THE NATIONAL LAW REVIEW

Bridging the Week by Gary DeWaal: November 5 - 9 and November 12, 2018 (To Tell the Truth; Smart Contracts; Swaps Trade Execution Requirements)

Monday, November 12, 2018

A swap dealer was fined US $12 million by the Commodity Futures Trading Commission for a host of purported noncompliance issues. It was also sanctioned for allegedly not disclosing in two annual chief compliance officer annual reports potential regulatory problems of which it was aware. Separately, the Securities and Exchange Commission penalized the founder and developer of an online platform that offered trading in ether and ERC20 digital tokens through an autonomous smart contract that interfaced with the Ethereum blockchain. The SEC claimed that the platform impermissibly operated as a national securities exchange when it did not have the requisite registration or did not transact in accordance with the terms of a valid exemption. Moreover, the SEC said that the founder of the trading platform should have foreseen the likely violation. As a result, the following matters are covered in this week's edition of *Bridging the Week*

Katten

Katten Muchin Rosenman LLP

Article By
Gary De Waal
Katten Muchin Rosenman LLP
Bridging the Week

Antitrust & Trade Regulation
Financial Institutions & Banking
Securities & SEC
All Federal

- Swap Dealer Agrees to Pay US $12 Million to CFTC for Noncompliance With Multiple Regulatory Requirements and Allegedly Filing Misleading Annual Compliance Reports (includes **Compliance Weeds**);
- Autonomous Doesn't Necessarily Mean Non-Regulated Says SEC in Fining Founder of Securities Cryptoasset Exchange Powered By Automated Smart Contract (includes **Policy and Politics**);
- Over One Commissioner's Vehement Dissent, CFTC Authorizes Publication for Comment Proposed Rules to Overhaul Swaps Trade Execution Requirements on Trading Facilities (includes **My View** and **Legal Weeds**);
- Ex-Bank Trader Fined US $350,000 and Banned From All CFTC Overseen Markets for Allegedly Concealing Swaps Trading Losses; Bank That Self-Reported, Cooperated and Remediated Receives Letter Closing Investigation (includes **Legal Weeds1** and **Legal Weeds2**); and more.

Video Version:

Article Version:

Briefly:

- **Swap Dealer Agrees to Pay US $12 Million to CFTC for Noncompliance With Multiple Regulatory Requirements and Allegedly Filing Misleading Annual Compliance Reports**: Commerzbank AG agreed to pay a fine of US $12 million to the Commodity Futures Trading Commission to resolve charges that, from December 31, 2012, through at least 2018, it failed to comply with various requirements for swap dealers, and for two years, it filed chief compliance officer annual reports that did not “adequately disclose” deficiencies in compliance of which it was aware. Commerzbank – a German-based bank provisionally registered by the CFTC as a swap dealer since December 31, 2012 – also consented to retain an outside consultant for at least two years to assess and make recommendations for improvements regarding its swap dealer requirements.

According to the CFTC, during “much” of the relevant time, including currently, Commerzbank failed to have an “effective, bank-wide process” to evaluate whether its transactions with certain non-US persons were subject to requirements for swaps under applicable law. Among other things, said the CFTC, the bank failed to assess systematically whether swap transactions with certain non-US persons were required to be reported to a swap data repository and did not routinely assess whether swaps had to be mandatorily cleared or executed on a designated contract market or swap execution facility. As a result, some swap trades required to be reported to an SDR were not reported, and some swap trades subject to a mandatory execution requirement were not executed on a SEF. Commerzbank also failed, alleged the Commission, to file with the CFTC large trade reports of reportable positions in physical commodity swaps containing all requisite information, as required, at some times.

Additionally, the CFTC claimed that in 2015, Commerzbank filed a CCO annual report for 2014 that failed to identify material compliance issues identified for the bank in 2014 by an outside consultant that had been retained to evaluate its policies and procedures for adherence to applicable requirements. According to the Commission, prior to filing the CCO annual report, a Commerzbank employee in Germany recommended disclosing the outside consultant’s findings; however, compliance personnel in the United States argued against this approach and their view prevailed. As a result, said the Commission, the bank made statements in its 2014 CCO annual report that certain policies and procedures, including those for reporting and recordkeeping, were effective, when they were not.

