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Bridging the Week by Gary DeWaal: July 8 – 12, and July 15, 2019 (Crypto Custody; An International Exchange and Truth; One + One = Two)

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Bridging the Week

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Monday, July 15, 2019

Staff of the Securities and Exchange Commission and the Financial Industry Regulatory Authority issued a joint statement setting forth concerns they have with the ability of broker-dealers to comply with the SEC's Customer Protection Rule when handling cryptosecurities. However, staff offered no meaningful path forward. Separately, a major international derivatives exchange agreed to pay a fine of US $150,000 to settle charges brought by the Commodity Futures Trading Commission that it made false statements to the US regulator in connection with a certification regarding its ongoing compliance with terms of a 2015 CFTC registration exemptive order. As a result, the following matters are covered in this week's edition of *Bridging the Week*:

- Customer Protection ABC, How Does It Translate to Cryptosecurity Custody? – SEC and FINRA Provide Considerations for Broker-Dealers (includes **My View**);
- International Exchange Sanctioned by CFTC for False Certification Regarding Compliance With Exemptive Order (includes **Legal Weeds**);
- One + One No Longer Equals One – CFTC Staff Offers Path for FCMs to Treat Separate Accounts of Single Customer as Separate Accounts of Distinct Entities (includes **My View**); and more.

Article Version:

Briefly:

- **Customer Protection ABC, How Does It Translate to Cryptosecurity Custody? – SEC and FINRA Provide Considerations for Broker-Dealers**: Staff of the Securities and Exchange Commission and the Financial Industry Regulatory Authority issued a joint statement setting forth concerns that appear to be delaying their approval of broker-dealers facilitating digital asset security transactions for customers. Although the staff identified specific issues for broker-dealers to consider, they provided no clear path forward, except where a broker-dealer solely facilitates cryptosecurity transactions on a peer-to-peer basis without exercising any control or custody.

Generally, staff noted that a broker-dealer holding cryptosecurities for customers would have to safeguard such digital assets just like all other assets – namely, separate from the firm's own assets – in order to enhance the likelihood of their return to customers in the case of the firm's failure. Staff noted that application of this requirement – commonly known as the "Customer Protection Rule" (click here to access SEC Rule 15c3-3) – has "produced a nearly fifty year track record of recovery for investors when their broker-dealers have failed."

Among other things, to demonstrate satisfactory control over an asset for purposes of the Customer Protection Rule, a broker-dealer or its agent must be able to demonstrate that it maintains "exclusive control" over the asset. Staff raised concerns over the potential ability of a broker-dealer or its agent to demonstrate the requisite exclusive control over a private key (effectively, the security code) to a digital wallet holding a cryptosecurity – even where it or its agent held the private key. Staff expressed concern that a broker-dealer "may not be able to demonstrate that no other party has a copy of the private key and could transfer the digital asset without the broker-dealer's consent." Staff also noted that, even with a private key, a broker-dealer might not be able to reverse or cancel a mistaken or unauthorized transaction.

Staff also expressed concern regarding the ability of a broker-dealer holding cryptosecurities to prepare accurate financial records, as required by law. This is because, said staff, it may be "difficult for broker-dealers to evidence the existence" of digital asset securities

which could impede their ability to produce accurate financial records, as well as independent third-party accountants' capability to test representations made by a broker-dealer's management in financial statements.

Finally, the SEC noted that the definition of a "security" under the law governing insurance protection for customer assets – the Securities Investor Protection Act – might not apply to cryptosecurities. This is because the law does not cover investment contracts or interests that are not the subject of a registration statement. (Click here to access 15 U.S.C. § 78lll)(14).)

Staff indicated, however, that many of its concerns regarding application of the Customer Protection Rule may not apply where a broker-dealer solely engages in "non-custodial activities" for digital asset securities such as facilitating the bilateral settlement of a transaction directly between a buyer and an issuer without interposing itself, or where a broker-dealer facilitates a peer-to-peer over-the-counter transaction between a buyer and seller with no digital security passing through the broker-dealer.

