THE NATIONAL LAW REVIEW

Insider Trading in Futures; Newer, Tougher AML Requirements; New CCO Obligations; Possible Bitcoin Fraud - Bridging the Weeks: November 23 – December 7, 2015 [VIDEO]

Monday, December 7, 2015

Compliance officers may be in the bullseye again as a result of new regulatory proposals introduced during the prior two weeks by the ***New York State Department of Financial Services*** and the ***Commodity Futures Trading Commission***. Meanwhile, another compliance officer put himself in the bullseye of the Securities and Exchange Commission by purportedly trading on confidential information his employer entrusted him to safeguard and not to profit from. Finally, the CFTC, for the first time, used its new ***Dodd-Frank*** anti-manipulation authority to sue and obtain a settlement from an individual charged with a securities law-type insider trading violation in connection with his personal futures trading. As a result, the following matters are covered in this week's edition of *Bridging the Weeks*:

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Bridging the Week

Criminal Law / Business Crimes
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CFTC Brings First Insider Trading-Type Enforcement Action Based on New Anti-Manipulation Authority:

Last week the Commodity Futures Trading Commission brought and settled its first enforcement action sounding in the securities concept of insider trading, relying on the relatively new Dodd-Frank Wall Street Reform and Consumer Protection Act's prohibition against employment of a manipulative or deceptive device in connection with futures trading.

According to the CFTC, from September 3 through November 26, 2013, Arya Motazedi, a gasoline trader employed by an unnamed "large, publicly traded corporation" misappropriated "non-public, confidential and material information" of his employer to benefit his own trading of energy futures contracts listed on the New York Mercantile Exchange, Inc. Specifically, on 34 occasions Mr. Motazedi allegedly traded opposite his employer's accounts to effectively and illicitly transfer funds from the firm to himself, and on 12 other occasions he traded in advance of orders he placed for the firm to generate "additional profits for himself to the detriment of the company."

The CFTC claimed that Mr. Motazedi owed a duty of confidentiality to his employer. This duty arose, said the Commission, because he and his employer "shared a relationship of trust and confidence," and because his employer had express policies that prohibited him from engaging in personal transactions that "created an actual or potential conflict of interest."

The CFTC charged that Mr. Motazedi's trading constituted fraud, as well as impermissible fictitious sales and non-competitive trades.

The CFTC also claimed that Mr. Motazedi's trading violated the relatively new Dodd-Frank provision (click here to access Commodity Exchange Act Section 6(c)(1)), US Code §9(1), and the corresponding CFTC rule (click here to access CFTC Rule 180.1) that prohibit any person from engaging in "any manipulative or deceptive device or contrivance" in connection with futures trading that uses, attempts to use, or employs "any manipulative device, scheme or artifice to defraud" or operates "as a fraud or deceit upon any person." The CFTC said that Mr. Motazedi's "knowing or reckless misappropriation and misuse" of his employer's proprietary trading information to trade his personal accounts breached his duty to his employer and thus was a violation of the relevant law and CFTC rule.

To resolve this matter, Mr. Motazedi agreed to pay restitution of almost US $217,000 to his employer and a fine of US $100,000, and agreed to be permanently banned from trading CFTC-supervised products subject to the rules of a registered trading facility.

On the same day the CFTC action and settlement were announced, the CME Group and Mr. Motazedi also settled a disciplinary action brought by NYMEX related to the same essential facts at issue in the CFTC matter. Mr. Motazedi also agreed to pay restitution to his former employer, a trading suspension and another fine of US $100,000 to resolve the NYMEX action.

My View: Once again, the Commodity Futures Trading Commission's Division of Enforcement has pushed the envelope on the application of Dodd-Frank's prohibition against employment of a manipulative or deceptive device in connection with futures trading, and its parallel rule 180.1. Here the CFTC used these provisions to prosecute an individual who allegedly traded based on the confidential information of his employer to his employer's detriment. The CFTC has used these provisions previously in a wide range of enforcement actions stemming from its first use in the JP Morgan “London Whale” episode to allegations of illegal off-exchange metals transactions, claims of more traditional manipulation of wheat and allegations of spoofing. The CFTC clearly regards its new Dodd-Frank authority “as a broad, catch-all provision reaching fraud in all its forms – that is, intentional or reckless conduct that deceives or defrauds market participants.” Because it is not clear what limits, if any, a court may ultimately place on the CFTC in using these provisions, they are a powerful tool for the Commission to pressure settlements from potential respondents. This is worrisome for the industry, which can only hope the Division uses its new tools judiciously.

