Last week was a week of many firsts in the financial services industry worldwide. For the first time, the Commodity Futures Trading Commission formally indicated that virtual currencies were commodities and thus swaps based on Bitcoin must be traded on a swap execution facility or a designated contract market. In addition, the CFTC brought its first enforcement action against a swap dealer for failing to file, as required by regulation, accurate large trader reports for certain swap positions involving physical commodities. Finally, the London Metal Exchange proposed position limits for the first time too. As a result, the following matters are covered in this week’s edition of Bridging the Week:

- CFTC Says Virtual Currencies Are a “Commodity” Under Federal Law, Files Charges Against Coinflip for Operating an Unregistered Bitcoin Options Trading Platform (includes Legal Weeds);

- Australian-Based Swap Dealer Sanctioned by CFTC in First Case for Violations of Large Trader Reporting Requirements for Physical Commodity Swap Positions (includes Compliance Weeds);

- Canadian Citizen Pleads Guilty to US Criminal Charges Related to Securities Layering and Spoofing:

- FDIC Vice Chairman Thomas Hoenig Defends Application of Leverage Ratio to Cleared Derivatives, Offers Avenue of Partial Relief (includes My View);

- SEC Penalizes Four Individuals for Defunct Clearing Firm’s Improper Margin Loans, Sues One Customer;

- Trader Fined US $171,000 by CFTC for Deceptive Trade Allocation Scheme Utilizing Block Trades; CME Group Previously Alleged Similar Wrongdoing (includes My View);

- SEC Discloses Elements of Cybersecurity Exams;

- LME Proposes Position Limit Regime; and more.

Video Version:
CFTC Says Virtual Currencies Are a “Commodity” Under Federal Law, Files Charges Against Coinflip for Operating an Unregistered Bitcoin Options Trading Platform

The Commodity Futures Trading Commission filed and simultaneously settled charges against Coinflip, Inc. and Francisco Riordan, its founder and chief executive officer, for operating a trading facility for Bitcoin options – Derivabit – without it being registered as a swap execution facility or a designated contract market.

According to the CFTC, because Bitcoin and other virtual currencies are “properly” defined as “commodities” under applicable law, all trading facilities for commodity options on Bitcoin must be registered with it as a SEF or a DCM, said the CFTC.

Since from at least March 2014 through July 2014, Coinflip operated Derivabit as a trading facility for Bitcoin options without proper registration, it violated applicable law, claimed the CFTC. Additionally, said the Commission, Mr. Riordan was liable for Coinflip’s violation as its so-called “controlling person.”

To resolve the CFTC’s charges, Coinflip and Mr. Riordan agreed to cease and desist from violating applicable law. No financial penalty was included in the settlement.

Although Timothy Massad, Chairman of the CFTC, previously implied that virtual currencies are “commodities” under applicable law and within the remit of the CFTC, this enforcement action marked the first unequivocal statement of the Commission’s view. (Click here for Mr. Massad’s December 10, 2014 testimony before the U.S. Senate Committee on Agriculture, Nutrition and Forestry, including his statements on the CFTC’s jurisdiction over virtual currencies.)

Two weeks ago, LedgerX LLC received temporary registration as a SEF by the CFTC in order to list and clear fully collateralized, physically settled options on Bitcoin. The firm’s application as a derivatives clearing organization is still pending.

Legal Weeds: Although in its Coinflip order the CFTC simply proclaimed that Bitcoin and other virtual currencies are “commodities” under applicable law, its legal conclusion appears correct. Under applicable law, commodities are broadly defined as any goods, articles, services, rights and interests “in which contracts for future delivery are presently or in the future dealt in” with two exceptions: onions and motion picture box office receipts, or any “index, measure, value or data related to such receipts.” Moreover, with limited exceptions (most notably, involving securities), the CFTC has exclusive jurisdiction under applicable law with respect to all trading of commodities of the nature of options, futures and swaps, including over most market participants. Inevitably, at
some point, there likely will be a challenge to the New York State Department of Financial Service’s effort to regulate certain virtual currency transactions and intermediaries through imposition of its so-called “BitLicense” and other requirements to the extent such obligations impact activities and persons under the exclusive jurisdiction of the CFTC. Stay tuned!

