlo indicated that staff has now presented the CFTC commissioners with swap dealing data and analysis that he hoped would enable them to "reach a consensus" on an appropriate *de minimis* level prior to year-end.

In 2015, before he was nominated as CFTC chairman, Mr. Giancarlo issued a white paper that severely criticized the Commission's swaps trading rules and proposed an alternative framework that he claimed more accurately reflected congressional intent. He recommended that, instead of continuing with overly proscriptive regulations governing SEF trading, the CFTC should encourage flexibility consistent with the congressional mandate. Before the FIA, Mr. Giancarlo indicated that he would present to the Commission for its consideration by year-end a rule proposal more aligned with congressional intent that would better permit US swap intermediaries to "fairly compete" globally.

The supplemental leverage ratio requires large US banks to set aside 5 percent of their assets as a guard against losses. Currently, these assets include cash posted as margin by customers for their swaps and other derivatives trading activity through the banks' future commission merchant subsidiaries. Mr. Giancarlo has frequently voiced his opposition to this treatment and noted that the US Department of Treasury recently expressed its concerns about this policy too. Last week, Mr.

Giancarlo indicated that "[w]e will work hard" with other regulators to address this treatment which he said "is not reflective of a clearing member's true exposure to swaps." (Click here for an example of Mr. Giancarlo's stated views in the article "Acting CFTC Chairman Giancarlo Gives Rehearsal Speech to ISDA Prior to Senate Committee Confirmation Hearing" in the May 14, 2017 edition of *Bridging the Week*. Click here for background on Treasury's views in the article "US Department of Treasury Recommends Modifications to Volcker and Bank Capital Rules, and Rationalization of Financial Regulation" in the June 18, 2017 edition of *Bridging the Week*.)

My View: Mr. Giancarlo's priorities for the CFTC parallel recommendations of the Department of Treasury for the CFTC issued in two reports last year. (Click here for background in the article "Treasury Calls for Better Coordination to Improve SEC and CFTC Efficiencies; Recommends Review of SROs to Minimize Conflicts and Increase Transparency" in the October 8, 2017 edition of *Bridging the Week*.) It would be helpful for the CFTC to itemize in one location all the recommendations by Treasury as well as those identified as part of its Project KISS initiative, and give its views regarding which recommendations it is likely to pursue and by when. If nothing more, this will help remove some uncertainty regarding possible future developments and permit market participants to plan future operations more reliably. (For background on Project KISS, click here to access "Derivatives Industry Wishes Upon a CFTC KISS Star and Hopes Dreams Come True" in the October 8, 2017 edition of *Bridging the Week*.)

- **Former Company Unit CIO Sued by SEC for Insider Trading Based on Knowledge of Cybersecurity Breach**: On March 14, the Securities and Exchange Commission filed civil charges against Jun Ying for allegedly trading on proprietary nonpublic information related to the massive 2017 hack and data breach of his employer, Equifax, Inc., in advance of the firm's public announcement of the incident. At the time, Mr. Ying was chief information officer of Equifax's US Information Systems business unit. According to the SEC, after Equifax's detection of the possible widespread breach in July 2017, Mr. Ying was enlisted on August 25 on a project to help deal with certain aspects of the problem. At the time, Mr. Ying was not advised that the breach was of Equifax's own system; however, by August 28, he deduced this from information he was given. In response, Mr. Ying exercised and sold options he owned, realizing total proceeds in excess of US $950,000. After the close of the market on September 7, Equifax made a public announcement regarding its data breach. According to the SEC, by selling his Equifax shares prior to the public announcement, Mr. Ying avoided a US $117,000 loss he would have incurred had he sold his shares after the news became public. The SEC filed its action against Mr. Ying in a federal court in Atlanta. On March 13, Mr. Ying was also indicted for insider trading by a federal grand jury for the same conduct.