The staff's joint statement was issued by the SEC's Division of Trading and Markets and FINRA's Office of General Counsel.

In other legal and regulatory developments regarding cryptoassets:

- **New York AG Claims Bitfinex's and Tether's Extensive Contacts With New York Warrant Continuation of Lawsuit Against Entities in State:** The New York Attorney General argued in a brief filed in connection with its lawsuit against companies associated with the management of the Bitfinex exchange and the stablecoin tether that the associated companies had "substantial ties" to New York to warrant a NY court exercising jurisdiction over its lawsuit. The NY AG filed its brief in opposition to a motion to dismiss by the companies.

According to the NY AG, during the relevant time covered by its lawsuit, Bitfinex both had clients in New York and was doing business in New York. Among other things, the NY AG claimed that the associated companies held accounts at NY banks and one other NY financial institution, and senior executives of the companies lived in and conducted work from New York. In April 2018, the NY AG filed a lawsuit against the companies and obtained an *ex parte* order from a NY court, claiming the companies used fiat currency balances supporting tether to help Bitfinex conduct certain day-to-day activities without adequate disclosure to tether holders. (Click here for background in the article "NY Attorney General Sues Stablecoin Issuer and Related Companies for Purportedly Misusing Tethered Fiat Currency Without Customer Disclosure" in the April 28, 2019 edition of *Bridging the Week*.)

- **Canada to Require Registration of Digital Asset Exchanges as Money Service Businesses:** Effective June 1, 2020, domestic and foreign virtual currency exchanges "dealing in virtual currency" in Canada will have to register with the Financial Transactions and Reports Analysis Centre of Canada (FINTRAC) as a money service business and maintain a compliance program with certain enumerated elements. Moreover, any MSB receiving CAN $10,000 or more in virtual currency will also be subject to recordkeeping, customer identification and reporting obligations. One of the objectives of Canada's new requirements is to ensure that "domestic and foreign MSBs are required to fulfill the same obligations."

- **First Cryptosecurities Approved by SEC for Regulation A+ Offering:** Last week, Blockstack Token LLC's offering of up to 295 million Stacks Tokens under Regulation A+ was qualified by the Securities and Exchange Commission. This offering was intended to help Blockstack further the development of the firm's decentralized computer network and decentralized applications. Under the SEC's qualification, Stacks Tokens were eligible for purchase by the general public beginning July 11 and will remain available through September 9, 2019. The offering price was set at US $30/share, and payment for Stacks Tokens may be made in US dollars, bitcoin or ether. SEC Regulation A+ provides a means for certain US and Canadian companies to issue up to US $50 million of equity securities, debt securities and debt securities convertible into equities during a rolling 12 month period, exempt from SEC registration requirements and potentially also exempt from state registration and qualification obligations. (Click here for additional background in the article "Developer of Decentralized Computing Network Files Reg A+ Offering for SEC Approval" in the April 14, 2019 edition of Bridging the Week.)

My View: Although it was important for staff of the SEC and FINRA to publicly identify issues that have been delaying qualification of broker-dealers to handle digital asset securities, it would have been far more helpful for the regulators to advise the industry as to what measures might be taken to satisfy their concerns.

Recently, the Commodity Futures Trading Commission approved the application of Eris Clearing LLC to clear fully collateralized virtual currency futures contracts potentially deliverable into spot cryptocurrencies. In 2011, the CFTC approved Eris Exchange LLC, Eris Clearing's indirect parent company, as a designated contract market. Branded together as "ErisX," Eris Clearing anticipate offering the clearing of digital asset futures contracts traded on Eris Exchange beginning later in 2019. ErisX began offering spot virtual currency contracts earlier this year. (Click here for background in the article "CFTC Approves New Clearing House as First Derivatives Clearing Organization for Fully Collateralized, Deliverable Virtual Currency Futures" in the July 7, 2019 edition of *Bridging the Week*.)