Similarly, charged the CFTC, Commerzbank’s 2015 CCO annual report filed in 2016 did not disclose problems with the bank’s large trader reporting compliance that Commerzbank identified in March 2015. This non-reporting followed a recommendation to disclose the LTR issues by a newly hired markets compliance officer that was not implemented.

The CFTC also alleged that Commerzbank failed to diligently supervise its activities as a swap dealer.

In settling this matter, Commerzbank did not admit or deny any of the Commission's findings or conclusions.

Compliance Weeds: Earlier this year, the CFTC revised its rule related to the responsibilities of chief compliance officers of futures commission merchants, swap dealers and major swap participants, as well as the obligations of such registrants for the annual compliance reports they are mandated to prepare and file with the CFTC. The goal was to make the rule simpler and clearer. Among other things, the CFTC eliminated the requirement that a registrant addresses each applicable CFTC requirement that it is subject to in its annual compliance report when evaluating its written policies and procedures. However, according to the CFTC, "the CCO must still conduct an underlying assessment of the policies and procedures to meet the requirement of the rule." (Click here for background regarding this rule change in the article "CFTC Amends Rules to Simplify CCO Duties and Annual Report Obligations of FCMs, SDs and MSPs" in the August 26, 2018 edition of *Bridging the Week*. Click here to access CFTC rule 3.3(e).)

All CCO annual reports submitted to the CFTC must be accompanied by a certification by the CCO or registrant's chief executive officer "that, to the best of his or her knowledge and reasonable belief, and under penalty of law, the information contained in the annual report is accurate and complete in all material respects." (See CFTC Rule 3.3(f)(3).)

In this action, the CFTC chose not to prosecute the signatory of the CCO annual report, but instead solely held Commerzbank liable for making "false statement[s] or misleading statement[s] of a material fact to the Commission, including … information relating to a swap." (Click here to access Commodity Exchange Act 6(c)(2), 7 U.S.C. §9(2).) This exercise of discretion by the Division of Enforcement to not bring an enforcement action against any individual was judicious.

However, this enforcement action makes clear that the Commission expects information in CCO annual reports to be accurate, including any representation that there have been no material noncompliance issues identified during the prior year. However, if an outside consultant's or internal audit report or any other information known by a compliance officer or management suggests otherwise and such a representation is still made, all bets may be off going forward.

- **Autonomous Doesn't Necessarily Mean Non-Regulated Says SEC in Fining Founder of Securities Cryptoasset Exchange Powered By Automated Smart Contract**: The Securities and Exchange Commission brought and settled charges against Zachary Coburn for enabling EtherDelta, an online platform that allows persons to buy and sell crypto-assets, many of which have the attributes of securities, to operate as an exchange for securities in interstate commerce without registering as a national securities exchange or operating pursuant to a lawful exemption, as required, from July 12, 2016, through December 15, 2017.

The SEC claimed that Mr. Coburn founded EtherDelta in July 2016, agreed to sell it to foreign purchasers in November 2017, and ceased receiving fees from EtherDelta as of December 16, 2017.

According to the SEC, during the relevant time, EtherDelta allowed buyers and sellers to trade certain digital assets, including ether and s0-called "ERC20 tokens." (ERC20 tokens are digital assets programmed pursuant to a standardized protocol that enables them to function on the Ethereum blockchain; most initial coin offerings utilize ERC20 tokens and many ERC20 tokens have attributes of securities.)

Generally, to trade on EtherDelta. market makers post their interest to buy or sell an approved crypto-asset and a taker accepts a maker's offer. This acceptance effectively forwards the proposed transaction to an autonomous EtherDelta smart contract that automatically confirms (1) the validity of the buy and sell messages; (2) if the conditions of the orders are valid (e.g., not cancelled or expired); and (3) that both the maker and take have sufficient funds and/or crypto-assets to consummate the trade. If these attributes are all satisfied, the smart contract updates its internal ledger to reflect the trade, and ultimately, the transaction is made a part of the permanent record of the Ethereum blockchain.

The SEC charged that, during the relevant time, Mr. Coburn wrote and deployed the EtherDelta smart contract, and "exercised complete and sole control over EtherDelta's operations." He also apparently approved which digital tokens could be traded on the trading facility. As a result, he should have known that his actions would cause EtherDelta to operate in violation of requirements to register as a national securities exchange or to be lawfully exempt. (Click here to access the definition of an exchange under the relevant provision of the Securities Exchange Act of 1934, 15 U.S.C. §78c(a), and here for the requirements of registration or an exemption, 15 U.S.C. §78e.)

