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Bridging the Weeks by Gary DeWaal: July 23 to August 3 and August 6, 2018 (Post-Trade Allocations; Exchange-Traded Products; Statutory Requirements)

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Bridging the Week

- Financial Institutions & Banking
- Securities & SEC

- All Federal

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For the second time this year, a Commodity Futures Trading Commission-registered futures commission merchant and National Futures Association member was sanctioned by both regulators for allegedly not supervising post-trade allocations of trades by a third party where the third party purportedly favored proprietary accounts over customer accounts. Separately, the Securities and Exchange Commission denied the application of the Bats BZX exchange to list and trade shares of the Winklevoss Bitcoin Trust because of its concerns regarding potential fraudulent and manipulative acts and practices in the underlying bitcoin market. As a result, the following matters are covered in this week's edition of *Bridging the Weeks*:

- CFTC and NFA Sanction FCM for Handling of Post-Trade Allocations by Trading Manager (includes **My View** and **Compliance Weeds**);

- SEC Says "No" to Winklevoss Bitcoin Trust While NFA Says "Yes" to Intermediaries' Crypto Businesses but Requires Disclosures (includes **My**

View); and more.

Article Version:

Briefly:

- **CFTC and NFA Sanction FCM for Handling of Post-Trade Allocations by Trading Manager**: R.J. O'Brien & Associates LLC – a Commodity Futures Trading Commission-registered futures commission merchant – agreed to pay US $750,000 in fines to the CFTC and the National Futures Association related to allegations that it did not adequately supervise the post-trade allocations of a trading manager and permitted the trading manager to trade for his wife's account even after he was banned from trading by NFA. RJO is also a member of NFA.

The CFTC said that RJO's supervisory breach occurred from January 2013 through February 2014.

As deduced from review of both the CFTC and NFA settlement orders and other public documents, it appears that, during the relevant time, RJO carried several accounts managed and controlled by Jonathan Hansen and his firm, Newport Private Capital LLC, which was registered with the CFTC as a commodity pool operator and commodity trading advisor. Apparently, Mr. Hansen often placed orders for customer accounts and proprietary accounts through RJO's electronic trading platform and was assigned a Tag 50 identification by RJO to process transactions executed through CME Group's trading platform. He also sometimes placed orders through X-Change Financial Access LLC ("XCF"), another CFTC registrant and NFA member, that were given-up to RJO. Orders were frequently placed on a bunched basis, and allocated later each day. According to the CFTC, Mr. Hansen disproportionately allocated profitable trades to proprietary accounts and unprofitable or less profitable trades

to customer accounts.

In September 2013, NFA issued a Member and Associate Responsibility Action against Mr. Hansen and his firm for reasons unrelated to their post-trade allocation practices. The MRA prohibited Mr. Hansen and any person acting on his behalf from remitting funds from any trading account he controlled without NFA's authorization, and required Mr. Hansen to be suspended totally from trading if he did not fulfill a financial obligation by January 15, 2014. (Click here to access the relevant MRA.) Mr. Hansen's financial obligation was not met, and, as a result, he was subject to a trading ban beginning on January 16.

Shortly after NFA's MRA went into effect, RJO permitted an account to be opened for Mr. Hansen's spouse, although the Commission acknowledged that "RJO was not aware of the relationship" between Mr. Hansen and this account. Mr. Hansen entered orders for this account, but did not have a written power of attorney.

According to the CFTC, during the relevant period, RJO did not follow certain of its own procedures in effectuating allocation instructions on behalf of Mr. Hansen and ignored various red flags that suggested wrongful post-trade allocations were occurring. Moreover, after the issuance of NFA's MRA, RJO allegedly permitted transfers of funds from Mr. Hansen's spouse's account without NFA's permission, as required. Finally, even after his trading ban went into effect, Mr. Hansen apparently controlled trading in his wife's account through Globex using his Tag 50 identification that had not been immediately deactivated by RJO. The CFTC and NFA said these matters constituted a failure to supervise by RJO.

