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Bridging the Week by Gary DeWaal: December 10 - 14 and December 17, 2018 (Bitcoin; Ether; Blue Sheets; CPO Internal Controls; Disruptive Trading)

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

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The Commodity Futures Trading Commission issued a request for input regarding the virtual currency ether. It wants to understand better how bitcoin and ether are different, and any unique qualities of ether (ETH), as it potentially considers permitting regulated markets to list futures or other derivatives based on ETH. Separately, the Securities and Exchange Commission fined three broker-dealers in aggregate over US $6 million for not providing accurate trading information as requested through electronic blue sheets. In two circumstances, 100 percent of all EBS requests during the relevant time periods were purportedly responded to with inaccurate information. As a result, the following matters are covered in this week's edition of *Bridging the Week*:

- CFTC Seeks to Fuel Up Its Knowledge of Ether (includes **Legal Weeds/My View**);
- Undetected Coding Errors Lead to More Than US $6 Million in SEC Fines for Three Broker-Dealers for Blue Sheet Reporting Violations (includes **Compliance Weeds**); and more.

This is the final regular edition of *Bridging the Week* for 2018. *Bridging the Week* will resume its regular Monday publication schedule on January 7, 2019.

Video Version:

Article Version:

Briefly:

- **CFTC Seeks to Fuel Up Its Knowledge of Ether**: The Commodity Futures Trading Commission issued a Request for Input to help it better understand the virtual currency ether (ETH) in anticipation of potential self-certifications and applications by CFTC-regulated markets to list futures and other derivatives products based on the virtual currency.

In its RFI, the CFTC seeks responses to 25 specific questions, including what are key use cases that demonstrate the functionalities and capabilities of the Ethereum network; does a proof of stake (POS) block validation system have a greater potential to be manipulated than a proof of work (POW) system; how does the governance of the bitcoin and Ethereum blockchains differ; and are there best practices for the creation and security of Ethereum wallets? However, the CFTC will accept any relevant comments even if not addressed by specific questions.

Comments must be provided to the CFTC by 60 days after publication of its RFI in the *Federal Register*.

Ether is another virtual currency like bitcoin, and for the past year has typically been among the top three cryptocurrencies on the basis of market capitalization. ETH is the currency (often referred to as "fuel") of the Ethereum blockchain network where it can be used to pay for computations or transaction fees. Ethereum was developed by Vitalik Buterin and two colleagues and first formally described in a white paper in 2013. (Click here to access the Ethereum white paper as currently posted (including recent edits) on GitHub.)

The first ether block was created in July 2015 after a public pre-sale of approximately 60 million ether beginning in July 2014. At the time of the pre-sale, approximately six million additional ether were created and used to compensate early contributors and pay for Ethereum development expenses prior to the genesis block, and an additional six million ether were created and held in reserve by the Ethereum Foundation. Today, like bitcoin, Ethereum blocks are created through a POW mining function where persons solve a mathematical problem for a reward of ether digital coins. However, the frequency of block creation is much greater on Ethereum than on the bitcoin blockchain, and the reward mechanism for miners solving mathematical problems for ether is different from bitcoin.

Ultimately, Ethereum is intended to switch from a POW validation system to a POS consensus system called Casper where persons' right to create blocks are anticipated to be based on their commitment to risk their own ether to validate a new block and a pseudo-random process to choose the block validator from among potential validators. The timing of Ethereum's migration from a POW to POS validation system is still pending, but the change may occur as soon as 2019.

Unlike bitcoin whose supply is capped at 21 million, there is no upward cap on the amount of ether although its issuance is currently limited to 18 million/year, and this amount is expected to decline after the Ethereum network implements a POS validation system.(Click here for a very good comparison of bitcoin and ether in the article "Comparing Bitcoin and Ethereum" by Lotte Fekkes (Radboud University, Bachelor Thesis, January 2018); click here for specific questions and answers regarding ether published by the Ethereum Foundation.)

Despite being a virtual currency, ether was principally purposed to serve as payment for transactions on the Ethereum blockchain, including those implemented by so-called smart contracts that would drive decentralized applications developed by programmers. Generally, a smart contract references self-executing software code often associated with a blockchain that automatically causes actions to occur between parties based on preprogrammed conditions being met without the involvement of a central authority. (Click here for background on smart contracts in the article "LabCFTC Tries to Smarten Public Regarding Smart Contracts" in the December 2, 2018 edition of *Bridging the Week*.)