In approving ErisX's order, the CFTC provided a path forward for CFTC registrants wanting to handle cryptocurrencies processed in connection with exchange-traded derivatives contracts and to comply with its equivalent of the SEC's customer protection rule (click here to access 7 U.S.C. § 6d). Drawing on the CFTC's order granting Eris Clearing its DCO authority, and insight into ErisX's proposed practices as described in an ErisX publication entitled "Owning and Safely Maintaining Digital Assets – ErisX's Approach to Custody, Wallets and Security" (click here to access), it appears that the CFTC has reasonable confidence that private keys can be protected through robust policies, procedures and practices that guard against both external and internal fraud, and that at least certain cryptoassets can be seen and verified on their host blockchains. Private insurance, disclosure and third-party validation also have an important role in the CFTC's view of a robust customer protection scheme involving digital assets.

It would be useful for the SEC and FINRA to review standards being applied by the CFTC in approving DCOs to see what measures could be exported to make the two securities regulators more comfortable with SEC registrants handling cryptosecurities. After all, as last week's qualification of Stacks Tokens may portend, more digital securities tokens could be on the way soon. (Click here to see also the CFTC's 2017 order approving LedgerX as a DCO for fully collateralized virtual currency swaps.)

- **International Exchange Sanctioned by CFTC for False Certification Regarding Compliance With Exemptive Order**: The Korea Exchange, Inc. agreed to pay a fine of US $150,000 to resolve charges that it falsely told the Commodity Futures Trading Commission that it complied with the terms of a CFTC-granted exemptive order, when it knew it did not.

The Korea Exchange, a central counterparty clearinghouse, received the exemptive order in October 2015 authorizing it to clear swaps for US persons without registering as a derivatives clearing organization with the CFTC because it was subject to comparable oversight by the Korean Financial Services Commission, its home regulator, as it would be if registered as a DCO. (Click here to access the KRX Order.) As part of its exemptive order, KRX was required to comply in all material respects with the Principles for Financial Market Infrastructures adopted by the Bank of International Settlements (click here to access), and certify its compliance to the CFTC at least

annually.

Among other things, as part of its PFMI obligations, KRX was required to stress test on a daily basis the adequacy of its financial resources and to evaluate and adjust its resources as appropriate in response.

According to the CFTC, from 2016 through early 2018, KRX conducted daily stress tests, but did not evaluate and adjust its resources as required. KRX considered how to fix this problem by October 2017 and changed its policies in on December 18, 2017; it implemented measures to fix its failure in March 2018. Notwithstanding, in February 2018, KRX certified to the CFTC that it observed the PFMIs in "all material respects" and had been complying with all terms in its exemptive order.

This making of a false statement of material facts when KRX knew or reasonably should have known they were false or misleading constituted a violation of applicable law, charged the CFTC. (Click here to access 7 U.S.C. § 9(2).)

KRX settled the CFTC's enforcement action without admitting or denying any of the Commission's findings or conclusions. In addition to paying a fine, KRX agreed to retain a third party to evaluate the exchange's PFMI compliance and to issue an assessment report to the CFTC within six months. The third party will have to conduct a second review of KRX two years after completion of its original report.

Legal Weeds: In September 2018, the CFTC prevailed in an enforcement action against Gregory L. Gramalegui for violating anti-fraud provisions of relevant law and disclosure requirements of CFTC rules in connection with his solicitation of customers for a futures trading system and an advisory service. The federal court in Colorado hearing this matter found that the CFTC proved its allegations and assessed a fine against Mr. Gramalegui of US $1.9 million and ordered disgorgement.

Among its claims, the CFTC charged Mr. Gramalegui with making false statements to it in violation of the same provision of law relied on by the CFTC in its KRX enforcement action. This law was adopted as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act in 2010.