In 2013, RJO settled an unrelated matter with the CFTC for an alleged breakdown in its oversight of post-trade allocations by a guaranteed introducing broker's associated person. It resolved that matter by payment of a fine of US $300,000 and entry of a cease and desist order. The CFTC also claimed in the current matter that RJO violated its prior cease and desist order in failing to supervise Mr. Hansen's post-trade allocations.

To resolve its current matters, RJO agreed to pay US $600,000 to the CFTC, and US $150,000 to NFA. In proffering its offer of settlements, RJO did not admit or deny any of the allegations of either regulator.

In May 2018, XFA agreed to pay two fines totaling US $250,000 to the regulators to settle charges that, from at least January 2013 through January 2014, it also failed to supervise the allocation of trades by Mr. Hansen and his firm. (Click here for details in the article "Former FCM Fined by CFTC and NFA for Processing CPO Client's Unlawful Post-Trade Allocations Despite Red Flags" in the June 3, 2018 edition of *Bridging the Week*.) XFA is currently registered with the CFTC as an introducing broker, but from March 2013 through February 2016, it was registered as an FCM. The firm was also registered as an IB prior to its registration as an FCM.

My View and **Compliance Weeds**: As I wrote at the time of the X-Change settlements,

"Although the CFTC charged XFA with failure to supervise under the general supervision requirement in its rules applicable to all Commission registrants

(click here to access CFTC Rule 166.3), the CFTC said in the XFA settlement order that the CFTC regulation dealing with the post-execution allocation of bunched orders "places an affirmative obligation on FCMs to monitor for unusual allocation activity and to make a reasonable inquiry into the matter if an FCM had actual or constructive knowledge of fraudulent allocations." However, there is no such express requirement in the relevant rule. The only two requirements for FCMs in the relevant rule (unless they are the eligible account manager engaging in the allocation) are (1) to maintain records to identify each order and account subject to a post-trade allocation and (2) not to accept orders for post-trade allocation from an eligible account manager if the CFTC advises it accordingly. (Click here to access the relevant CFTC regulation, Rule 1.35(b)(5).)

That being said, under an NFA guidance, FCMs have an express, affirmative obligation to take "appropriate action" if they have actual or constructive knowledge that allocations for its customers are fraudulent. (Click here to access NFA Interpretive Notice 9029 to Compliance Rule 2-10.) The CFTC acknowledged this NFA guidance in its XFA settlement order, as well as in the 2013 *Federal Register* release where the CFTC adopted its amended bunch order rule. (Click here to access 68 Fed. Reg 34,790, 34,792 (June 11, 2003).)

In times of CFTC budget shortages – like now – it is not clear what is the benefit of both the CFTC and NFA bringing parallel actions against XFA for effectively the same offense, particularly where NFA has an express guidance on an FCM's obligations related to its handling of bunched orders, the cited CFTC rule is silent on an FCM's specific obligations, and the basis for the CFTC's failure to supervise claim against an FCM in connection with bunched orders ultimately derives from the NFA guidance."

My same analysis and questioning applies to the CFTC's current action against RJO.

That being said, registrants that enact policies and procedures in response to regulatory requirements must adhere to such internal requirements or their failure could be used against them in enforcement or other regulatory actions or private litigation. Moreover, if regulators expressly prohibit or condition dealings with certain persons (e.g., through the Specially Designated Nationals and Blocked Persons List publicized by the Office of Assets Control of the US Department of Treasury – click here to access background), registrants must ensure they have procedures in place to be aware of such prohibitions and restrictions, and take reasonable measures to ensure compliance. Moreover, depending on the express requirements of the prohibition or conditioning, it may be appropriate to review beneficial owners of accounts, as well as all authorized traders – as indicated by express trading authorizations or permissioned trading system access – in addition to reviewing account names.