To resolve this matter, Mr. Coburn agreed to pay a fine of US $75,000 and disgorge profits of US $300,000 plus interest.

In unrelated crypto-asset developments:

- Ex-Proprietary Trading Firm Employee Sanctioned by CFTC for Stealing Employer's Virtual Currencies: Joseph Kim settled charges brought by the Commodity Futures Trading Commission for stealing litecoins and bitcoins from his prior employer – Consolidated Trading, LLC, a proprietary trading firm – from September through November 2017, to cover losses in his personal trading account. The CFTC also claimed that, after Mr. Kim was fired by his employer, he fraudulently solicited funds from five individuals to continue trading virtual currencies to make up his personal losses. Previously, Mr. Kim was pleaded guilty to criminal charges brought by the Department of Justice related to his misappropriation. He was sentenced to 15 months' imprisonment on November 9 related to this matter. (Click here for background regarding Mr. Kim's criminal action in the article, "Trader Criminally Charged for Allegedly Misappropriating Employer's Cryptocurrencies" in the February 18, 2018 edition of *Between Bridges*. Click here for a copy of his plea agreement.)

- Bank Argues Cryptocurrencies Just Like Money to Justify Charging Cash Advance Fees: Chase Bank USA, N.A. said its decision to charge credit card holders cash advance fees and interest for their cryptocurrency transactions after previously not assessing such charges did not constitute a violation of any applicable laws, in connection with its effort to dismiss a lawsuit against it in a federal court in New York City. The lawsuit, filed by Brady Tucker as a purported class action, had alleged that the bank's decision to suddenly charge it higher rates for purchases of cryptocurrencies constituted a violation of applicable laws that require 45 days' written notice before making a change in the terms of any contract governing credit. (Click here to access the relevant provision of the Truth in Lending Act, 15 U.S.C. §1637(i)(2) and here for its implementing regulation, Regulation Z, 12 C.F.R. §1026.9(c)(2)(i)(A).) Chase Bank argued that its credit card agreement expressly permitted it to charge cash advance fees for "cash-like transactions" and that "cryptocurrency is like cash." (Click here for background on Mr. Tucker's initial lawsuit in the article "Is it a Purchase or a Cash Advance" in the April 22, 2018 edition of *Bridging the Week*.)

Policy and Politics: Just a few weeks ago, Brian Quintenz, a CFTC commissioner warned that all products and transactions within the Commission's jurisdiction are subject to the Commission's regulation even if they are executed on a blockchain utilizing autonomous smart contracts. If there are violations of laws or regulations, it may be challenging to identify who is responsible, he said, but someone is. Mr. Quintenz suggested that code developers could be likely targets for unlawful uses of a smart contract if they could reasonably foresee at the time they created the relevant code that it would likely be used by US persons in a prohibited fashion.

Some have argued that an autonomous trading facility powered by a smart contract should not be subject to CFTC or SEC regulatory requirements. At least one CFTC commissioner has suggested otherwise, and now the SEC, in an enforcement action and settlement, has expressed its equivalent view as Mr. Quintenz on the topic. (Click here for background on Mr. Quintenz's comments in the article "CFTC Commissioner Warns Just Because It's Decentralized Doesn't Mean It's Not Regulated" in the October 21, 2018 edition of *Bridging the Week*.)

- **Over One Commissioner's Vehement Dissent, CFTC Authorizes Publication for Comment Proposed Rules to Overhaul Swaps Trade Execution Requirements on Trading Facilities**: The Commodity Futures Trading Commission proposed by a vote of four commissioners to one to modify swap trading requirements on swap execution facilities, and by a unanimous vote of all five commissioners, to maintain the swap *de minimis* threshold at US $8 billion. One of the newest commissioners, Dan Berkovitz, was the dissenting vote.