**Briefly:**

- **Australian-Based Swap Dealer Sanctioned by CFTC in First Case for Violations of Large Trader Reporting Requirements for Physical Commodity Swap Positions:** The Australia and New Zealand Banking Group Ltd., an Australian-based Commodity Futures Trading Commission-registered swap dealer, was charged by the Commission with violating regulatory requirements related to the reporting of large swap positions involving physical commodities. According to the CFTC, from at least March 1, 2013, to November 20, 2014, ANZ failed on certain days to submit any reports of its large positions, while at other times it “routinely” submitted required reports that included errors. Under applicable law and CFTC regulations, swap dealers and other reporting entities are required to file with the Commission on a daily basis reports of swap positions involving certain physical commodities in excess of certain minimum levels in particular formats. Among other errors, ANZ, prior to September 2013, failed to identify any relevant commodity; throughout the period, populated the field “Commodity Reference Price” in a manner different than required by the Commission; and throughout the period, reported positions in units of the relevant commodity rather than the futures equivalent level. ANZ agreed to pay a US $150,000 fine to resolve the CFTC’s complaint.

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

- **Canadian Citizen Pleads Guilty to US Criminal Charges Related to Securities Layering and Spoofing:** Aleksandr Milrud, who earlier this year was charged by the Securities and Exchange Commission with engaging in disruptive trading activity known as “spoofing” or “layering” in connection with high-speed purchases and sales of various exchange-traded securities from January 2013 through January 2015, agreed to plead guilty in a related criminal matter brought by the US Department of Justice. According to the SEC, Mr. Milrud—a Canadian citizen who resides in Ontario, Canada, and has a residence in Aventura, Florida—used other traders—primarily in China and Korea—to place multiple “non-bona fide orders” for stocks to induce other traders to trade on one side of the market at “artificially inflated or depressed prices” and then to cancel the orders. Mr. Milrud and the other traders engaged in this strategy to effectuate orders to purchase or sell the relevant security on the other side of the market at favorable prices, charged the SEC. In connection with his criminal action, Mr. Milrud will plead guilty to one count of conspiring to commit securities fraud, and face imprisonment of up to five years, and a fine equal to the greater of US $250,000 or twice the gross amount of any profits he made from his trading. Mr. Milrud’s SEC action remains pending. (Click here for further background)

- **FDIC Vice Chairman Thomas Hoenig Defends Application of Leverage Ratio to Cleared Derivatives, Offers Avenue of Partial Relief:** Thomas Hoenig, Vice Chairman of the Federal Deposit Insurance Corporation, defended the inclusion of certain exposures of banks to cleared derivatives, including through the clearing activities of their futures commission merchant affiliates on behalf of customers, in the calculation of their so-called “leverage ratio,” in a speech before the Exchequer Club of Washington, DC, on September 16, 2015. (The leverage ratio refers to the amount of shareholder equity and disclosed reserves a bank maintains divided by its total exposures. Under Basel III, banks are expected to maintain a leverage ratio of 3 percent while
the Board of Governors of the Federal Reserves expects most insured bank holding companies to maintain a leverage ratio of 5 percent, and the systematically important financial institutions 8 percent.) According to Mr. Hoenig, “…the clearing mandate [was] not a mandate to weaken the prudential regulation of banking organizations as a means to stimulate the derivatives business.” Mr. Hoenig rejected the argument that cash received from an FCM’s customers for initial margin should be excluded from a bank’s calculation of its exposures because an FCM only acts as an agent for its clients. This is not the case, said Mr. Hoenig, because FCMs can ordinarily invest customers’ cash deposits and earn income. However, Mr. Hoenig indicated that a bank could exclude customers’ cash deposited as initial margin with an FCM affiliate if the agreements between the customers and the FCM eliminated “any right to investment income from the collateral.” Mr. Hoenig noted that “[s]ome institutions have done this.” However, Mr. Hoenig proposed no means for a bank to exclude from its total exposure calculation affiliated FCMs’ guarantee of client performance to clearing houses. According to Mr. Hoenig, “[s]uch guarantees, whether for derivatives or other obligations, are included in the leverage ratio to ensure that banks do no move significant sources of exposure off-balance sheet.”