- **SEC Says "No" to Winklevoss Bitcoin Trust While NFA Says "Yes" to Intermediaries' Crypto Businesses but Requires Disclosures**: The Securities and Exchange Commission disapproved a proposed rule change by the Bats BZX Exchange, Inc. to permit its listing and trading of shares of the Winklevoss Bitcoin Trust. The SEC denied BZX's application, claiming that its proposed rule change was not consistent with requirements of applicable law, mainly "to prevent fraudulent and manipulative acts and practices" and "to

protect investors and the public interest."

As proposed, the investment objective of the Trust was for its shares to track the price of bitcoin traded on the Gemini Exchange, a digital asset exchange owned by Gemini Trust Company LLC, the Trust's custodian that is also a trust company licensed by the New York Department of Financial Services. The Trust only would hold bitcoins as assets.

Among other things, the SEC claimed that, despite BZX's assertions to the contrary, bitcoin and the bitcoin markets are not "uniquely resistant to manipulation." As a result, said the SEC, BZX should have entered into "a comprehensive surveillance sharing agreement with a regulated market of significant size related to bitcoin" as an alternative means to meet its requirement to prevent fraudulent and manipulative acts and practices. However, the SEC claimed BZX did not enter any such agreement. Although BZX pointed to its surveillance sharing agreement with the Gemini Exchange, the SEC said that the Gemini Exchange was not a regulated market despite its supervision by the NYDFS. Moreover, even if it the Gemini Exchange was adequately regulated, it was not a "significant" bitcoin-related market, the SEC observed.

Finally, BZX argued that even if its agreement with the Gemini Exchange was not satisfactory, its traditional means of identifying and deterring fraud were satisfactory to meet its statutory obligations. The SEC rejected this argument too. BZX had proposed that, consistent with other SEC approval orders, it would require exchange market makers to disclose their dealings in the underlying commodity (as well as related derivatives). Also, as it could with shares in other exchange-traded products, BZX would be able to obtain information regarding trading in shares of the Trust from Intermarket Surveillance Group members and affiliate members, as well as from information on the blockchain and from the Gemini Exchange. The SEC said, however, that these mechanisms were unsatisfactory as they would not provide insight into the underlying bitcoin or bitcoin derivatives holdings of all BZX market participants or the identity of market participants trading in the underlying bitcoin OTC market or other bitcoin trading venues. (The ISG consists of an international group of exchanges, market centers, and market regulators that perform front-line market surveillance in their respective jurisdictions. Click here for details.)

BZX initially filed its application for a rule change on June 30, 2016. The SEC declined its request on March 10, 2017. (Click here to access the SEC Order.) Thereafter, BZX promptly filed a petition requesting the SEC reconsider its denial, which the Commission granted on April 24.

Commissioner Hester Peirce dissented from the Commission's determination. She claimed that BZX's proposed rule change "satisfies the statutory standard" and that the SEC's refusal to approve the rule "sends a strong signal that innovation in unwelcome in our markets, a signal that may have effects far beyond the fate of bitcoin [exchange-traded product]." In rejecting BZX's application the SEC noted, however, that "its disapproval does not rest on an evaluation of whether bitcoin, or blockchain technology more generally, has utility or value as an innovation or an investment."

Applications for other bitcoin-related exchange-traded products remain pending at

the SEC. (e.g., applications by NYSE Arca – click here to access background – and by CBOE BZX Exchange, Inc. – click here to access background).

In other developments regarding digital assets and fintech:

- NFA Issues Advisory to FCMs, IBs, CTAs and CPOs: The National Futures Association proposed to adopt an Interpretive Notice that would require futures commission merchants, introducing brokers, commodity trading advisors and commodity pool operators to affirmatively make certain disclosures to customers, counterparties or investors that engage or may engage in activities related to spot virtual currencies or derivatives based on virtual currencies with or through them.

