

# The Banking Law Journal

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Steven A. Meyerowitz

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# A Flurry of CFTC Actions Shock the Cryptocurrency Industry

*Joseph B. Evans and Alexandra C. Scheibe\**

*Cryptocurrency derivative trading has been rising in popularity over the last few years and it is unsurprising that the Commodity Futures Trading Commission is taking a more active enforcement role. This article discusses a major Commission settlement order with a cryptocurrency industry participant and charges against each of 14 entities for offering cryptocurrency derivatives and margin trading without registering as a futures commission merchant.*

The Commodity Futures Trading Commission (“CFTC”) sent shockwaves across the cryptocurrency industry when it released a \$1.25 million settlement order with Kraken, one of the industry’s largest market participants. While the \$1.25 million settlement number is not overly significant given the size of Kraken and other similar market participants, this settlement signals that the CFTC is continuing to step into the fray as a primary cryptocurrency regulator. To that end, the following day, the CFTC announced that it had charged each of 14 entities for offering cryptocurrency derivatives in the cryptocurrency space and margin trading without registering as a futures commission merchant (“FCM”).

With these actions, the CFTC has now established itself as a key regulator of the industry along with the U.S. Securities and Exchange Commission (“SEC”), the U.S. Department of Justice (“DOJ”), and the U.S. Department of the Treasury (“Treasury”). Market participants should be aware that the CFTC will continue to take a more active role in regulation and enforcement of commodities and derivatives transactions moving forward.

The CFTC alleged that each of the defendants was acting as an unregistered FCM. Under Section 1a(28)(a) of the Commodity Exchange Act (the “Act”),<sup>1</sup> an FCM is any “individual, association, partnership, or trust that is engaged in

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<sup>1</sup> 7 U.S.C. § 1(a)(28)(A).

soliciting or accepting orders for the purchase or sale of a commodity for future delivery; a security futures product; a swap . . . any commodity option authorized under section 6c of this title; or any leverage transaction authorized under section 23 of this title.” In order to be considered an FCM, that entity must also “accept[] money, securities, or property (or extends credit in lieu thereof) to margin, guarantee, or secure any trades or contracts that result or may result therefrom.”<sup>2</sup>

## THE KRAKEN SETTLEMENT

On September 28, 2021, the CFTC issued an order filing and settling charges against respondent Payward Ventures, Inc. d/b/a Kraken for offering margined retail commodity transactions in cryptocurrency—including Bitcoin—and failing to register as an FCM. Kraken is required to pay a \$1.25 million civil monetary penalty and to cease and desist from further violations of the Act. The CFTC stated that, “This action is part of the CFTC’s broader effort to protect U.S. customers.”

The CFTC’s order finds that from approximately June 2020 to July 2021, Kraken violated Section 4(a) of the Act<sup>3</sup> by offering to enter into, entering into, executing and/or confirming the execution of off-exchange retail commodity transactions with U.S. customers who were not eligible contract participants or eligible commercial entities. The CFTC also found that Kraken operated as an unregistered FCM in violation of Section 4d(a)(1) of the Act.<sup>4</sup> According to the order, Kraken served as the sole margin provider and maintained physical and/or constructive custody of all assets purchased using margins for the duration of a customer’s open margined position.

Margined transactions worked as follows: The customer opened an individual account at Kraken and deposited cryptocurrency or fiat currency into the account. The customer then initiated a trade by selecting (1) the trading pair they wished to trade; (2) a purchase or sale transaction; and (3) a margin option. All trades were placed on Kraken’s central limit order book and executed individually for each customer. If a customer purchased an asset using margin, Kraken supplied the cryptocurrency or national currency to pay the seller for the asset. If a customer sold an asset using margin, Kraken supplied the cryptocurrency or national currency due to the buyer.

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<sup>2</sup> See 7 U.S.C. § 1(a)(28)(A)(II.) 7 U.S.C. § 6d(1), requires FCMs to be registered with the CFTC.

<sup>3</sup> 7 U.S.C. § 6(a)(2018).

<sup>4</sup> 7 U.S.C. § 6d(a)(1) (2018).

Trading on margin allowed the customer to establish a position but also created an obligation for the customer to repay Kraken at the time the margined position was closed. The customer's position remained open until they submitted a closing trade, they repaid the margin or Kraken initiated a forced liquidation based on the occurrence of certain triggering events, including limitations on the duration of an open margin position and pre-set margin thresholds.

Kraken required customers to exit their positions and repay the assets received to trade on margin within 28 days, however, customers could not transfer assets away from Kraken until satisfying their repayment obligation. If repayment was not made within 28 days, Kraken could unilaterally force the margin position to be liquidated or could also initiate a forced liquidation if the value of the collateral dipped below a certain threshold percentage of the total outstanding margin. As a result, actual delivery of the purchased assets failed to occur.