My View: Most importantly, in his speech, Mr. Hoenig acknowledged that banks can reduce some of the deleterious impact of the leverage ratio caused by their affiliated futures commission merchants if their FCMs agree to forego earning investment income on customer cash deposits. This can be accomplished through amendments to customer agreements (he does not contemplate any amendments to law or rules). According to Mr. Hoenig, “[i]f the resulting contract ensures the FCM truly is acting merely as an agent, it need not record an asset.” Moreover, Mr. Hoenig suggested that the FCM could even retain the economic impact of the investment income by having the client retain “…the income on the invested funds and then [paying] a fee to the clearing member.” Although this appears to be a practical fix to at least some of the tsuris caused by application of the leverage ratio to FCMs’ clearing business, it is premised on a fallacy. According to Mr. Hoenig, “[a]s substantial as derivatives risks were [during the 2008 financial crisis] to the broader economy, they remain no less substantial, opaque, and interconnected today. If anything the case for more capital is greater today.” It is not clear why Mr. Hoenig claimed that transparency is still an issue for all derivatives when, in the United States, as recently as the second quarter of 2015, almost 75 percent of all average daily notional volume of interest rate derivatives and CDS index markets were centrally cleared and information on all cleared and non-cleared swaps are now mandated to be reported.

- **SEC Penalizes Four Individuals for Defunct Clearing Firm’s Improper Margin Loans, Sues One Customer:** Four former officers of now-defunct Penson Financial Services, Inc., once the second largest clearing US broker-dealer, and of Penson Worldwide, Inc., its publicly traded parent company (collectively, "Penson"), were charged by the Securities and Exchange Commission with a series of accounting and disclosure failures related to Penson’s extension of margin loans to certain customers in excess of amounts permitted under federal securities laws. According to the SEC, PFSI made approximately US $100 million of margin loans between 1999 and 2008 to Christopher Hall and his affiliates, including Call Now, Inc., substantially secured by distressed municipal bonds related to “a financially struggling horse racetrack” operated by Call Now in Texas. (In 2006 Call Now became the largest shareholder of PWI.) However, when the margin collateral “plummeted in value” during the financial crisis of 2008, PFSI failed to liquidate Hall’s and his affiliates’ collateral to avoid realizing large losses for Penson. Instead Penson increased the amounts of margin loans to these customers. The SEC claimed that Penson should have recognized losses on the loans as early as 2009, but did not do so until 2011. Thus, Penson’s broker-dealer’s and public company’s required financial statement filings with it for year-ends 2009 and 2010 were not in conformity with generally accepted accounting principles, said the SEC. The four former officers were Philip Pendergraft, a co-founder, director and chief executive officer of PWI and an executive vice president of PFSI from 1995 to 2012; Kevin McAleer, PWI’s chief financial officer from 2006 to 2012; Thomas Johnson, a director of PWI from August 2003 to May 2011 and also a director of Call Now from 2001 to 2011; and Charles Yancey, PFSI’s president and CEO from 2005 to 2012. To settle this matter, the four individuals agreed to pay fines totaling US $175,000 and various undertakings. Simultaneously with this action, the SEC filed a separation complaint against Mr. Hall.

- **Trader Fined US $171,000 by CFTC for Deceptive Trade Allocation Scheme Utilizing Block Trades; CME Group Previously Alleged Similar Wrongdoing:** The Commodity Futures Trading Commission charged Robert McMahon with orchestrating a scheme to allocate better-priced futures trades to himself, and worse-priced futures trades to a customer. The alleged transactions involved natural gas futures contracts traded on the New York Mercantile Exchange during July 2010. As a result of two such transactions on July 28, 2010, Mr. McMahon achieved profits of US $171,800,
claimed the Commission. According to the Commission, Mr. McMahon, with the assistance of an
unnamed NYMEX-based floor-trading clerk, first placed a market order for natural gas futures
contracts as requested by a customer. At approximately the same time as a fill was reported for
the market order, the floor clerk reported a non-competitive block trade between the customer
and Mr. McMahon, at a price worse than the market price for the customer (and a better-than-
market price for Mr. McMahon). The floor clerk then allocated both the market fill and the
better-than-market fill price offsetting block trade to Mr. McMahon’s account ensuring Mr.
McMahon a profit, said the Commission. To settle this matter, Mr. McMahon agreed to pay a fine
of US $171,800 and be barred from trading on any CFTC-registered entity. Mr. McMahon was
previously ordered by CME Group business conduct committees to pay a fine of US $100,000,
disgorge profits of US $ 178,490, pay restitution of $188,960 and be permanently barred from
trading any CME Group product in connection with similar activity on the Commodity Exchange,
Inc. on seven different trade dates from July 2007 through April 2010, and on three occasions
on two trade dates between June 2010 and July 2010 on NYMEX. (Click here and here to access
relevant CME Group Notices of Disciplinary Action.)

