

CLIENT ALERT

CFTC Enforcement Actions Against Tether, Kraken and Bitfinex Reassert Agency's Broad Jurisdiction in Crypto

October 19, 2021

AUTHORS

Neal E. Kumar | J. Christopher Giancarlo | Justin L. Browder | Serge B. Agbre
Alexandra Calabro

The Commodity Futures Trading Commission ("CFTC") continues to push an aggressive enforcement regime against participants in the steadily growing digital asset markets. In recent weeks, the CFTC has published separate speaking order settlements against major institutions involved in digital asset markets, including Tether, Kraken and Bitfinex.¹ Importantly, these settlements demonstrate a long term trend at the CFTC to pursue enforcement actions in the digital asset markets because the investigations associated with these settlements appear to originate from prior CFTC administrations.

These settlements also bring to light the complicated web of CFTC jurisdiction over the commodities markets. The Tether settlement highlights the CFTC's limited jurisdiction to pursue fraud and manipulation in the commodities market. Importantly, the Tether settlement also represents the first CFTC settlement addressing a so-called stablecoin, and serves

¹ *In re Tether Holdings Limited, et al.*, Order Instituting Proceedings Pursuant to Sections 6(c) and (d) of the Commodity Exchange Act, Making Findings, and Imposing Remedial Sanctions, CFTC Docket No. 22-4 (Oct. 15, 2021) ("Tether Order"); *In re Payward Ventures, Inc. (d/b/a/ Kraken)*, Order Instituting Proceedings Pursuant to Sections 6(c) and (d) of the Commodity Exchange Act, Making Findings, and Imposing Remedial Sanctions, CFTC Docket No. 21-20 (Sept. 28, 2021) ("Kraken Order"); *In re iFinex Inc., et al.*, Order Instituting Proceedings Pursuant to Sections 6(c) and (d) of the Commodity Exchange Act, Making Findings, and Imposing Remedial Sanctions, CFTC Docket No. 22-05 (Oct. 15, 2021) ("Bitfinex Order").

CFTC Enforcement Actions Against Tether, Kraken and Bitfinex Reassert Agency's Broad Jurisdiction in Crypto

to lay down a marker that the CFTC considers one of the major stablecoins in the digital asset market to be a commodity under the CFTC's jurisdiction rather than a security regulated by the Securities and Exchange Commission ("SEC"). On the other hand, both the Kraken and Bitfinex settlements showcase the CFTC's jurisdiction to regulate fully certain retail commodity transactions that trade on margin.

In total, these enforcement actions resulted in penalties amounting to approximately \$43.75 million, with the Tether settlement representing nearly all of the total amount at \$41 million.²

Tether Settlement

In 2014, Tether introduced a stablecoin called the U.S. dollar tether token ("USDt"), which is pegged to the U.S. dollar.³ The CFTC defined a "stablecoin" as a type of virtual currency whose value is derived from a fiat currency.⁴ Although Tether offered a number of tether tokens, the dominant offering was the USDt. In reaching its decision in the Tether Order, the CFTC determined that stablecoins, like those offered by Tether, fall within the definition of a "commodity" under the CEA on the basis that courts have ruled that digital currencies fall within the definition of a commodity.⁵

Since 2014, Tether "represented that one USDt may always be redeemed for one U.S. dollar."⁶ Prior to November 2017, USDt could only be acquired and redeemed through Tether's platform. At some point in November 2017, Tether's systems were the target of a cyber-attack which resulted in the unauthorized transfer of nearly 31 million units of USDt. For a period of time following the cyber-attack, Tether ceased issuing and redeeming USDt, and tokens could be acquired or redeemed only through Tether's affiliate, Bitfinex. Since November 2018, USDt could be acquired from either Tether or Bitfinex, among a number of other cryptocurrency exchanges.⁷

In the Tether Order, the CFTC alleged that since introducing the currency in 2014, Tether made numerous public representations that the USDt, as well as its other tether tokens, were directly linked to fiat currency. One such assertion, in the form of a whitepaper published on Tether's website, stated that "[e]ach Tether issued into circulation will be backed in a one-to-one ratio with the equivalent amount of corresponding fiat currency held in reserves by Hong Kong-based

² In the Tether Order, Tether was issued a civil penalty of \$41 million. In the other orders, Kraken and Bitfinex were issued a civil penalties of \$1.25 million and \$1.5 million, respectively.