In other legal developments regarding cryptoassets:

- New Jersey Federal Court Finds ICO-Issued Cryptoasset a Security for Motion to Dismiss: In response to a motion to dismiss by defendants, a federal court in New Jersey ruled that the plaintiff had sufficiently alleged that cryptoassets issued by defendants in an initial coin offering – Latium X tokens – were investment contracts and thus securities under applicable law. Plaintiff – Joevannie Solis – had alleged that the Latium Network, Inc., and its co-founders – David Johnson and Matthew Carden – engaged in the unlawful sale of unregistered securities. In rejecting defendants' dismissal motion, the court ruled that the plaintiff had adequately pleaded that his purchase of LATX tokens constituted an investment of money in a common enterprise with the expectation of profits to come solely through the efforts of others. In part, this was because the plaintiff's complaint set forth examples of defendants' promotional literature and statements that supported "the inference that Plaintiff purchased LATX tokens with the expectation of profit rather than as a means of using the [company's blockchain] tasking platform." (Click here for background on standards that have been applied in assessing whether an ICO-issued digital token is a security in the article "Brooklyn Federal Court Rules ICO-Issued Digital Assets Could Be Securities" in the September 16, 2018 edition of *Bridging the Week*.)

- SEC Settles with Non-Registered Fund Investing in Digital Assets: CoinAlpha Advisors LLC settled an enforcement action brought by the SEC alleging that it offered and sold shares in an investment fund that invested in digital assets without registering the shares or relying on a valid exemption. According to the SEC, the fund raised over US $600,000 from 22 persons from October 2017 through May 2018 through a general solicitation. Although the fund filed a Form D Notice of Exempt Offering of securities with the SEC on November 3, 2017, the fund did not take "reasonable steps" to ensure its investors were "accredited investors" and thus qualified to invest in the fund, charged the Commission. Accredited investors are certain enumerated persons under an SEC rule (e.g., persons with a net worth in excess of US $1 million; click here to access SEC Rule 501 under Regulation D).

- Two Former Executives of Claimed First-in-Kind Decentralized Bank Settle SEC Charges for Fraudulent ICO: Jared Rice, former chief executive officer of AriseBank, and Stanley Ford, the bank's former chief financial officer, agreed, jointly and severally, to settle charges related to the bank's allegedly fraudulent initial coin offering that began in October 2017. The defendants agreed to disgorge profits of over US $2.25 million and pay a fine and interest of almost US $250,000 to resolve this matter. They did not admit or deny any charges. Recently, Mr. Rice was indicted in connection with his alleged fraudulent activities in a federal court in Texas. (Click here for background regarding Mr. Rice's indictment and the SEC's allegations in its civil action in the article "CEO of Decentralized Banking Platform Indicted and Arrested for Purported Fraudulent Conduct" in the December 2, 2018 edition of *Bridging the Week*.)

- Switzerland Says Although Its Laws Can Accommodate Blockchain Technologies, Some Adjustments Would Help: The Federal Council of Switzerland – the country's supreme executive and directorial authority – issued a report saying that the country's current legal framework is well situated to support new fintech developments, including blockchain technologies. However, it has directed two government departments – the Federal Department of Finance and the Federal Department of Justice and Police – to organize consultations in Q1 2019 to provide enhanced legal certainty in civil law for the transfer of rights by means of digital registers; to clarify insolvency law regarding the treatment of segregated cryptoassets in the event of bankruptcy; and to propose "...a new and flexible authorisation for blockchain-based financial market infrastructures " in financial market law, among other law adjustments. The Federal Council also recommended making it clearer that decentralized platforms are subject to the country's anti-money laundering law. The objective of the law adjustments would be "...to create the best possible framework conditions so that Switzerland can establish itself and evolve as a leading, innovative and sustainable location for fintech and blockchain companies – and innovative companies in general."

In February 2018, the Swiss Financial Market Supervisory Authority (FINMA) endeavored to provide some clarity of its own oversight of different types of digital tokens – which it named "payment tokens," "utility tokens" and "asset tokens." FINMA claimed that it was not the issuance of a token through an initial coin offering that made it a security; rather, it was the nature of the token that was issued. (Click here for details in **My View** to the article, "SEC Sues Bitcoin-Denominated Trading Platform for Operating an Unlicensed Securities Exchange; Principal Criminally Charged" in the February 25, 2018 edition of *Bridging the Week*.)