According to the court, "a statement is actionable under this section when it is either literally untrue or when it fails to include all information necessary to give the recipient a complete and accurate picture of the state of affairs communicated." Here the court found that the defendant violated this provision of law when he told the CFTC in connection with a deposition that he did not advertise for clients but that clients found him through Google and other search engines; he did not send out marketing emails between September 2014 and 2015; and he played no role in a statement on his website that "most traders have made enough on one trade to pay for the[ir] monthly subscription," as well as when he did not tell the CFTC that he communicated to customers other than through one identified email account and that he had altered the copy of his website prior to producing it to the CFTC, among other statements and misstatements. Each of these statements was false or misleading, said the court.

Mom always said to tell the truth and not to mislead people. The CFTC has tools to sanction persons for not following mom's advice – even persons located outside the United States. (Click here to access the court's full decision.)

- **One + One No Longer Equals One** – CFTC Staff Offers Path for FCMs to Treat Separate Accounts of Single Customer as Separate Accounts of Distinct Entities: Staff of the Commodity Futures Trading Commission issued an advisory authorizing derivatives clearing organizations to permit their futures commission merchant clearing members carrying multiple accounts for the same beneficial owner to treat each account as an account of a separate entity for purposes of disbursements under ordinary circumstances, subject to conditions. Specifically, an FCM can remit funds back to a customer from an over-margined account, while another account of the same customer is subject to a margin call.

For customer accounts under the same beneficial ownership at an FCM to benefit from this treatment, each account must satisfy all initial and variation margin calls within "a one day period." Moreover, the customer cannot be in default under the FCM's customer agreement, and neither the customer nor the FCM can be in financial distress or bankruptcy, among other circumstances. If the FCM chooses to offer this arrangement to a customer, it cannot repeatedly change it; must disclose in writing to the customer that in case of the FCM's bankruptcy, all separate accounts will be combined; and must disclose to all customers – whether they might take advantage of the FCM authority or not – that it makes these arrangements available. By no later than July 1, 2020, FCMs seeking to take advantage of these arrangements must update their internal risk management policies and procedures to include stress testing and credit limits on individual accounts and combined accounts of the same beneficial owner.

Notwithstanding, no FCM documentation may prevent an FCM from (1) calling the beneficial owner of an account for margin or (2) commencing a lawsuit against a beneficial owner for a shortfall in any account where the beneficial owner fails to meet a margin call. No FCM documentation may guarantee a beneficial owner against any loss or promise to limit loss.

In response to the CFTC advisory, CME Clearing authorized its clearing member FCMs to effectuate the CFTC's advisory for their customers (click here to access). The CFTC's Guidance was issued by the Divisions of Clearing and Risk and Swap Dealer and Intermediary Oversight.

My View: In May 2019, the futures industry's Joint Audit Committee issued two reminders to futures commission merchants, one regarding the prohibition against making guarantees against loss contained in a CFTC rule (click here to access CFTC Rule 1.56(b).), and the other mandating aggregation of all accounts of the same beneficial owner for the same regulatory account classification (e.g., customer segregated, customer secured and cleared swaps customer) for margin purposes, as previously advised by JAC in May 2014 (click here to access JAC Regulatory Alert 14-03).

(Click here for background regarding the JAC's May 2019 guidances in the article "Futures Industry Self-Regulators Warn FCMs Against Limiting Losses of Customers and Not Combining Accounts for Aggregate Margin Call Calculations" in the May 19, 2019 edition of *Bridging the Week*.)

The new CFTC advisory reiterates JAC's reminder regarding customer documentation, but modifies JAC's instructions on the handling of different accounts of the same beneficial owner for margin purposes for each DCO that implements the CFTC advisory (as CME Clearing already has).

As a result, the JAC should conform its May 2019 guidance to the CFTC's current advisory to eradicate regulatory ambiguity as soon as possible. It would be helpful, when doing so, for the JAC to address what is "one business day" for purposes of meeting a margin call (24 hours or end of the following business day) as well as providing expectations regarding intra-day margin calls.