Briefly:

- **NYS Proposes Tough New AML Requirements; International Bank Sanctioned by UK FCA for Alleged AML Breakdown**: The New York State Department of Financial Services has proposed new tough anti-money laundering and financial crime prevention regulations for NYS-regulated banking entities, as well as certain non-bank entities including check cashers and money transmitters licensed under NY’s banking law. Under proposed new rules, affected entities must have enhanced transaction monitoring and filtering programs that “reflect all current [AML laws], regulations and alerts” and that are designed to stop transactions that are prohibited by US government sanctions programs. They must also have processes to help ensure their transaction monitoring and filtering programs utilize accurate data from all relevant sources. Moreover, on an annual basis, the chief compliance officer or functional equivalent of an affected entity must certify under oath that the firm’s transaction monitoring and filtering program “complies” with all provisions of the new regulation. The new proposed rules will be subject to a 45-day comment period after their publication in the *NYS Register*. Separately, Barclays Bank plc agreed to pay a financial penalty of over GBP 72 million (approximately US $108 million) to the Financial Conduct Authority in the UK related to a single transaction arranged during 2011 and 2012 “for a number of ultra-high net worth politically exposed persons.” FCA claimed that, in arranging the transaction – which was valued at GBP 1.88 billion (approximately, over US $2.8 billion) – Barclays did not engage in enhanced due diligence despite red flags that should have prompted greater inquiry. It was also unclear, at the relevant time, said the FCA, “who, if anyone, within Barclay’s front office senior management … was responsible overall for overseeing [the firm’s] handling of the financial crime risks associated with [the relevant transaction].” Importantly, FCA brought its action although it made no finding that “financial crime was facilitated by Barclays.”

My View: Compliance officers will be placed in an impossible circumstance if they must certify that their firms comply with all laws, even if just to the best of their knowledge. It is one thing to require a chief compliance officer to prepare a firm’s annual compliance report, relying on sub-certifications from various corporate officers; however, the obligation to certify its accuracy should more appropriately lie with the chief executive officer. This is because, ultimately, all corporate officers report to the CEO, not the CCO. The CCO is not a supervisor. Moreover, CCOs are employees of a firm, not of the State of NY, and should not be viewed as adjuncts to government enforcement staff.

- **Ex-Compliance Officer Charged With Trading Stocks Based on Information His Employer Expected Him to Protect**: An ex-compliance officer of Goldman, Sachs & Co. was charged by the Securities and Exchange Commission with trading on confidential inside information he was entrusted to use for internal surveillance purposes, not for proprietary gain. According to the SEC, from July to October 2015, Yue Han was employed by GSCO as an associate in its Surveillance Analytics Group within the company’s compliance department. In connection with at least four companies GSCO advised on mergers and acquisitions, Mr. Han traded for his own account or that of an apparent relative in China based on information he accessed as a result of his position with the firm, said the SEC. In October 2015, before this case was filed, Mr. Han left GSCO and the United States and is believed now to be in Shanghai. The SEC seeks an asset freeze, an injunction, disgorgement and a fine against Mr. Han, as well as Wei Han, the apparent relative whose account Mr. Han traded for.

- **Multiple Swap Dealers Sued for Allegedly Impeding Roll-Out of Centrally Executed Interest Rate Swaps**; **EU Shuts Down Inquiry Regarding Credit Default Swaps**: The Public School Teachers' Pension and Retirement Fund of Chicago filed a purported class action lawsuit against 12 swap dealers and, in some cases, certain of their affiliates, alleging they conspired to prevent interest rate swaps from being traded on exchanges. To support its allegation, plaintiff claimed, among other things, that respondents worked together to coerce IRS swap execution facilities “to allow only a Request for Quote … trading method.” According to the plaintiff, executing trades through an RFQ is functionally equivalent to executing a trade opposite a dealer over-the-counter. Plaintiff also alleged that respondents “jointly agreed” to boycott SEFs “that took steps to permit the buy-side to trade IRS on electronic platforms outside of the Dealer Defendants’ control” and “force” SEFs to require the “disclosure of the identity of every swap counterparty to the other on every trade.” The plaintiff filed its lawsuit in a federal court in Manhattan. Separately, the European Commission announced it has closed antitrust proceedings against 13 investment banks related to credit default swaps trading. In 2013, the EC had raised preliminary concerns that the banks "had coordinated" to prevent Deutsche Borse in 2007 and the Chicago Mercantile Exchange in 2008 from offering a CDS marketplace. The EC said it is still investigating the actions of Markit and the International Swaps and Derivatives Association in connection with this matter. (Click here to access the initial EC press release regarding its investigation.)