NFA proposed very different disclosure obligations for FCMs and IBs as compared to CTAs and CPOs, and, generally, NFA will mandate different requirements in connection with activities related to spot virtual currencies as opposed to virtual currency derivatives. (Click here for details regarding the NFA Advisory in the article "National Futures Association Proposes Interpretive Notice Requiring FCM, IB, CTA and CPO Disclosures Regarding Virtual Currency Activity" in the July 27, 2018 edition of *Between Bridges*.)

- OCC and Fintech Charters: The Office of the Comptroller of the Currency announced it will begin accepting applications from financial technology companies for special purpose national bank ("SPNB") charters. It is intended that such companies would engage in one or more of "core banking functions" of paying checks or lending money, but would not take deposits. Typically, special purpose national banks' operations are limited to certain activities, such as fiduciary activities. Fintech companies that seek to become SPNBs will be evaluated on their "unique facts and circumstances" and if granted a charter, will be supervised like "similarly situated" national banks for capital, liquidity and financial inclusion commitments. New York Department of Financial Services Superintendent Maria Vullo vehemently objected to OCC's announcement. According to Ms. Vullo, "a national fintech charter will impose an entirely unjustified federal regulatory scheme on an already fully functional and deeply rooted state regulatory landscape." The NYDFS has previously challenged the authority of OCC to grant special fintech charters. The US federal court hearing the matter denied the NYDFS's challenge, claiming it was premature at the time. (Click here for details in the article "Challenges to NY BitLicense and Potential OCC Fintech Charter Quashed" in the January 7, 2018 edition of *Bridging the Week*.)

- Token Alliance's Best Practices for Non-Securities Utility Tokens: The Token Alliance – an industry initiative of the Chamber of Digital Commerce – issued a comprehensive overview of the regulation of digital assets in the United States and other select jurisdictions, and proposed best practices for sponsors of digital tokens that are not intended to be securities or an instrument over which the Commodity Futures Trading Commission might have anti-fraud or anti-manipulation authority – i.e., utility tokens. To avoid unintended regulatory interactions, The Token Alliance recommended, among other things, that (1) sponsors fully develop their proposed system or application before distribution of a utility token, (2) utility tokens not be distributed before they can be used to

access a proposed system or application; (3) utility token holders should not be permitted to sell the digital assets on credit; (4) utility tokens should be promoted for their utility purpose not the potential value of the token's project; and (5) utility tokens should not be constructed so that holders expect profits from the underlying project. White papers discussing utility tokens should include explanations of the technology; use cases for the project; characteristics and functions of the token; and risks. In its overview, The Token Alliance also provided principles and guidelines for token trading platforms.

- FINRA Seeks Comments of Technological Innovation: The Financial Industry Regulatory Authority sought input on how it can support technological innovation to help investors and capital markets. In addition to soliciting general comments, FINRA is seeking insight on three specific areas: data aggregation services that would aggregate information from different financial accounts into a single location for investors; supervisory processes related to the use of artificial intelligence; and how to develop a machine-readable rulebook. Comments are due by October 12. In January 2017, FINRA issued a report regarding digital ledger technology and discussed, among other topics, regulatory considerations for broker-dealers (click here to access).

- **Follow-up** – Jon Montroll: Jon Montroll pleaded guilty to committing securities fraud in connection with the operation of a securities exchange that traded shares in virtual currency-related businesses. He also pleaded guilty to obstruction of justice for making false statements to the Securities and Exchange Commission in connection with its investigation related to his activities. In February 2018, both the SEC and the United States Department of Justice filed charges against Mr. Montroll in a federal court in New York, and the SEC additionally filed charges against BitFinder, Mr. Montroll's purported securities exchange. The SEC claimed that, from December 2012 through November 2013, Mr. Montroll misappropriated customers' bitcoin; lied about a hack of the BitFunder ecosystem in the summer of 2013 that resulted in a loss of 6,000 bitcoin; and raised funds for shares of a specific security – Ukyo.Loan — and misappropriated funds from these investments too. (Click here for further details regarding the SEC's and DOJ's allegations in 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*.)

