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Bridging the Week: April 10 to 14 and 17, 2017 (Theft of Trade Secrets; No Spoofing; Third-Party Payments; Fake News) [VIDEO]

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Bridging the Week

Global
Financial Institutions & Banking
Securities & SEC
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Two employees of unrelated trading firms were criminally charged in a federal court in New York City with stealing or trying to steal the source code of their employers' proprietary trading platforms – one individual last week and the other on April 7. Separately, a broker-dealer and its chief executive officer accused last month by the Securities and Exchange Commission of aiding and abetting a client's purported ongoing manipulative trading activities vehemently disputed such allegations, and said that its customer's trading represented ordinary market activity. Additionally, the SEC sued 27 firms and individuals for their role in issuing fake news related to certain companies. Fake news? I've heard that somewhere before! As a result, the following matters are covered in this week's edition of *Bridging the Week*:

- Employees Criminally Charged With Theft of Trade Secrets From Two Financial Services Trading Firms ;
- Defendants Named in SEC Spoofing Claim Vehemently Dispute Customer's Trading Violated Law;
- FINRA Resolves Charges Against Broker-Dealer for Inadequate Controls for Third-Party Payments From Customer Accounts; Hong Kong Regulator Sanctions Yet Another Broker for Similar Offense;
- SEC Sues 27 Firms and Individuals Over Fake News to Mislead Investors; and more.

Video Version:

Article Version

Briefly:

- **Employees Criminally Charged With Theft of Trade Secrets From Two Financial Services Trading Firms**: One former employee of Susquehanna International Group LP ("SIG") and another from KCG Holdings, Inc. were criminally charged in federal court with offenses related to the alleged theft of trade secrets from their former employers. In one action last week, Dmitry Sazonov was criminally charged for his alleged attempted theft of proprietary computer code for an SIG trading platform; while in the other, Zhengquang Zhang was criminally charged on April 7 for his alleged theft of proprietary computer code regarding algorithmic models and the trading platforms of KCG. Both cases were initiated by the US Attorney's Office for the Southern District of New York. According to the complaint against him, Mr. Sazonov was employed as a software engineer by "Firm-1" from July 2004 through February 6, 2017 ("Firm 1" is associated with SIG through Mr. Sazonov's LinkedIn profile). After he learned that a fellow employee had left SIG on February 3, Mr. Sazonov purportedly copied and converted SIG proprietary source code to PDF format, and subsequently appended separate pieces of the newly created PDF file to innocuous documents and files on his company desktop computer. He then repeatedly attempted to obtain these documents and files after he was later terminated by SIG on February 6. In the second action, Mr. Zhang, a technician employed by KCG from March 2010 through March 2017, was alleged to have stolen proprietary source code and transferred it to an external third-party development site, and also to have accessed the computer desktops of other KCG employees remotely without permission. (Mr. Zhang can also be tied to KCG through his LinkedIn profile.) If convicted, both Mr. Sazonov and Mr. Zhang could be subject to imprisonment up to 10 years and a fine of US $250,000.

  My View: When Regulation Automated Trading was first proposed by the

Commodity Futures Trading Commission in November 2015, one of the greatest objections was that persons likely subject to the regulation would have to provide to the Commodity Futures Trading Commission and the Department of Justice, upon request and without subpoena, proprietary source code related to their trading systems. The CFTC endeavored to make this requirement more palatable in a November 2016 supplemental proposal by subjecting any request for source code by the CFTC to a heightened process of review. (Click here for background on Regulation AT and the supplemental proposal in the article "Proposed Regulation AT Amended by CFTC; Attempts to Reduce Universe of Most Affected to No More Than 120 Persons" in the November 6, 2016 edition of *Bridging the Week*.) However, even the revised proposal was widely criticized as inadequate. As current Acting Chairman of the CFTC, J. Christopher Giancarlo said at the time, "The Supplemental Notice before us today … would strip owners of intellectual property of due process of law" by not requiring production of source code solely by a subpoena. "Abrogating the legal rights of property owners is not assuaged by imposing a few additional procedural burdens on the government agency seizing their property." Even if the defendants in the two criminal actions filed last week are ultimately exonerated, the criminal charges against them provide a fresh reminder of how surreptitiously source code can be stolen, and why it is so important that owners of source code have a say before an objective tribunal in how it might be produced to the government when required by law.