- **Flash Boys Lawsuit Against CME Group Dismissed**: A US federal court in Chicago dismissed a lawsuit previously brought by a purported class of public investors who claimed that, beginning in 2005, the Chicago Board of Trade and the Chicago Mercantile Exchange disadvantaged their trading by allowing certain high-frequency traders "to profit from peeking at everyone else's orders and price data and to act on this price and order information." The court dismissed the lawsuit claiming that, in many cases, there was no private right of action for allegations made by plaintiffs, or they did not plead their cause of action with sufficient detail. (Click here for details regarding plaintiff's lawsuit in the article, "*Flash Boys* Redux: CBOT and CME Sued for Allegedly Revealing Price Data to High Frequency Traders Before Anyone Else; CME Vehemently Refutes Charges" in the April 13, 2014 edition of *Bridging the Week*.) In August 2015, a federal court in New York City dismissed five lawsuits against multiple stock exchanges, Barclays PLC and Barclays Capital Inc., that all echoed claims made in Michael Lewis's 2014 book *Flash Boys: A Wall Street Revolt* that high-frequency traders have gained an unfair advantage trading stocks. (Click here for details.)

- **Spoofing Case Filed by SEC**: Three individuals and two trading companies were charged by the Securities and Exchange Commission with spoofing and engaging in a fraudulent trading scheme to take advantage of certain benefits received by public investors. The individuals are Behruz Afshar, Shahryar Afshar, and Richard Kenny, IV, while the trading companies are Fineline Trading Group LLC and Makino Capital LLC. Under various exchange rules, option orders from public customers must be identified as customer or professional. According to the SEC, orders identified as customer have priority of execution over orders marked professional, and also can earn higher rebates and pay lower fees. The SEC claimed that, from at least December 2010 to December 2012, the Afshars and Mr. Kenny fraudulently represented to Lightspeed Trading LLC, a broker-dealer carrying accounts for Fineline and Makino, that the firms were separately owned by Behruz and Shahryar, respectively, when in fact Behruz had an ownership interest in both companies. This enabled the three individuals to direct most of their trading for each quarter to one of the two companies only, ensuring that the other company qualified as a public customer the following quarter and received public customer benefits. The SEC claimed this acted as a deceit on the relevant exchanges. In addition, the SEC claimed that the respondents engaged in "spoofing"-type conduct on the Nasdaq OMX PHLX exchange in order to receive rebates for providing market liquidity. According to the SEC, respondents would place larger orders on one side of the market that were hidden from public disclosure because of their nature (i.e., all or nothing orders), and small spoofing-type orders on the other side of the market that would improve the prevailing best bid or offer in order to attract orders from other market participants. The SEC claimed this operated as a deceit against the other market participants who joined the fake orders placed by respondents and ended up executing transactions against the larger orders previously placed by respondents on the opposite side of the market. These other market participants ended up paying extra fees for taking liquidity from the marketplace, while the respondents received rebates for providing liquidity. The SEC seeks disgorgement, civil penalties and a cease and desist order from respondents.

- **SEC Sues Promoters of Investments in Bitcoin Mining Power for Offering and Selling a Ponzi Scheme**: The Securities and Exchange Commission filed a lawsuit in a US federal court in Connecticut claiming that Homero Garza's, GAW Miners, LLC's and ZenMiner, LLC's (d/b/a Zen Cloud) offer and sale to investors of interests in computing power to mine virtual currency was illegal and constituted a Ponzi scheme. According to the SEC, from August through December 2014, respondents sold investment contracts to over 10,000 investors that represented shares in profits that would be generated from computing power (termed "hashlets") they collectively purchased to mine virtual currency. In general, "miners" of some virtual currency, including Bitcoin, use increasingly powerful computers to solve complex mathematical problems and are rewarded for success by receiving newly created digital coins. Such computers also store the transaction history of all previously created digital coins on a public ledger, which, in the case of Bitcoin, is known as the blockchain. However, claimed the SEC, respondents sold interests in far more computing power than they actually had. As a result, funds raised from new investors, were sometimes used to pay off older investors. The SEC claimed that the sales by respondents of investment contracts in computing power constituted fraud and the offer and sale of unregistered securities. The SEC seeks an injunction against the defendants as well as disgorgement of profits and a fine.