- **Follow-up** – The Entrepreneurs Headquarters Limited: A federal court in New York ordered The Entrepreneurs Headquarters Limited and Dillon Dean, its sole founder and principal, to pay over US $1.9 million in total sanctions in connection with an enforcement action brought by the Commodity Futures Trading Commission that charged that the defendants solicited bitcoin from customers in order to pool their funds and invest in financial products, including binary options traded on the Nadex, a CFTC-registered binary options exchange. In reality, claimed the CFTC, the defendants misappropriated customers' funds, including using assets from some customers to pay other customers in a Ponzi scheme. Pursuant to a default order, the defendants must pay almost US $1.5 million as a fine, and US $432,185 as restitution to customers.

My View: Commissioner Pierce's dissent to the SEC's denial of a proposed rule change by Bats BZX Exchange to permit the listing and trading of shares of the Winklevoss Bitcoin Trust is spot on. There is no language in the relevant statute that appears to require Bats BZX to address trading in spot bitcoin, as opposed to the exchange-traded product it proposed to accommodate, in a defense of its rules intended to preclude fraudulent and manipulative conduct. The language of the relevant statute is clear:

An exchange shall not be registered as a national securities exchange unless the Commission determines that

(5) The rules of the exchange are designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing settling, processing information with respect to, and facilitating transactions in securities, to remove impediments to and perfect the mechanisms of a free and open market and a national market system, and, in general, to protect investors and the public interest.

(Emphasis added.)

Nothing in this provision suggests that an exchange must address the potential for fraud or manipulation on another exchange or trading facility, let alone in the over-the-counter market, in order for its rules related to the listing of a specific security to be approved by the SEC.

According to Ms. Pierce, BZX more than adequately met its requirement under the plain language of the law.

Moreover, in any case, even assuming the SEC's reading of the relevant statute is correct, the SEC provides short shrift to the value of the regulatory oversight of the NYDFS. Earlier this year, NYDFS expressly required virtual currency entities it licensed, including the Gemini Exchange, to adopt measures designed to effectively detect, prevent and respond to fraud, attempted fraud and similar wrongdoing. (Click here for background in the article "NYS Financial Services Regulator Ups the Obligations of State-Licensed Virtual Currency Entities" in the February 11, 2018 edition of *Bridging the Week*.)

As Apple achieved US $1 trillion in market value this week, I recalled that, when the company was first listed in 1980, Massachusetts denied its citizens access to the stock on the ground it was too risky. This was a wrong decision then, just as the SEC's decision now is an incorrect outcome. (Click here for a relevant article from the December 12, 1980 edition of *The Wall Street Journal*.)

As NFA demonstrates in permitting registrants under its oversight to transact in cryptocurrencies and cryptocurrency derivatives, the correct approach is to require appropriate disclosure of risks, not to preclude access to new investment products.

With appropriate disclosure, investors can determine on their own whether any investment, including an ETP based on bitcoin, is too risky because the underlying market is or is not especially susceptible to fraud or manipulation. Investor

intermediaries' application of suitability requirements will also help serve as a check on inappropriate investments by consumers.

The SEC should, and only has authority to, assess whether an exchange under its jurisdiction has rules to prevent fraud or manipulation of the securities it lists, not the commodities underlying those securities. It should not, on its own, expand its authority because it does not feel comfortable with the underlying asset to an exchange-traded product.