Legal Weeds: Actions sounding in insider trading are no longer within the sole purview of the SEC. The Commodity Futures Trading Commission has now brought two enforcement actions charging persons with insider trading for misappropriating their employer's trading information. In the first action brought in 2015, the CFTC alleged that Arya Motazedi, a gasoline trader for a large publicly traded corporation, similarly misappropriated trading information of his employer for his own benefit. In the second action, the CFTC 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. Both actions were grounded in a provision of law under the Dodd-Frank Wall Street Reform and Consumer Protection Act and a CFTC rule that prohibit use 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. Click for background on these CFTC enforcement actions in the article "Ex-Airline

Employee Sued by CFTC for Insider Trading of Futures Based on Misappropriated Information" in the October 2, 2016 edition of *Bridging the Week*.)

- **Gibraltar Suggests Many ICO-Issued Digital Tokens Are Commercial Products, Not Securities**: The government of Gibraltar issued a proposal for the regulation of digital token sales, secondary digital token market platforms, and investment services relating to non-security and non-virtual currency digital tokens that also expressed a narrow view of what constitutes a security token. According to Gibraltar Finance, most digital tokens are not securities because they are not structured as such – meaning they afford no equity interest or right to distributions (e.g., of profits or in the event of a firm's insolvency). They more often represent "the advance sale of products that entitle holders to access future networks or consume financial services" – and thus represent "commercial products," or have the characteristics of virtual currencies. Holders of the digital tokens, said Gibraltar Finance, expect a return once a project is complete and successful, which is "similar to early acquisition and holding of commodities with a view to trading them later at a higher price." Under Gibraltar law, digital tokens that are akin to securities are already subject to existing securities regulation. Its proposed new regulatory regime will solely address tokens that are commonly referred to as "utility" or "access" tokens and will deal with primary market promotion, sale and distribution. Generally, Gibraltar proposes to implement disclosure rules and financial crimes provisions, require authorization and supervision of token sale sponsors, require authorized sponsors to implement and follow a self-created code of conduct, and regulate the conduct of secondary market platforms. Gibraltar hopes to complete its implementation of a regulatory scheme by October 2018. Gibraltar Finance, a Gibraltar goverment initiative, attempts to promote Gibraltar as a center for financial services within the European Union.

Unrelatedly, the Joint Economic Committee of Congress presented its 2018 Economic Report of the President. In it, the Committee provided an overview of the growth of cryptocurrencies and initial coin offerings in 2017 and acknowledged the disparate regulatory treatment of digital tokens in the United States. Among other things, the Committee recommended that "[r]egulators should continue to coordinate among each other to guarantee coherent policy frameworks, definitions, and jurisdiction" going forward not to inhibit the development of blockchain technology. (Click here to access a copy of the Committee's report; see pages 201-227.)

My View: The SEC takes a very broad view of what constitutes a security. This view is principally premised on the agency's interpretation of the landmark 1946 Supreme Court decision of *SEC v. W.J. Howey* (click here to access) that labeled as an investment contract (and thus, as a security) any (1) investment of money (2) in a common enterprise (3) with a reasonable expectation of profits (4) to be derived solely from the entrepreneurial or managerial efforts of others. The SEC argues that an investment contract could also exist when persons invest money in a project and expect profits through the appreciation in value of their investment attributable to the entrepreneurial or managerial efforts of others, even if such "profits" can be realized solely by investors reselling their investments. As a result, the SEC argues that an investment contract could include instruments that convey no traditional ownership rights on its holders or any direct rights to revenue – such as many digital tokens issued as part of ICOs. (Click here for background on the SEC's views in the article "Non-Registered Cryptocurrency Based on Munchee Food App Fails to Satisfy SEC's Appetite for Non-Security" in the December 17, 2017 edition of *Bridging the Week*.)

However, under this approach, privately issued gold coins promoted by their issuers could potentially

be deemed investment contracts by the SEC, as could special edition collectible automobiles hyped by their manufacturers. In these instances, purchasers would reasonably expect to realize a premium to ordinary market value if they resell their asset because of the entrepreneurial or managerial efforts of others designed to create buzz around their asset. This seems like an attenuated view of what should be considered a security. For example, under the SEC's interpretation, persons who pre-purchased a first generation Tesla Roadster in 2008 prior to its rollout – expecting it would rise in value because of hype and promotional efforts of Elon Musk on behalf of Tesla electric cars generally – would likely also be driving a security. However, this outcome makes no sense. The SEC's view could also potentially capture some virtual currencies within the definition of a security as well.