- **Defendants Named in SEC Spoofing Claim Vehemently Dispute Customer's Trading Violated Law**: Lek Securities Corporation ("LEK"), a broker-dealer, and Samuel Lek, the firm's principal owner and chief executive officer, vehemently opposed the motion of the Securities and Exchange Commission filed in March in a federal court in New York City, seeking a preliminary injunction against them for their role in allowing a customer, Avalon FA Ltd, to engage in purported manipulative trading activity through LEK. Separately, Avalon also filed papers opposing the entry of a preliminary injunction against it. In its enforcement action against LEK, Mr. Lek and Avalon, the SEC alleged that Avalon engaged in two types of manipulative conduct: layering and cross-market manipulation involving equities and related options from December 2010 through at least September 2016. The SEC said that LEK and Mr. Lek were aware of Avalon's improper activities when, among other things, Mr. Lek received an email in May 2012 explicitly describing the layering scheme from an individual who shortly afterwards became an Avalon trade group leader, as well as when regulators, exchanges and other market participants alerted LEK and Mr. Lek on various occasions from 2012 through 2016 that they were concerned Avalon was engaging in layering. (Click here for details of the prior SEC action in the article "US Broker-Dealer, Its CEO and a Non-US Client Sued by SEC for Layering and Other Manipulative Schemes" in the March 12, 2017 edition of *Bridging the Week*.) In its opposition to the SEC's motion, LEK and Mr. Lek denied any wrongdoing and claimed that the brokerage firm maintained a "robust program" to prevent layering by any of its clients, including Avalon. LEK, Mr. Lek and Avalon all claimed that Avalon's alleged spoofing orders were legitimate and disseminated no false information to the market. The defendants argued that there was nothing "false" about any of Avalon's orders, and that each alleged spoofing order was an order "Avalon was willing to engage in… at the order amounts submitted and necessarily would have been held to them if they had been accepted, which often happened." Late last month, LEK and Mr. Lek were also charged in a disciplinary proceeding by the Financial Industry Regulatory Authority and 10 exchanges with aiding and abetting the alleged manipulative trading of Avalon, as well as other violations. (Click here for further details in the article "Following SEC Action, Broker-Dealer and CEO Also Charged by FINRA and 10 Securities Exchanges With Aiding and Abetting Client's Layering, Spoofing and Cross-Market Manipulation" in the April 2, 2017 edition of *Bridging the Week*.)

> **Legal Weeds**: The Securities and Exchange Commission's enforcement action against LEK, Mr. Lek and Avalon principally charged violations of a general anti-fraud provision of law and a related SEC regulation (Click here to access Section 10(b) of the Securities Exchange Act and SEC Rule 10b-5). Securities law and SEC regulations have no express prohibition against trading conduct sometimes referred to as "spoofing" or "layering." This contrasts with derivatives law, where the Commodity Futures Trading Commission was provided with both an express anti-spoofing and general anti-fraud law in the Dodd-Frank Wall Street Reform and Consumer Protection Act, and afterwards enacted a regulation to parallel the general anti-fraud provision. The CFTC has referenced both provisions in enforcement actions that allege spoofing. (Click here for an example in the article "London-Based Futures Trader Arrested, Sued by CFTC and Criminally Charged With Contributing to the May 2010 "Flash Crash" Through Spoofing" in April 22, 2015 edition of *Between Bridges*.) Currently, a federal appeals court in Chicago is deciding whether the CEA's anti-spoofing provision is unconstitutionally vague following a criminal action brought against Michael Coscia and his subsequent conviction and imprisonment. (Click here for background in the article "Federal District Court Approves Flash Crash Spoofer's US $38 Million Settlement; Federal Appeals Court Appears Sympathetic to Michael Coscia's Claim That Spoofing Prohibition Is Too Vague" in the November 20, 2016 edition of *Bridging the Week*.)

- **FINRA Resolves Charges Against Broker-Dealer for Inadequate Controls for Third-Party Payments From Customer Accounts; Hong Kong Regulator Sanctions Yet Another Broker for Similar Offense**: FSC Securities Corporation, a Securities and Exchange Commission-registered broker-dealer, agreed to pay a fine of US $200,000 to resolve a disciplinary action brought by the Financial Industry Regulatory Authority claiming that it failed to maintain adequate supervisory controls related to the payment of customers funds to non-approved third parties. Specifically, FINRA alleged that, from March 2009 through April 2010, FSC authorized payments to a bank account controlled by PFG, LLC, an investment fund created by a former employee of FSC. A then-current employee of FSC recommended the PFG fund to his clients, even though it was not approved by FSC and he received a percentage of the management fees generated by the fund. Ultimately, the PFG fund lost "millions of dollars" and the customers who invested in the fund suffered "significant losses," said FINRA. FINRA claimed that FSC did not have systems or controls to monitor for patterns of payment from multiple clients to a single third party. Unrelatedly, as has now occurred on multiple recent prior occasions, the HK Securities and Futures Commission resolved a disciplinary action against a licensed HK brokerage firm for failure to have adequate safeguards to prevent the risks of money laundering associated with third-party deposits and transfers. (Click here for background on prior similar enforcement actions by the SFC in the article "Another Broker Sanctioned by HK SFC for AML Violations Related to Money Transfers Between Clients and Third Parties" in the April 9, 2017 edition of *Bridging The Week*.) In this action, SFC claimed that iSTAR International Futures Co. Limited accepted third-party deposits on behalf of clients without appropriate documentation and, in one instance, permitted a payment from a client's account to the account of one of iSTAR's own officers. iSTAR agreed to pay a fine of HK $3 million (approximately US $386,000) to resolve this matter.