More Briefly:

- **FINRA Settles Claim Broker-Dealer Ignored Multiple Red Flags of Potentially Manipulative Trading and Took Inadequate Measures in Response**: Clearpool Execution Services, LLC, a registered broker-dealer, agreed to pay a fine of US $473,000 to be shared by the Financial Industry Regulatory Authority and various exchanges, to settle charges brought by the self-regulatory organization that from July 2014 through September 2016 it failed to implement and maintain an adequate system reasonably designed to detect and preclude manipulative trading in the form of layering and spoofing.

In its Letter of Waiver, Acceptance and Consent, FINRA — for itself and on behalf of all the SROs – acknowledged that Clearpool used systems to potentially block manipulative trades on a pre-trade basis and to evaluate trades for manipulative conduct on a T+1 basis. These systems generated "thousands of layering and other manipulative alerts" at FINRA, multiple exchanges and in the firm's surveillance systems. However, Clearpool at first limited its review of suspect trades on a T+1 basis, and then, when it amended its pre-trade checks with a real-time surveillance system in February 2015, set parameters for pre-trade blocks that were too generous, claimed FINRA. In response to reports it reviewed, Clearpool terminated trading privileges of hundreds of individual traders of one customer account it carried but never terminated the account itself. FINRA said this was despite the account being subject to multiple inquiries by SROs, and other red flags.

- **Japan FSA and US CFTC Agree to Authorize Eligible Local Nationals to Trade Swaps on Other's Registered Trading Facilities Based on Regulation Comparability Determination:** The Commodity Futures Trading Commission exempted certain Japan-based electronic trading platforms that offer derivatives trading from registration as a swap execution facility, while the Japan Financial Services Agency committed to facilitate the qualification of SEFs to be authorized as foreign ETP operators in Japan without local registration. The CFTC's exemption applies to enumerated Japan-based ETPs (as amended from time to time) regulated by the JFSA, subject to various conditions. Among other things, counterparties subject to swaps reporting requirements under CFTC rules must continue to make required reports notwithstanding their execution of swaps on an exempt foreign ETP.

- **Proposed CFTC Rule to Exempt Certain Non-US CCPs From DCO Registration Draws Strong Dissent From Two Commissioners and One Mild Expression of Skepticism**: The Commodity Futures Trading Commission issued two proposals related to non-US-based derivatives clearing organizations. Under one proposal, non-US-based central counterparty clearinghouses that are not systemically important and are subject to "comparable, comprehensive supervision and regulation" by competent regulators in their home country may qualify as an exempt DCO. In such capacity, foreign CCPs may facilitate clearing services for swaps entered into by eligible US contract participants through non-US clearing members that are not registered as futures commission merchants. Additionally, the CFTC proposed that non-US-based CCPs could register as DCOs with the CFTC and satisfy their registration requirements mostly through adherence to their local home country regulatory obligations. The CFTC would continue to require adherence to US customer funds protection requirements.

Although he supported the CFTC's proposal to mostly defer to foreign regulators' oversight of non-systemically important non-US-registered DCOs, Commissioner Dan Berkovitz, along with Commissioner Rostin Behnam, dissented from the CFTC's proposal to allow certain non-US CCPs to be exempted from DCO registration. According to Mr. Berkovitz, "[t]he proposal would jeopardize U.S. customers, create systemic risks to the U.S. financial system, promote the use of foreign intermediaries at the expense of U.S. firms, and exceed this agency's limited exemptive authority." Mr. Berkovitz most objected to the proposal's prohibition against US-registered FCMs from serving as FCMs for US customers at exempt DCOs. Although she voted in favor of the proposal to exempt certain foreign CCPs from registering as DCOs, Commissioner Dawn Stump also expressed concerns about the inability of registered FCMs to provide services to US persons and requested public comment on this aspect.