My View: It would not be surprising if some question the appropriateness of the Commodity Futures
Trading Commission bringing this me-too enforcement action against Mr. McMahon, given the CFTC’s
limited resources and the fact that the CME Group has previously prosecuted and sanctioned Mr. Mahon
for apparently the identical conduct – and more of it! However, given the egregiousness of the
alleged violations, it is not surprising that the CFTC would seek a broader trading ban – beyond
just CME Group markets – for Mr. McMahon. Although the commencement of a CFTC enforcement action on
the heels of a virtually identical exchange action most likely does not violate the double jeopardy
prohibition of the US constitution (because it does not subject a person twice in jeopardy for “life
or limb” for the same offense; click here to review the Fifth Amendment to the US Constitution), it
reasonably strikes many as fundamentally unfair and a questionable allocation of scarce CFTC
resources. The CFTC should rarely and only in the most egregious circumstances exercise its
authority to bring “me too” cases and make clear, when it does, why it is doing so.

- SEC Discloses Elements of Cybersecurity Exams: Last week the Securities and Exchange Commission
provided additional guidance following up on its prior disclosure that it would focus on
cybersecurity compliance and controls among its 2015 examination priorities for broker-dealers
and investment advisers. Among other elements, the SEC’s Office of Compliance Inspections and
Examinations announced that, in connection with its assessment of the effectiveness of
registrants’ cybersecurity controls, it will focus on registrants’ governance and risk
assessment; access rights and controls; data loss prevention; vendor management; training; and
incident response. Two weeks ago, the National Futures Association submitted to the Commodity Futures Trading Commission for its approval a proposed Interpretive Notice requiring certain NFA members to maintain formal, written information systems security programs. Firms impacted
by NFA’s proposal are futures commission merchants, commodity trading advisors, commodity pool
operators, introducing brokers, retail foreign exchange dealers, swap dealers and major swap
participants. (Click here for background)

- LME Proposes Position Limit Regime: The London Metal Exchange proposed to introduce position
limits for the first time. Initially the limits will apply only to the exchange’s new aluminum premium contract. However, LME reserves the right to extend limits to other contracts.
Currently, in order to help militate against the risks of market squeezes, and manipulative or
abusive conduct, LME members are subject to the exchange’s lending guidance which potentially requires dominant position holders to sell relevant contracts to the market at published levels
for a set period of time. (Click here to access a copy of LME’s Metal Lending Guidance.) LME
claims that requiring lending is effective because of the “prompt day structure of [LME
contracts] which permits lending at specified rates for a short period.” However, this
technique won’t work for the new aluminum premium contract that only will have monthly prompt
dates. The Markets in Financial Instruments Directive II contemplates position limits for
physical metals contracts such as LME contracts. MiFID II is expected to become effective
January 2017. Comments on the LME’s proposals will be accepted through October 15, 2015.

And more briefly:

- Federal Court Maintains Prohibition Against SEC Prosecuting Barbara Duka in In-House Tribunal: The efforts of the Securities and Exchange Commission to proceed with an administrative
enforcement proceeding against Barbara Duka were further stalled when a US federal court in New
York denied a motion by the SEC to stay its August 12, 2015 injunction against it from
prosecuting Ms. Duka before an administrative law judge. The court reiterated that Ms. Duka is
likely to prevail in her constitutional argument that the appointment of the ALJ by the SEC was illegal; Ms. Duka would likely suffer irreparable hard if the administrative proceeding were to proceed; and the SEC would not suffer irreparable harm by delaying the administrative proceeding (because it can always proceed against Ms. Duka in federal court). Likewise, a US appellate court in New York stayed SEC administrative enforcement proceedings against Lynn Tilton and Patriach Partners, her advisory firm, to permit it to consider similar issues.

- **Company and CEO Agree to Pay SEC US $30 Million to Resolve Allegations They Traded on Hacked Non-Public News**: Jaspen Capital Partners Limited and Andriy Supranonok, its chief executive officer, agreed to pay US $30 million to settle charges by the Securities and Exchange Commission that they took part in a widespread scheme to trade on non-public information obtained through unauthorized hacking of three major newswire services. Last month, the SEC brought charges against 32 defendants, including Jaspen and Mr. Supranonok, for their roles in the scheme, while criminal indictments were also filed against nine of the defendants. (Click [here](#) for additional background)

- **FINRA Identifies Best Practices for Liquidity Risk Management and Issues Guidance**: The Financial Industry Regulatory Authority issued guidance regarding effective liquidity management at broker-dealers, including clearing firms and large introducing brokers. At the same time, FINRA said each broker-dealer “should review its liquidity condition under possible stress events and determine which liquidity management practices are best suited to its particular business.” Effective controls and practices identified by FINRA included ensuring management’s and staff’s understanding of issues that could reasonably be expected to arise in stress events; having appropriate governance to help anticipate and track cash outflows under stress scenarios and address a firm’s funding needs; having concrete plans to respond to severe stress events; implementing funding plans, including committed facilities (e.g., without restrictive covenants that are likely to make such facilities less available) to respond to severe stress situations; and having the capacity to perform daily computations to ensure firms can respond to customer requests to withdraw funds. Firms must know when to switch from business as usual to contingent funding mode, said FINRA.