- **CFTC Proposes Regulation of Automated and Algorithmic Trading Systems and Registration of Certain Proprietary Traders**: The Commodity Futures Trading Commission proposed a comprehensive set of new rules that, if adopted, potentially would impose many new obligations on certain CFTC registrants that use automated or algorithmic trading systems to trade futures, options or swaps on designated contract markets (but not on swap execution facilities). Potentially impacted registrants are future commission merchants, floor brokers, swap dealers, major swap participants, commodity pool operators, commodity trading advisors, introducing brokers and certain persons proposed to be registered as floor traders for the first time because of their automated or algorithmic trading activities. FCMs who are clearing members of DCMs and carry accounts for covered algorithmic traders; DCMs (but not SEFs); and the National Futures Association would also be impacted by the CFTC's proposed new requirements. The CFTC's proposed new rules would also mandate the registration with the CFTC as a floor trader any person who uses an algorithmic trading system that electronically and directly routes orders to a DCM other than first through a clearing-member FCM, unless such person is otherwise registered with the CFTC in another approved capacity. All current categories of CFTC registrants that engage in algorithmic trading and newly required to be registered floor traders would be required to maintain copies of all source code used in a production environment, including all changes, in accordance with general CFTC record-keeping requirements (e.g., retain for five years), and, upon request, make available such source code for inspection by CFTC and US Department of Justice staff without subpoena or other process of law. The proposed new rules also impose new requirements on compliance officers of algorithmic trading firms, as well as of FCMs that carry positions for algorithmic trading customers.

My View: As I reflected in my initial commentary on proposed Regulation AT, the Commodity Future Trading Commission's proposed rules were designed with noble objectives – to prevent and ameliorate the potential impact of algorithmic trading systems breaking down and causing widespread adverse market impact or being used for nefarious purposes. The proposed rules generally are not prescriptive, but attempt to federalize already existing best practices and, in many cases, rules of exchanges and the National Futures Association. That being said, there are material provisions in the proposed regulation that hopefully will be fixed in any final rule. Among other things, source code should not be required to be made available as easily as contemplated to the Commodity Futures Trading Commission or US Department of Justice staff. Moreover, the role of compliance officers at so-called "AT Persons" must be clarified. The CFTC must make it clear that compliance officers are not potentially exposed to liability if an algorithmic trading program goes haywire simply because AT persons are required to ensure that non-compliance staff and compliance staff have a plan "of internal coordination and communication between [such persons] regarding design, changes, testing and controls," which plan should be constructed "to detect and prevent" breaches of law and rules by algorithmic systems. Finally, threshold issues must be considered: is there a better way to build upon best practices already adopted by many algorithmic traders and other industry participants, rather than to create a new federal infrastructure? Might the implications under proposed Regulation AT of a breach of internal procedures by AT persons prompt AT persons to formally lessen already implemented best practices to avoid potential regulatory issues? Finally, under the proposed regulation, the National Futures Association is potentially required to "establish and maintain a program," among other things, for "perfecting the mechanisms of trading on designated contract markets by adopting rules for each category of member" dealing with pre-trade risk controls, standards for system development, testing and other matters, and training of staff" (emphasis added). NFA may have very talented staff, but it might be a bit too much to expect even these highly qualified professionals to come up with measures that "perfect" a process! Moreover, as one of my colleagues at Katten Muchin Rosenman has pointed out to me, it appears unlikely that NFA has the current authority to create any such program – perfect or less than perfect – under its prevailing Articles of Incorporation (click here to access the relevant potentially problematic provision – Article III, Section 2(b)).