> **Compliance Weeds**: These unrelated enforcement actions on different sides of the Pacific Ocean remind me how important it is for regulated institutions to maintain something equivalent to a ledger of all problems of any kind that can be readily reviewed to better detect multiple red flags associated with any customer or other person. Too often firms operate in disparate pillars, where problems seen by one division are not associated with problems seen by another, or regulatory issues considered by one control group (e.g., Anti-Money Laundering) are not considered by another control group (e.g., Compliance) for independent regulatory implications. Additionally, sometimes a firm's monitoring systems are designed to look at multiple problems by single clients, but are not set up to review common problems by multiple clients associated with a single third party or other person (e.g., an internal employee). Enhancements may be in order! (Click here for my related Compliance Weeds associated with the article "Clearing Firm's Failure to File Suspicious Activity Reports in Response to Red Flags Charged as Violation of FINRA Requirements" in the March 26, 2017 edition of *Bridging the Week*.)

- **SEC Sues 27 Firms and Individuals Over Fake News to Mislead Investors**: The Securities and Exchange Commission filed enforcement actions naming 27 individuals and entities for promoting the stocks of multiple public companies through positive spins in published articles and blog entries, while not telling readers that the authors were indirectly paid by the public companies for their bullish sentiments. Moreover, the SEC claimed that in many of the articles the author expressly (and falsely) denied being compensated by the relevant public company. Of the 27 persons named, three are public companies, seven are stock promotion or communication firms, and 17 are individuals, including two chief executive officers, six firm employees and nine writers. All the defendants were charged with committing fraud. To date, 17 of the named defendants have settled their enforcement actions through fines ranging from US $2,200 to US $3 million. In the pending enforcement actions against 10 remaining defendants, the SEC seeks injunctions and fines.

More Briefly:

- **CFTC Staff Gives OK for US FCM to Post Customer Securities to a UK**

Individual Segregated Account: The Division of Swap Dealer and Intermediary Oversight authorized an US-based futures commission merchant to post customer-owned securities with its UK affiliate to margin its customers' foreign futures and foreign options positions executed on a UK-based foreign board of trade and cleared through a central counterparty subject to oversight by the Bank of England as a "regulated clearing house." As a condition for the DSIO's relief, the UK affiliate of the US FCM indicated that it would deposit the US FCM's customers' securities in an individual client segregation account at the CCP as well as adhering to other conditions. The US FCM claimed it required the relief because under European rules a clearing member must have both legal and beneficial ownership of all securities posted with a European CCP as margin or must have customer consent to treat such securities as if it had such ownership. The DSIO said these requirements are inconsistent with its own rules that generally prohibit an FCM from commingling its own money, securities or property with its customer funds. (Click here to access CFTC Rule 30.7(e).)

> **Legal Weeds**: The relief granted by the DSIO to the US FCM was in the form of a no-action letter. According to the CFTC, a no action letter "binds only the staff of the Division that issued it or the Office of the General Counsel with respect to the specific fact situation and persons addressed by the letter."

- **Financial Conduct Authority Seeks Comments on Proposed Distributed Ledger Technology Regulation**: The UK Financial Conduct Authority issued a discussion paper on distributed ledger technology and seeks feedback through July 17. Although the FCA acknowledged that there is no single formal definition of DLT, it observed that DLT can be described "as a set of technological solutions that enables a single, sequenced and cryptographically-secured record of activity to be safely distributed to, and acted upon by a network of varied participants." The FCA said that, while it is technology neutral, it seeks to understand through comments the risks and opportunities of DLT, and how use of DLT might be impacted by its regulations. Among other things, the FCA queried how a firm can demonstrate "appropriate outsourcing arrangements" when it relies on DLT and "what governance arrangements do firms plan to have in place when using applications on public, permissioned networks?"