Among other things, the CFTC proposed to amend the definition of a SEF to include certain swap brokering entities, including interdealer brokers and aggregators of single-dealer platforms; broaden the scope of the mandatory trade execution requirement to include swaps subject to a clearing requirement and listed by a SEF or designated contract market for trading; eliminate the current requirement that SEFs offer only order book or request-for-quote methods of execution and instead authorize SEFs to utilize more flexible alternative means of execution subject to enhanced disclosure requirements; and modify the current mandate that SEFs offer participation on an impartial and non-discriminatory basis to solely require transparent, fair and non-discriminatory access to all "similarly situated" market participants. The proposed amended rules would also establish new obligations for a "SEF Trading Specialist" that would include SEF employees who facilitate swaps trading or execution for a SEF, and would be subject to fitness qualification, proficiency testing, ethics training, and a code of conduct. SEFs would have to supervise SEF trading specialists, but such persons would not be formally registered with the CFTC.

In his dissent, Mr. Berkovitz said that adoption of the proposed new swap trading requirements "would reduce competition by cementing the oligopoly of the largest bank dealers as the main source of liquidity and pricing in the swaps markets." He also claimed that "[a]uthorizing discrimination based on the type of entity will permit the largest bank dealers to establish and maintain exclusive pools of liquidity for themselves."

CFTC Chairman J. Christopher Giancarlo, on the other hand, said that the current SEF rules which limit the methods of execution are contrary to the express provision of the Dodd-Frank Wall Street Reform and Consumer Protection Act that authorizes SEFs to operate by "any means of interstate commerce." Mr. Giancarlo argued that SEF rules today have prompted the shift of "swaps price discovery" from SEFs to introducing brokers who "are not subject to conduct and compliance requirements appropriate for swaps trading."

The CFTC will accept comments on its proposed new requirements for 75 days after they are published in the *Federal Register*.

Separately, the CFTC approved maintaining the current threshold for requiring a person to become registered as a swap dealer at US $8 billion. Under this calculation, a person is not required to register in such capacity unless its swaps dealing activities for the prior 12-month period exceeds an aggregate gross notional amount equal to the threshold amount. The CFTC also requested comment on give-up practices related to swaps transactions intended to be cleared; comments will be accepted for 60 days following the request's publication in the *Federal Register*.

My View and **Legal Weeds**: Although Mr. Berkovitz's views are well argued and passionately expressed, it is not clear why the new commissioner would object to permitting the public to comment on the chairman's proposal. Reforming requirements related to SEFs have been a priority of Mr. Giancarlo even prior to the time he became CFTC chairman.

However, what Congress definitively meant when it said that SEFs could conduct their activities "through any means of interstate commerce" – the Commodity Exchange Act phrase often quoted by Mr. Giancarlo to support his reform measures – is not fully clear. This is because the phrase does not stand alone in the definition of a SEF. Rather it is preceded by language that appears to set some parameters: "The term 'swap execution facility' means a trading system or platform in which multiple participants have the ability to trade swaps by accepting bids and offers made by multiple participants in the facility or system, through any means of interstate commerce." (Click here to access 7 U.S.C. §1a(50).)

In footnote 136 of the *Federal Register* release related to the Commission's proposal, the CFTC acknowledged the controversy regarding this language when it argued that its proposed elimination of the current order book or RFQ-to-three trade execution requirement and possible replacement by different methodologies including RFQ-to-one would not violate applicable law. According to the Commission, the view that this language does not permit an RFQ-to-one execution methodology:

…does not appropriately give meaning to the "ability" factor of the SEF definition. Therefore, the Commission seeks to clarify the application of the "ability" factor as it applies to RFQ-to-one transactions. The Commission believes that an entity that permits its market participants to use its RFQ-to-one functionality to issue concurrent or serial RFQs to multiple, different recipients would fit within the SEF definition, as it provides participants the "ability" to accept bids and offers from multiple participants within the trading system or platform.

Arguably, the better (or at least a conjunctive) authority for the Commission's proposal lies in the broad capability of SEFs to "make available for trading any swap" – an ability offered without any restrictions – and to "establish rules governing the operation of the facility, including rules specifying trading procedures to be used in entering and executing orders posted on the facility" applying "reasonable discretion" as long as such rules comply with core principles applicable to SEFs – not the definition of a SEF. Moreover, SEFs must adhere to only two overarching objectives: promote trading on their facilities and pre-trade price transparency. No requirement limits methods of executions on SEFs to RFQs or an order book. (Click here to access 7 U.S.C. §7b-3.)