Legal Weeds/My View: Earlier this year, William Hinman, the Director of the Division of Corporation Finance of the Securities and Exchange Commission, said that the virtual currency ether is not a security. It may have once been a security, but not today. As a result, transactions involving ether are not securities transactions.

Moreover, Mr. Hinman indicated that he could envision that certain utility tokens might also not be securities. He said that such a conclusion might be appropriate “where there is no longer any central enterprise being invested in or where the digital asset is sold only to be used to purchase a good or service available through the network on which it was created.”

In evaluating whether a digital token is likely a security, Mr. Hinman set forth 13 considerations, including:

- Is there a single person or small group that is behind the sale of the digital asset and do they play a “significant role” in the development and maintenance of the token and its potential increase in worth?
- Does this person or group have a stake or other interest in the digital token and are they incentivized to cause an increase in value of the digital asset? Do purchasers anticipate such an effort and increase in value?
- Do the customer protection provisions of applicable law make sense, including disclosure obligations of a person or entity that plays a key role in the system?
- Do persons or entities other than the promoters exercise governance rights?
- Is token creation tied to the needs of users or for speculation?
- Is the token marketed and distributed to the general public?
- Is the system underlying the token fully functioning or in the early stages of development?

Unfortunately, Mr. Hinman’s comments were solely his personal views, and did not reflect the official views of the SEC. It would be helpful if the SEC, like the CFTC has done in connection with its ether RFI, were to engage formally with the public to divine a bright line between security and utility tokens.

The CFTC is commended for issuing its RFI on ether. Hopefully the CFTC can use input from its public solicitation to help develop a standard template that could be used by prospective developers of new futures or derivatives contracts based on virtual currencies to expedite approvals or self-certifications of such contracts on cryptocurrencies other than bitcoin and ether. Also, let's hope the CFTC won’t hold-up proposed contracts based on ether currently in process while it waits for and evaluates responses to its RFI.

(Click here for further background on ether and the Ethereum blockchain, as well as Mr. Hinman’s position on security and utility digital tokens, in the article “Anything but Sleep Inducing: SEC Corporate Finance Director Says Ether Not a Security and Canada Issues Guidance on Utility Tokens” in the June 17, 2018 edition of *Bridging the Week*.)

- **Undetected Coding Errors Lead to More Than US $6 Million in SEC Fines for Three Broker-Dealers for Blue Sheet Reporting Violations**: The Securities and Exchange Commission levied cumulative fines in excess of US $6 million against three registered broker-dealers for their failure to submit accurate securities trading records in response to electronic blue sheet requests. The three firms and their fines were Citadel Securities LLC (US $3.5 million); MUFG Securities Americas Inc. (MUSA; US $1.4 million); and Natixis Securities Americas LLC (US $1.25 million). MUFG is a subsidiary of Mitsubishi UFJ Securities Holdings Co., Ltd.

According to the SEC, both Citadel – from November 2012 through August 2016 – and Natixis – from December 2012 through February 2017 – included incorrect trade execution time on 100 percent of their EBS submissions. Because of coding errors, both firms converted execution times to Greenwich Mean Time as opposed to Eastern Time. For Citadel, these errors were included in 2,774 responses to EBS requests filed with the Commission involving 80 million trades, while for Natixis, these mistakes were in 1,237 responses involving almost 150,000 trades.

Many of Citadel's and Natixis's EBS responses also reflected other errors too, said the SEC.

From May 22, 2015, through March 30, 2018, said the SEC, MUSA had errors on almost all its 860 EBS submissions; erroneous information was included for 677,613 out of 687,176 transactions. In its submissions, MUSA made errors regarding order execution times, exchange codes, transaction type identifiers, opposing broker number and contra-party identifiers. The SEC claimed that MUSA also failed to include 2,151 securities transactions in its filings.

Generally, the SEC alleged that each of the broker-dealers failed to have adequate pre-submission controls to validate that information in their EBS submissions was accurate.

Each of the companies voluntarily settled its SEC action. In resolving these matters, the SEC noted respondents' remedial efforts, including retention of outside consultants and implementation of enhanced controls.

Compliance Weeds: Just a few months ago, the SEC fined Convergex Execution Solutions, LLC (now known as Cowen Execution Services, LLC), a registered broker-dealer, US $2.75 million for submitting to it data that was incomplete or deficient in response to a high number of electronic blue sheet requests. (Click here for details in the article "Feeling Blue (Sheets): Broker-Dealer Resolves SEC Enforcement Action for Faulty Electronic Regulatory Submissions for US $2.75 Million Fine" in the September 16, 2018 edition of *Bridging the Week*.