- **Copper Trader Ordered to Disgorge US $3 Million to Settle CME Group Disciplinary Action for Two-Day Position Limit Violation**: Han Lin, a non-member of the New York Mercantile Exchange, agreed to disgorge profits of almost US $3 million for allegedly violating spot month position limits in copper futures after the close of business on one day – November 26, 2014 – which he liquidated the following business day. Mr. Lin also agreed to pay a fine of US $65,000 to resolve the disciplinary action brought by NYMEX. Separately, Toronto-Dominion Bank, also a NYMEX non-member, agreed to pay a fine of US $15,000 to resolve a disciplinary action claiming that, on October 23, 2014, it entered into one exchange for related position transaction which did not involve the bona fide transfer of a related position. Finally, two other NYMEX non-members, Eric Mlak and Cornerstone Futures LLC, agreed to settle charges related to their alleged execution of block trades for customers on multiple occasions that were not reported to the exchange within required time periods. Cornerstone was also charged with not initially reporting accurate trade details related to the block trades to NYMEX. To resolve these matters, Mr. Mlak agreed to a three-month trading suspension for any CME Group-traded product, while Cornerstone agreed to pay a fine of US $50,000.

And more briefly:

- **Members of European Parliament Ask for Delay in MiFID II Roll-Out**: It appears increasingly likely that there will be a delay in the implementation date of the Markets in Financial Instruments Directive II and the Markets in Financial Instruments Regulation, currently scheduled for January 3, 2017. Last week two members of the European Parliament – Roberto Gualtieri and Markus Ferber – formally wrote to Jonathan Hill, Commissioner for Financial Stability, Financial Services and Capital Markets Union for the European Commission, noting they are "open to considering a wholesale delay" of the roll-out date of MiFID II and MiFIR. On November 10, 2015, Steven Maijoor, Chair of the European Securities and Markets Authority, advised the Economic and Monetary Affairs Committee of the European Parliament that the "timing for stakeholders and regulators alike to implement the rules and build the necessary IT systems is extremely tight" and that some aspects of scheduled implementation were "already unfeasible."

- **Canadian Securities Regulators Implement Best Practice Principles for CCPs and Equivalents**: Eight Canadian provincial securities regulators agreed to coordinate their oversight of clearing agencies, trade repositories and matching service utilities. The regulators executed a memorandum of understanding in which they agreed, among other things, that a single regulator will act as the lead overseer for each covered entity.
- **IOSCO and BIS Issue Best Practices to Promote Cybersecurity by Financial Market Infrastructures**: The International Organization of Securities Commissions and the Bank for International Settlements issued a consultation paper regarding additional measures financial market infrastructures (e.g., clearinghouses, exchanges) should implement to help strengthen their defenses against cyber attacks and their ability to recover quickly should an attack occur. Among other things, FMIs must ensure (1) continual buy-in by directors and senior management to maintaining a robust cybersecurity program; (2) the ability to recover quickly and safely from any attack; and (3) they receive good intelligence regarding potential threats and undertake ongoing systems' testing. Comments should be submitted by February 23, 2016.
- **European Interest Rate Swap Clearing to Begin June 2016**: Central clearing of certain classes of interest rate swaps will become mandatory in the European Union beginning July 21, 2016. These classes are plain vanilla fixed to float IRS, basis or float to float IRS, forward rate agreements and overnight index swaps.
- **NFA Provides Guidance on Annual Affirmation Requirement for Persons Claiming Exemption or Exclusion from CPO or CTA Registration Requirements**: The National Futures Association published guidance on the annual affirmation requirement for entities currently operating under an exemption for registration as a commodity pool operator or a commodity pool adviser. Under CFTC rule, any person claiming such exemption has to annually affirm the basis of its exemption or exclusion within 60 days of each calendar year – or next year, by February 29, 2016.
- **SEC Currently Investigating a Possible Offer and Sale of OTC Security-Based Swaps to Non-Qualified Counterparties**: The Securities and Exchange Commission filed a subpoena enforcement action in a federal court in San Francisco where it said that it was currently investigating whether NetCirq, LLC, a formerly registered broker-dealer, may have engaged in unlawful activities related to the secondary market trading of pre-initial publicly offered companies. Specifically, the SEC is endeavoring to determine whether the company may have sold or offered security-based swaps to non-eligible persons without a registration statement being in place, or not on a licensed securities exchange. The SEC action does not relate to the substance of its investigation, but solely to an effort to obtain certain documents from respondent which the respondent, to date, has not yet provided.