- **CFTC Proposes to Amend Definition of “Material Terms” to Reduce Reconciliation Obligations of Swap Counterparties**: The Commodity Futures Trading Commission proposed to amend the definition of “material terms” in connection with the ongoing obligation of swaps dealers and major swap participants to provide swap counterparties with data to reconcile their swap portfolios. The proposed rule reduces the data fields that must be exchanged between relevant parties on an ongoing basis mostly consistent with prior staff no-action letters. Comments will be accepted by the CFTC for 60 days after publication of the proposed rule in the *Federal Register*. (Click [here](#) for additional information.)

- **IOSCO Proposes Measures to Support Cross-Border Regulation**: The International Organization of Securities Commissions issued a report regarding cross-border regulation. Generally, the report provides an overview of issues that arise when home and host regulators oversee activities where there might be conflicts and inconsistencies between domestic and foreign laws. The report is aimed to assist regulators develop a “cross-border toolkit” that identifies various approaches to cross-border regulation and the impact on investor protection, markets and systemic risk, and to establish a foundation for the development of guidance on how particular tools can be used to enhance protections. The report addresses some issues related to passporting (i.e., allowing the holder of a regulatory license or approval in one jurisdiction to offer financial products and services in another jurisdiction relying on a common set of rules), mainly that to work passporting may require an express legal framework or international treaty “with a high degree of rule convergence and harmonization in processes.”

- **One CFTC Commissioner Challenges Commission’s Position Limits and Aggregation Proposal, Another Recommends Ground Rules for Algorithmic Traders**: Commodity Futures Trading Commissioner J. Christopher Giancarlo urged the Commission to consider all costs and benefits in developing new position limits and aggregation requirements and to rely on data to determine whether particular position limits are “necessary or appropriate.” According to Mr. Giancarlo, in a speech given before the Annual Capital Link Global Commodities, Energy & Shipping Form in New York City last week, “I am very concerned that the overall effect of the CFTC’s position limit framework is to impose a federal regulatory edict in place of business judgment in the course of everyday business risk hedging activity.” Separately, in a speech before the ISDA North America conference last week, CFTC Commissioner Sharon Bowen urged the Commission to impose “reasonable ground rules” on algorithmic traders. Requirements would include that algorithmic
traders implement “sufficient risk controls.” These would encompass pre-trade risk controls and “processes for immediately disconnecting any algorithm from the market when needed,” said Ms. Bowen. In addition, Ms. Bowen suggested that rules be adopted that “foster increased communication” internally and with exchanges when an algorithm malfunctions and that market transparency regarding algorithmic trading be increased. She specifically asked that exchanges be required to identify the percentage of trades involving one algorithmic trader trading with itself (so-called “self-trades”).

- **CFTC Staff Issues Interpretations for DCOs:** On September 18, 2015, the staff of the Division of Clearing and Risk of the Commodity Futures Trading Commission issued an interpretation to clarify that certain of its risk-management regulations related to derivatives clearing organizations conform to requirements of the Principles for Financial Market Infrastructures. The PFMIs are high-level best practices for key financial market infrastructures, including financial exchanges, trade repositories, and clearinghouses and clearing agencies, that set forth standards for organization; credit and liquidity risk management; settlement; default management; general business and risk management; and other topics (click here to access the Principles). Staff of CFTC’s Division of Market Oversight and DCR also issued an interpretation that use of a so-called “firm or forced trades” process by a derivatives clearing organization will not by itself require a DCO to register as a swap execution facility. Some DCOs use this process to help price certain swaps where public market prices are not available in order to help process variation margin payments and collections by clearing members.

- **CFTC Agricultural Advisory Committee to Meet September 22:** The Agricultural Advisory Committee of the Commodity Futures Trading Commission will meet this week on September 22. Among other topics will be speculative positions limits for agricultural commodities.

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