In July 2016, Citigroup Global Markets Inc. agreed to pay a US $7 million fine to the Securities and Exchange Commission to resolve charges that, from 1999 through 2014, it submitted 2,382 erroneous blue sheets with it and 753 erroneous blue sheets with the Financial Industry Regulatory Authority. According to the SEC, these errors occurred as a result of a coding error in Citigroup's electronic blue sheet computer system that was not detected until 2014.

Earlier in 2016, Deutsche Bank Securities Inc. agreed to pay a fine of US $6 million to resolve charges brought by FINRA that it filed "thousands" of deficient blue sheets with it and the SEC from 2008 through 2015.

Under an SEC rule, broker-dealers must submit to the SEC upon request true and complete copies of trading records they are required by law to make and keep. Another SEC rule requires broker-dealers to submit such securities transactions records to the SEC electronically upon request. (Click here to access SEC Rule 17a-4(j) and here for SEC Rule 17a-25. Click here to access Securities Exchange Act § 17(a)(1), 15 U.S.C. § 78q(a)(1).)

Relevant entities that may be required to file electronic blue sheets with regulators should periodically review submissions against source information to ensure their systems are properly capturing and processing such data correctly. In each of the Citadel, MUSA and Natixis orders, the SEC expressly cited the companies for not having adequate pre-submission controls to validate that their EBS submissions were complete (e.g., in the case of Natixis, to implement sufficient "periodic sampling or manual validation" of EBS data prior to submission).

(Click here for additional background in the article "Computer Coding Error Results in Broker-Dealer Blue Sheets' Errors Over 15 Years and US $7 Million SEC Fine" in the July 17, 2016 edition of *Bridging the Week*.)

More Briefly:

- **NFA Proposes Internal Controls Framework to Enhance Supervision**: The National Futures Association proposed an interpretive notice to provide commodity pool operators with guidance to design and implement adequate systems of internal controls in order to comply with their general obligation of supervision.

Although NFA recognizes that what constitutes an "adequate internal control system" may vary from CPO to CPO based on its size and complexity of operations, NFA will require all CPOs to formally implement an internal control system designed to prevent fraudulent actions by employees, management and third parties; to help secure the integrity of customer funds; and to "provide reasonable assurance" that financial reports are accurate and that a CPO complies with applicable Commodity Futures Trading Commission and NFA requirements. CPOs should also have an escalation policy for employees to report violations of their internal control systems to management, and "whether and when a matter should be reported to [a] firm's regulator." A CPO's internal control system should be documented in writing.

Under the proposed NFA guidance, CPOs must conduct a periodic risk assessment to determine where their most "critical" risks arise and design controls to address those risks. Critically, persons involved with handling pool funds, trade execution activities, financial records and risk management should be different from persons who supervise such activities. The NFA recommends that all CPOs' internal control procedures should address pool subscriptions, redemptions and transfers; risk management and investment; the valuation of pool funds; and the use of administrators.

NFA's proposed guidance should be effective by year-end, unless objected to by the CFTC.

Separately, NFA also proposed rule changes to incorporate references to swaps, counterparties and related parties , as appropriate, in relevant rules, and to make clear that certain of its rules apply to all commodity interests, while some to only specific membership classes.

- **BIS Economists Argue that CCP - Bank Interactions May Lead to Destabilizing Feedback Loop Under Certain Stress Scenarios**: Three economists from the Bank of International Settlements argued in a paper published on December 16 that interdependencies between central counterparty clearing houses and large bank clearing members related to the clearing of over-the-counter derivatives could lead to a "destabilizing feedback loop" under certain stress scenarios, amplifying stress. This situation could arise, said the authors, because of balance sheet interlinkages and the structure of default fund waterfalls where OTC derivatives clearing is "highly concentrated" among banks and CCPs. Accordingly, recommended the authors, the risks of banks and CCPs should be considered together and not separately in connection with stress tests. The three authors of the report are Umar Faruqui, Wenqian Huang and Elod Takats.