> **Helpful to Getting the Business Done**: The FCA discussion paper is quite thoughtful and provides an excellent primer for those trying to understand what DLT is. It will be interesting to see whether DLT would qualify as an approved storage medium under the Commodity Futures Trading Commission's proposed revisions to its record-retention rules. (Click here for background on these proposed new rules in the article "New Records Retention Regime for 21st Century Proposed by CFTC" in the January 16, 2017 edition of *Bridging the Week*.)

- **FinCEN Updates Advisory Regarding Problematic Jurisdictions**: The Financial Crimes Enforcement Network issued a revised advisory setting forth jurisdictions that have "strategic deficiencies" in anti-money laundering and Countering the Financing of Terrorism standards and thus require countermeasures (North Korea) or enhanced due diligence (Iran). In addition, FinCEN noted that the Financial Action Task Force has added Ethiopia to the list of countries having AML/CFT deficiencies. The list already includes Afghanistan, Bosnia and Herzegovina, Iraq, Laos, Syria, Uganda, Vanuatu and Yemen.

- **ESMA Clarifies Which Products May Be Eligible for Portfolio Margin**: The European Securities and Markets Authority issued an opinion setting forth when a clearing organization ("CCP") may offer the most favorable portfolio margin treatment as contemplated under the European Market Infrastructure Directive. Under EMIR, a CCP employing portfolio margin for multiple correlated instruments may provide a margin reduction up to 80 percent of the difference between the sum of margins for each product determined on an individual basis and a margin based on an estimation of the exposure of the overall portfolio. However, if a CCP is not exposed to any "potential risk from the margin reduction" it may apply a 100 percent reduction of the difference. According to ESMA, the most favorable portfolio margin treatment may only apply for contracts covered by the same default fund and in the same asset class. In its opinion, ESMA provided a number of examples of specifically correlated contracts that would qualify for the most favorable portfolio margin treatment (e.g., credit derivatives of the same underlying name or index with different maturities) and not qualify (e.g., interest rate derivatives using different currencies and an interest rate swap vs. a bond future).
- **FINRA Seeks Comments on New Rules for Capital Formation**: In order to evaluate whether any amendments to its rules, operations and administrative processes might enhance the capital raising process in the United States while continuing to promote investor protection, the Financial Industry Regulatory Authority solicited comments on all its rules impacting capital formation. In addition, FINRA sought feedback regarding specific proposed amendments to its rule dealing with underwriting terms and arrangements in order to "simplify and clarify its provisions" (click here to access FINRA Rule 5110) and certain of its research rules to authorize a limited safe harbor to permit desk commentary to be provided to institutional investors without being subject to restrictions pertaining to research reports and debt research reports (click here to access FINRA Rules 2241 and 2242). Comments on all these FINRA matters will be accepted through May 30. In testimony before the Senate Committee on Banking, Housing and Urban Affairs last month, SEC chairman nominee Jay Clayton indicated that helping capital formation by US companies would be a priority for him if confirmed as chairman by the full Senate. (Click here for background in the article, "SEC Chairman Nominee Urges Making US Capital Markets Great Again" in the March 26, 2017 edition of *Bridging the Week*.)
- **Sanction Guidelines Updated by FINRA**: The National Adjudicatory Council of the Financial Industry Regulatory Authority updated its sanction guidelines for use by hearing panels and the NAC itself. Among other things, the NAC added explicit sections related to systematic supervisory failures, short interest reporting and borrowing from or lending to customers. In addition to the prior sanctions recommended for failure to discharge supervisory obligations (US $10,000 to US $146,000), the NAC now suggests that systematic supervisory failures (e.g., where a supervisory failure "is significant and is widespread or occurs over an extended period of time") should be penalized by fines of US

$10,000 to US $73,000 for individuals and sanctions of US $10,000 to US $292,000 for firms. The NAC also indicated that responsible individuals should be suspended from 10 days to six months.

- **LME Proposes Accountability Levels Regime for Precious Metals Contracts**: The London Metal Exchange is consulting on the imposition of spot position limits, and individual prompt and all prompts accountability levels for its precious metal contracts (gold and silver). LME will consider all current prompt dates through the first prompt day of the next month as spot; all other prompt dates will be non-spot. Under LME's proposed accountability level regime, LME members who hold positions for themselves or their clients in excess of accountability levels would be required to explain to LME the rationale for holding such large positions and will have certain daily position reporting obligations too. LME may order a person with positions in excess of an accountability level not to increase its position or to reduce its position. LME members would be required to enforce position limits and accountability levels (as required by LME) against their clients related to positions the members hold on their clients' behalf. LME will accept comments on its proposal through May 12.