In any case, the proposed revised swaps trading requirements offer many interesting ideas and deserve to be considered.

- **Ex-Bank Trader Fined US $350,000 and Banned From All CFTC Overseen Markets for Allegedly Concealing Swaps Trading Losses; Bank That Self-Reported, Cooperated and Remediated Receives Letter Closing Investigation**: Jacob Bourne, the former head of the inflation trading desk at Deutsche Bank, was fined US $350,000 for purportedly mismarking his swap trading portfolio to disguise the amount of his losses. After he was confronted by bank management, Mr. Bourne allegedly altered his marks on an internal spreadsheet to correctly match marks provided by a third-party brokerage company.

Mr. Bourne consented to payment of the fine to resolve the CFTC's charges. He also agreed never to trade on any market overseen by the CFTC.

According to the CFTC, from June 15 through July 6, 2017, Mr. Bourne entered phony end-of-day marks for inflation swap instruments into an internal spreadsheet designed to value his overall portfolio. At the time, Deutsche Bank required entry of precise marks provided by a third-party brokerage company for such valuations. Mr. Bourne's fake entries had the effect of appearing to diminish his overall trading loss of US $16.26 million by US $13.82 million. When management inquired about the variances between the entered valuations and third-party brokerage marks during the week of June 26, 2017, Mr. Bourne purportedly claimed it was an error in the internal spreadsheet, and subsequently fixed the spreadsheet to hide his mismarked entries.

Deutsche Bank initially accepted Mr. Bourne's explanation, but upon further review, determined he had impermissibly altered his positions. At the time, it placed Mr. Bourne on administrative leave, and after a full investigation, terminated him during September 2017. The CFTC determined not to bring an enforcement action against Deutsche Bank in connection with this matter because of its "timely, voluntary self-disclosure" of the incident, full cooperation, and "proactive remediation efforts." Uncharacteristically, the CFTC published a letter to Deutsche Bank where it informed the bank of its decision not to bring an enforcement action against it (click here to access the letter).

Legal Weeds1: The CFTC's enforcement action against Mr. Bourne was grounded in the provision of applicable law that prohibits the use or employment of "any manipulative or deceptive device or contrivance" in connection with a swap. (Click here to access the relevant provision of law, 7 U.S.C. §9(1).) There was no allegation that Mr. Bourne's offense had any market impact; it only harmed Deutsche Bank.

Recently, a federal district court in California held that this relevant provision of law can only be used by the CFTC to prosecute acts of purported fraud that constitute fraud-based market manipulation, not private fraud. (Click here for background in the article "California Federal Court Dismissal of CFTC Monex Enforcement Action Upsets Stable Legal Theories" in the May 6, 2018 edition of *Bridging the Week*.) This decision was appealed and is currently being considered by a federal Court of Appeals in California. (Click here for background in the article "CFTC Tells Appeals Court That California District Court's Legal Rationale to Dismiss Complaint Against Precious Metal Dealer Was Deeply Flawed" in the September 9, 2018 edition of *Bridging theWeek*.)

Legal Weeds2: In October 2017, the CFTC's Division of Enforcement heralded that potential wrongdoers who voluntarily self-reported their violations; fully cooperated in any subsequent CFTC investigation; and fixed the cause of their wrongdoing to prevent a re-occurrence would receive "substantial benefits" in the form of significantly lesser sanctions in any enforcement proceeding and "in truly extraordinary circumstances," no prosecution at all. By publicly disclosing the letter it provided to Deutsche Bank to advise the bank there would be no charges brought against it arising from Mr. Bourne's rogue activities, the CFTC's Division of Enforcement apparently sought to broadcast that, because of the bank's self-reporting, full cooperation and remediation, this was one of those extraordinary circumstances! (Click here for background on the CFTC's Division of Enforcement cooperation guidelines in the article, "New Math: Come Forward + Come Clean + Remediate = Substantial Settlement Benefits Says CFTC Enforcement Chief" in the October 1, 2017 edition of *Bridging the Week*.)