- **CME Group Exchanges Fine Non-Members for Disruptive Trading That Does Not Involve Layering**: CME Group exchanges sanctioned two non-members for engaging in transactions during pre-opening sessions that allegedly were not made for the purpose of bona fide transactions. Arturo Spiro agreed to pay a fine of US $15,000 and be banned from trading on any CME Group exchange for 20 business days for engaging in such conduct on the Chicago Board of Trade and Chicago Mercantile Exchange on various occasions from January 1 through June 15, 2017, while Jason Berry also consented to a fine of US $15,000 and a 20-business-day all CME Group exchanges trading ban for trading in such a manner on multiple days from June 28 through September 19, 2016. CME said that Mr. Berry's trading was designed to identify the depth of the order book in the E-mini S&P future contract.

Separately, Krishna Mohan agreed to pay a fine of US $10,000 and be barred from trading on any CME Group exchange for three years for engaging in spoofing-type trading activities from November through December 2013. Mr. Mohan was also accused of not fully answering certain questions during an exchange interview. Last month, Mr. Mohan pleaded guilty in a federal court in Texas to manipulating commodities futures trading on the CME and the CBOT for over two years by placing orders with no intent of execution. (Click here for background in the article "Three Traders Plead Guilty to Spoofing Violations" in the November 11, 2018 edition of *Bridging the Week*.)

Finally, Ziemba Capital Management LLC agreed to pay a fine of US $40,000 for violating CME spot month position limits in Lean Hogs futures contracts. CME found that on various times from the close of business on December 7, 2017, through December 12, 2017, accounts owned or controlled by the principals of ZCM violated the 950 spot-month limit when their positions were aggregated.

- **SEC OCIE Reminds IAs of Obligations Regarding Electronic Messaging**: The Securities and Exchange Commission's Office of Compliance Inspections and Examinations provided guidance to investment advisers on best practices to help them comply with their obligation to make and keep certain books and records related to their investment advisory business in light of the increasing use of electronic messaging by adviser personnel for business-related communications. Among other things, OCIE recommends that IAs only permit forms of electronic communication that it believes can be used in compliance with all books and records requirements, including retention of records; prohibit use of applications and technologies that can be easily misused by employees to send messages or communicate anonymously; require employees that receive business messages in a form not permitted by the firm to transfer such message to an electronic system that is in compliance with SEC books and records requirements; and where advisers permit the use of social media, personal email accounts and personal websites for business purposes, adopt and implement procedures to monitor, review and retain such communications. IAs should have training for employees regarding prohibitions and limitations on electronic messaging and use of applications and requiring supervision where social media, personal email and personal website use is authorized.

- **FINRA Highlights Top Examination Findings for 2018**: The Financial Industry Regulatory Authority published its 2018 annual report setting forth observations from recent examinations and pointing out both weaknesses and good practices by members. Among other matters, FINRA, during examinations, found instances where registered representatives did not adequately assess customers' financial situation and needs, investment experience, risk tolerance, time horizons and other important factors in making recommendations. In some instances it found unsuitable recommendations involving complex products and over-concentration of illiquid products, including volatility-linked products. Inadequate training by registered representatives and supervisors regarding specific complex and high-risk products sometimes contributed to inappropriate recommendations, observed FINRA. Contrariwise, FINRA found some members had comprehensive written supervisory procedures regarding volatility-linked products, including prohibitions and restrictions on registered representatives' recommendations to retail clients, as well as controls to enforce such restrictions.

- **Authority of Broker-Dealers to Rely on Investment Advisers for Their Own CIP Obligations Extended by SEC**: The Division of Trading and Markets of the Securities and Exchange Commission extended the authority of broker-dealers to rely on investment advisers to perform some or all of their obligations to know their customers (as well as their beneficial owners) for anti-money laundering purposes as part of their mandatory customer identification program (click here to access the SEC rule requiring CIPs for broker-dealers, 31 CFR 1023.320). Trading and Markets initially granted such relief in response to a request by the Securities Industry Association in 2004; it has been extended numerous times, most recently in 2016. The relief was initially predicated on the expectation that IAs would be covered by a CIP rule; they have not been to date (a proposal to subject investment advisers to AML requirements was proposed in 2015; click here to access the relevant *Federal Register* announcement). The current extension is until the earlier of December 12, 2020, or the date a proposed AML rule for IAs becomes effective. A broker-dealer may rely on an investment adviser for its CIP obligations provided such reliance is "reasonable under the circumstances," the investment adviser is registered under US law, and the IA enters into a contract with the broker-dealer agreeing to comply with applicable CIP requirements and other conditions.