Gibraltar's definition of a security is far more narrow and appropriate and commonsensical. According to Gibraltar Finance, "[m]ost often, [digital] tokens do not qualify as securities under Gibraltar or EU legislation." This is because "they represent the advance sale of products that entitle holders to access future networks or consume future services." There is no direct or indirect tie to an underlying project's income stream, and there are no distribution rights in case of a project's insolvency.

According to Gibraltar Finance, digital tokens are "representations of something else, whether tangible or intangible." As such, they are analogous to derivatives, as "trading tokens is not necessarily the same activity as treading its underlying asset (where one exists)."

This analysis makes sense and provides a roadmap for a rational allocation of regulatory oversight in the United States over cryptocurrencies. Digital tokens that are directly or indirectly tied principally to the income flow of a project or accord the holders rights in insolvency are securities that, along with their offer and sale, implicate federal and state securities laws. Cryptocurrencies that are not securities and do not serve principally as a medium of exchange are a derivative instrument (perhaps a privilege) on commodities, potentially implicating the exclusive jurisdiction of the Commodity Futures Trading Commission – although applicable law and CFTC regulations may have to be amended to make this unequivocal. When digital tokens are designed to serve principally as a medium of exchange and serve as such, they are virtual currencies and should be treated analogously to fiat currencies under law. (Click here for an overview of the current regulation of cryptocurrencies in the US in the testimony of Mike Lempres, Chief Legal and Risk Officer of Coinbase, on March 13 before the House Committee on Financial Services, Subcommittee on Capital Markets, Securities, and Investment.)

More briefly:

- **South Carolina Securities Commissioner Obtains C&D Against Crypto Mining Company for Selling Unregistered Securities**: The Office of the Attorney General of South Carolina (SC AG) imposed a cease and desist order on Swiss Gold Global, Inc. and Genesis Mining Ltd. – both non-US-based entities – for offering and selling a security in the state that was not federally registered or exempt from registration. Swiss Global was also accused of acting as an unregistered broker-dealer. According to the SC AG, Swiss Global offered cryptocurrency mining contracts to investors. The proceeds of these mining contracts were pooled and used by Genesis for cryptocurrency mining operations**,** said the SC AG. According to the order, cryptocurrencies were then mined solely through the computational efforts of Genesis and proceeds shared with investors. Thus the mining contracts were of the nature of investment contracts, said the SC AG.

- **Transaction Fee Cap Pilot Program for NMS Stocks Proposed by SEC**: The Securities and Exchange Commission proposed a new rule as part of a two-year pilot program that would subject stock exchange fee pricing to temporary pricing restrictions. Under the proposal, there would be three test groups – two would have different limits on fees for removing and providing displayed liquidity (with no cap on rebates), and the third would maintain current fee caps and prohibit rebates and linked pricing for removing and providing

displayed or undisplayed liquidity. The SEC will accept comments on its proposal for 60 days following its publication in the *Federal Register*. The Canadian Securities Administrators previously considered adoption of a similar pilot program for Canadian marketplaces but decided not to go forward in 2016. In light of the SEC's implementation of a pilot program now, it will reconsider its prior action, but will propose a pilot program only after publication of a notice for comment (click here for details).

- **FCA Publishes Thought Piece on Enhancing Culture in Financial Services**: The UK Financial Conduct Authority issued a paper to provoke discussion on transforming culture in financial services. In the paper are 28 essays from leading academics, industry leaders and international regulators discussing what good culture might look like, the role of regulators in promoting good culture and how to improve behavior. FCA is not soliciting feedback on its discussion paper, but hopes to prompt debate as to what is a “healthy” culture and how to promote it.

- **CBOT Settles With Nonmember for Purported Wash Sales to Transfer Positions**: Sumitomo Mitsui Trust Bank, Limited, agreed to pay a fine of US $105,000 to resolve charges that on four trade dates in February 2016, a trader for the firm’s Tokyo branch engaged in transactions in Treasury futures markets where the accounts beneficially owned by the firm were on both side of each transaction. The purpose of the trades was to move positions from one account to the other. The exchange claimed that the firm provided no training to the relevant trader so he could be aware that such transactions were prohibited.

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