More Briefly:

- **Alleged Spoofer Exonerated in Criminal Trial Agrees in Principle to CFTC Settlement**;**Two More Purported Spoofers Criminally Charged**: Andre Flotron, the former UBS trader accused of conspiracy to defraud in connection with purported spoofing-type trading activity involving precious metals futures contracts listed on the Commodity Exchange, Inc., and found not guilty of criminal charges by a jury hearing his case in Connecticut in April 2018, apparently agreed to settle related civil charges initially brought by the Commodity Futures Trading Commission in January 2018. Although terms on this settlement have not been finalized, both the CFTC and Mr. Flotron agreed to report back to the US federal court hearing this matter by September 18 to report on developments. (Click here for a discussion of the federal court verdict regarding Mr. Flotron in the article "Former UBS Trader Found Not Guilty of Conspiracy to Defraud for Alleged Spoofing" in the April 29, 2018 edition of *Bridging the Week*, and here for a discussion of the CFTC action in the article "CFTC Names Four Banking Organization Companies, a Trading Software Design Company and Six Individuals in Spoofing-Related Cases; the Same Six Individuals Criminally Charged Plus Two More" in the February 4, 2018 edition of *Bridging the Week*.)

Separately, two additional traders formerly associated with Deutsche Bank – James Vorley and Cedric Chanu – were named in criminal complaints filed in a US federal court in Chicago related to alleged spoofing trading activities on the Commodity Exchange, Inc. from at least December 2009 through November 2011. These two individuals – both non-US nationals – purportedly coordinated with another former Deutsche Bank employee who pleaded guilty in June 2017 to engaging in spoofing, manipulation, and attempted manipulation of gold and silver futures on the Comex from December 2009 through February 2012. (Click here for background on this plea agreement in the article "Former Newbie Bank Trader Pleads Guilty to Criminal Charges and Settles CFTC Civil Charges for No Fine for Spoofing, Attempted Manipulation and Manipulation of Gold and Silver Futures" in the June 4, 2017 edition of *Bridging the Week*.)

Unrelatedly, New York Mercantile Exchange and Comex business conduct committees fined and barred multiple non-US nationals from accessing any CME Group market for engaging in alleged disruptive trading activities and not cooperating with exchange disciplinary proceedings. The fines ranged from US $50,000 to US $100,000.

- **CFTC Proposes Simplifying Notification Requirements for Swap Dealers Related to Segregated Funds for OTC Swaps**: The Commodity Futures

Trading Commission proposed various rule amendments to provide more flexibility in connection with the segregation of assets held as collateral in uncleared swap transactions by swap dealers and major swap participants. The proposed amendments address current notification requirements to counterparties regarding their choice to have their initial margin segregated, as well as initial margin investment and custody requirements, among other matters. Comments on the CFTC proposals are due by September 28. The CFTC also proposed amendments to its position limits rules for security futures products, expanding the default level for equity SFP position limits and amending the criteria to be applied by designated contract markets for setting a higher level of position limits and accountability levels. Comments to this proposal are due by October 1.

- **IOSCO Recommends How Trading Venues Should Monitor and Communicate Extreme Volatility Events**: The International Organization of Securities Commissions issued eight recommendations to help trading venues better deal with extreme volatility episodes and assist orderly trading. Among the recommendations are that (1) trading venues should implement and maintain "appropriate" volatility control mechanisms during trading hours to manage extreme volatility and assist orderly trading; (2) the mechanisms should be appropriately calibrated to, among other things, the nature of the financial instrument or underlying asset, their liquidity or trading profile and price, as well as volatility control mechanisms for related instruments; (3) the mechanism should be regularly monitored to assess whether recalibration might be appropriate; (4) the nature of volatility mechanisms should be communicated to the public; and (5) trading venues' trading related instruments should communicate as appropriate when volatility mechanism are triggered.

- **FINRA Seeks Comments on Membership Application Process**: The Financial Industry Regulatory Authority proposed amendments to its rules to expedite and make more efficient the process to become a new member or for an existing member to engage in new business activities. Among other matters, the amended rules aim to eliminate certain procedural redundancies between new and continuing membership application processes; codify existing practice to reduce the review periods for membership application processes; and clarify events that would require a CMA. Comments to FINRA proposed amendments are due by October 5.