More Briefly:

- **Related Dark Pools Resolve SEC Charges They Improperly Disclosed Subscribers' Confidential Information by Agreeing to US $12 Million Fine**: The Securities and Exchange Commission charged ITG Inc. and AlterNet securities, its affiliate, with not adequately protecting the confidential information of its participants in connection with POSIT – a dark pool the two firms operated. ITG and AlterNet are broker-dealers registered with the SEC that operated POSIT as an alternative trading system. According to the SEC, from 2010 to 2017, ITG provided participant information regarding aggregated trading activity to other persons while advising participants it maintained such information confidentially. On at least one instance, in response to a question, ITG falsely advised a participant that it "never" revealed "client trading activity in ITG's system or dark pool," alleged the Commission. The SEC also said that ITG did not make material disclosures to its participants regarding POSIT, including that, at some point after 2010 through mid-2014, the dark pool actually consisted of two separate pools of liquidity with distinct rules regarding routing depending on participant type and that, at one point after mid-2014, speedbumps were implemented involving orders from high frequency traders. The respondents settled the SEC's enforcement by agreeing to pay a fine of US $12 million.

- **Three Traders Plead Guilty to Spoofing Violations**: Three former futures traders pleaded guilty to commodities fraud and spoofing violations for trading activities on CME Group exchanges. Krishna Mohan and Kamaldeep Gandhi pleaded guilty in a federal court in Texas to manipulating commodities futures trading on the Chicago Mercantile Exchange and the Chicago Board of Trade for over two years by placing orders with no intent of execution. These transactions apparently resulted in market losses of over US $60 million. Separately, Mr. Gandhi also admitted to placing spoofing orders on the CME alone that resulted in additional market losses in excess of US $1.3 million. Independently, John Edmonds pleaded was charged and pleaded guilty in a federal court in Connecticut to commodities fraud and conspiracy to commit wire fraud, commodities fraud and spoofing for illicit trading activities for over six years on the New York Mercantile Exchange and the Commodity Exchange, Inc.

Mr. Gandhi and Mr. Mohan were previously subject to CFTC enforcement actions, and Mr. Gandhi, CME Group exchanges' disciplinary actions, related to their alleged spoofing activities. (Click here for an overview of Mr. Gandhi's prior actions, and here for background on Mr. Mohan's CFTC action in the article "CFTC Names Four Banking Organization Companies, a Trading Software Design Company and Six Individuals in Spoofing-Related Cases; the Same Six Individuals Criminally Charged Plus Two More" in the February 4, 2018 edition of *Bridging the Week*.)

- **CME Group Increases Offenses Potentially Subject to Summary Fines**: CME Group updated its list of infractions for which the chief regulatory officer or designee may summarily issue a fine without a hearing. Fines may not exceed US $5,000 for individuals or US $10,000 for firms or facilities. These infractions include reporting concerning large trader, open interest and long positions eligible for delivery; registrar reports; block trade or EFRP reporting; user IDs on CME Globex trades (Tag 50); automated/manual indicator on CME Globex trades (Tag 1028); sender location on CME Globex trades (Tag 142); CTI (customer indicator) codes; front-end audit trail requirements; certain reporting related to accounts; and CME brokerage reassignment trade recordation requirements. CME Group's Market Regulation department intendeds to continue to issue warning letters for a first offense; however, no person may receive more than one warning letter for the same offense during a rolling 12-month period.
- **Bank Sanctioned More Than US $38 Million by SEC for Role in Pre-Releasing ADRs to Unqualified Parties**: Citibank, N.A. agreed to pay a fine and disgorgement in excess of US $37 million to resolve Securities and Commission charges that, from August 2011 through November 2016, it provided so-called "pre-release" American Depository Receipts to brokers when neither the broker not their counterparties actually possessed the underlying foreign shares, as required by law. The SEC claimed that Citibank often released ADRs when it knew or should have reasonably known that the brokers and their counterparties were not complying with their pre-release obligations. ADRs are financial instruments that represent shares in foreign companies. (Click here for background on ADRs.)
- **OFAC Issues New Iran-Related FAQs**: In connection with its re-imposed sanctions on Iran, the United States Department of Treasury's Office of Financial Assets Control added over 700 individuals, entities, aircraft and vessels to its roster of Specially Designated Nationals and Blocked Persons with whom US persons generally are prohibited from conducting business. It simultaneously revised its Frequently Asked Questions to address the revived Iranian sanctions.

Source URL: https://www.natlawreview.com/article/bridging-week-gary-dewaal-november-5-9-and-november-12-2018-to-tell-truth-smart