The CFTC asserted that these transactions were unlawful because they were required to take place on a designated contract market. Additionally, by soliciting and accepting orders for, and entering into, retail commodity transactions with customers and accepting money or property (or extending credit in lieu thereof) to margin these transactions, Kraken was operating as an unregistered FCM.

Coinciding with the release of the enforcement action against Kraken, CFTC Commissioner Dawn D. Stump issued a "concurring statement." In it, she appeared to be calling upon the CFTC to adopt more specific rules governing the products that are the subject of the enforcement action. Commissioner Stump asserted that it would be helpful to cryptocurrency market participants if the CFTC clarified its position on the applicability of the Act, as well as registration requirements. The CFTC will likely issue guidance or rules to clarify its position on which cryptocurrency-related products trigger registration requirements.

## **CFTC CHARGES 14 CRYPTOCURRENCY ENTITIES**

On September 29, 2021, the CFTC issued a press release and 14 complaints against cryptocurrency trading platforms. The CFTC is seeking a sanction "directing [the cryptocurrency platforms] to cease and desist from violating the provisions of the Act set forth herein."

All of the complaints are somewhat similar in that the CFTC alleges that each of the cryptocurrency platforms "from at least May 2021 and through the present" have offered services to the public "including soliciting or accepting



orders for binary options that are based off the value of a variety of assets including commodities such as foreign currencies and cryptocurrencies including Bitcoin, and accepting and holding customer money in connection with those purchases of binary options.”

The CFTC has taken the position that “binary options that are based on the price of an underlying commodity like forex or cryptocurrency are swaps and commodity options as used in the definition of an FCM.”

In a prominent enforcement action previously filed by the CFTC in the U.S. District Court for the Eastern District of New York, the court held that “virtual currency may be regulated by the CFTC as a commodity” and that it “falls well-within the common definition of ‘commodity’ as well as the CEA’s definition of commodities.”<sup>5</sup> In the action the CFTC filed against BitMEX in October of 2020, it alleged that “digital assets, such as bitcoin, ether, and litecoin are ‘commodities’” as defined under Section 1a(9) of the Act.<sup>6</sup>

In public statements and enforcement actions, the CFTC has previously taken the position that Bitcoin, Ethereum and some other cryptocurrencies are commodities. However, in these recently filed complaints, the CFTC did not appear to limit the cryptocurrencies that would be considered “commodities” to just Bitcoin, Ethereum, and Litecoin. Instead, the CFTC broadly referred to “commodities such as foreign currencies and cryptocurrencies including Bitcoin.” It remains to be seen which of the hundreds of cryptocurrencies on the market will be considered “commodities.” It is also an open question as to whether there are certain cryptocurrencies or cryptocurrency referencing financial products that the SEC and CFTC will determine are subject to the overlapping jurisdiction of both regulators, similar to mixed swaps under the derivatives rules.

The CFTC also singled out two of these cryptocurrency platforms, alleging that they issued false statements to the effect that it “is a registered FCM and RFED with the CFTC and member of the NFA.” The CFTC noted that neither of these entities were ever registered with the National Futures Association (“NFA”) and one of the NFA ID numbers listed “identifies an individual who was once registered with the CFTC but has been deceased since 2009.”

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<sup>5</sup> See, *CFTC v. McDonnell, et al.*, 287 F. Supp. 3d 213, 228 (E.D.N.Y. Mar. 6, 2018); *CFTC v. McDonnell, et al.*, No. 18-cv-461, ECF No. 172 (E.D.N.Y. Aug. 23, 2018).

<sup>6</sup> 7 U.S.C. § 1a(9); See, *CFTC v. HDR Global Trading Limited, et al.*, No. 20-cv-8132, ECF 1, ¶ 23 (S.D.N.Y. Oct. 1, 2020).

## **WHAT'S NEXT**

While the SEC, Treasury, and DOJ are often considered the most prominent federal regulators in the cryptocurrency space, this recent sweep by the CFTC is not the first time it has flexed its muscles. The CFTC went to trial and won in 2018, accusing an individual of operating a boiler room. In October 2020, the CFTC filed a case against popular cryptocurrency exchange BitMEX for failing to register as an FCM, among other counts. However, unlike those one-off enforcement actions, the recent actions targeting multiple market participants is a big step forward for the CFTC.

Cryptocurrency derivative trading has been rising in popularity over the last few years and it is unsurprising that the CFTC is taking a more active enforcement role. While the CFTC and other regulators have issued some regulatory guidance, regulators appear to be taking a “regulatory guidance by enforcement action” strategy.