- **FSB Seeks Financial Industry Input on Response and Recovery Practices for Cyber Incidents**: As part of its intended development of effective practices related to financial institutions' response and recovery practices for cybersecurity incidents, the Financial Stability Board is seeking input from financial industry members. Ultimately, FSB proposes to publicize effective practices based on industry input and other sources, and not to articulate any international standard. Responses will be accepted through August 28, 2019. FSB is an international organization comprising representatives of national authorities responsible for financial stability in material international financial centers that monitors and makes recommendations about the global financial system.

Follow-up:

- **CFTC Echoes SEC Proposal to Margin Security Futures at 15 Percent of Current Market Value**: The Commodity Futures Trading Commission joined the Securities and Exchange Commission in proposing that the minimum margin on security futures contracts be set at 15 percent of current market value. Previously, the SEC proposed amendments to a regulation that would lower the margin requirement for unhedged security futures from 20 percent to 15 percent, pending CFTC approval of the same proposal. The SEC and CFTC have now also jointly proposed conforming revisions to their margin offset table to enable exchanges to set margin less than 20 percent for customers holding security futures and one or more related securities and futures. Comments to the Commissions' proposals will be accepted for 30 days following their publication in the *Federal Register*. (Click here for background regarding the proposals in the article "Reduced Margin Requirements for Security-Based Futures Proposed by SEC; CFTC View Pending" in the July 7, 2019 edition of *Bridging the Week*.)

For further information:

Canada to Require Registration of Digital Asset Exchanges as Money Service Businesses:
http://www.gazette.gc.ca/rp-pr/p2/2019/2019-07-10/html/sor-dors240-eng.html

CFTC Echoes SEC Proposal to Margin Security Futures at 15 Percent of Current Market Value:
https://www.cftc.gov/media/2196/FederalRegister070919b/download

Customer Protection ABC, How Does It Translate to Cryptosecurity Custody? – SEC and FINRA Provide Considerations for Broker-Dealers:
https://www.sec.gov/news/public-statement/joint-staff-statement-broker-dealer-custody-digital-asset-securities

FINRA Settles Claim Broker-Dealer Ignored Multiple Red Flags of Potentially Manipulative Trading and Took Inadequate Measures in Response:
http://www.finra.org/sites/default/files/fda_documents/2014042373804%20Clearpool%20Execution%20Services%2C%20LLC%20CRD%201

First Cryptosecurities Approved by SEC for Regulation A+ Offering:
https://blog.blockstack.org/blockstack-token-sale-sec-qualified/

FSB Seeks Financial Industry Input on Response and Recovery Practices for Cyber Incidents:

https://www.fsb.org/wp-content/uploads/P110719.pdf

International Exchange Sanctioned by CFTC for False Certification Regarding Compliance With Exemptive Order:
https://www.cftc.gov/media/2221/enfkoreaexchangeorder071219/download

Japan FSA and US CFTC Agree to Authorize Eligible Local Nationals to Trade Swaps on Other's Registered Trading Facilities Based on Regulation Comparability Determination:
https://www.cftc.gov/media/2216/JapaneseCEASection5hgOrder/download

One + One No Longer Equals One – CFTC Staff Offers Path for FCMs to Treat Separate Accounts of Single Customer as Separate Accounts of Distinct Entities:
https://www.cftc.gov/csl/19-17/download

Proposed CFTC Rule to Exempt Certain Non-US CCPs From DCO Registration Draws Strong Dissent From Two Commissioners and One Mild Expression of Skepticism:

- Giancarlo:
  https://www.cftc.gov/PressRoom/SpeechesTestimony/giancarlostatement071119
- Berkovitz:
  https://www.cftc.gov/PressRoom/SpeechesTestimony/berkovitzstatement071119?utm_source=govdelivery
- Stump:
  https://www.cftc.gov/PressRoom/SpeechesTestimony/stumpstatement071119

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