³ The following entities are collectively referred to herein as "Tether": Tether Holdings Limited, Tether Operations Limited, Tether Limited, and Tether International Limited.

⁴ Tether Order at 3.

⁵ Tether Order at 8 ("Digital assets are commodities. . . . The USDt token, a virtual currency stablecoin, is a commodity and subject to the applicable provisions of the Act and Regulations."); *see also* *CFTC v. McDonnell*, 287 F. Supp. 3d 213, 217 (E.D.N.Y. 2018); *CFTC v. My Big Coin Pay, Inc.*, 334 F. Supp. 3d 492, 495–98 (D. Mass. 2018).

⁶ Tether Order at 3.

⁷ *Id.* at 4.

CFTC Enforcement Actions Against Tether, Kraken and Bitfinex Reassert Agency's Broad Jurisdiction in Crypto

Tether Limited.”⁸ Another statement, made in the context of a newly announced banking relationship, affirmed that the “[USDt] in the market are fully backed by US dollars that are safely deposited in [Tether’s] bank accounts.”⁹

However, according to the Tether Order, the company did not in fact hold sufficient fiat currency reserves to back each tether token in circulation. For a majority of the time period between June 1, 2016 and February 25, 2019, the total amount of fiat currency held by Tether was significantly below that which Tether purported to hold. In particular, from September 2, 2016 through November 1, 2018, the Tether Order alleged that USDt was only fully backed by actual fiat currency 27.6% of the time.¹⁰ The Tether Order did not provide additional detail regarding the average ratio of USDt to USD during the relevant period.

The Tether Order alleged that Tether also relied upon unregulated entities and third parties to hold customer funds. For example, Tether commingled funds with its affiliate, Bitfinex, transferred certain funds to “an unlicensed money transmitting business (the ‘Payment Processor’) registered in Panama,” and provided funds to Bitfinex to assist Bitfinex with liquidity issues it experienced on a separate platform.¹¹ Tether’s reserves were also held in non-fiat financial products and other types of assets such as commercial paper and bank repurchase agreements. Additionally, Tether counted anticipated receivables and wire transfers as part of the reserves tied to its stablecoin.

The Tether Order further alleged that Tether did not track the funds it was holding in reserve. Although Tether developed a specialized database following the 2017 cyber-attack to track the amount of fiat currency held in reserve against USDt, for much of the relevant period, “there was no automated process for incorporating bank statements and balances into the Tether Database, and information regarding the amount of fiat currency held in [Tether’s] accounts as Tether Reserves had to be manually inputted into the Tether Database.”¹² Until 2018, much of Tether’s internal accounting related to tracking the tokens in circulation revolved around a manually updated spreadsheet. This manual process led to a significant amount of information remaining untracked.

On February 25, 2019, Tether amended its website disclosure to no longer state that its tokens were fully backed by fiat currency. The revised disclosure explained that USDt were backed by “traditional currency and cash equivalents and, from time to time, may include other assets and receivables from loans made by Tether to third parties, which may include

⁸ *Id.*

⁹ *Id.* at 5.

¹⁰ *Id.*

¹¹ *Id.* at 6.

¹² *Id.*

CFTC Enforcement Actions Against Tether, Kraken and Bitfinex Reassert Agency's Broad Jurisdiction in Crypto

affiliated entities.”¹³ Following the relevant period, Tether also implemented more automated accounting and tracking systems.

Based on these events, the CFTC alleged that Tether intentionally or recklessly made materially false or misleading statements (or omissions) of fact concerning CFTC-jurisdictional commodity sales.¹⁴ The CFTC ordered Tether to pay a civil monetary penalty of \$41 million based upon the CFTC's anti-market manipulation regulations.

Kraken and Bitfinex Settlements

Although the CFTC's jurisdiction over commodity markets is limited to anti-fraud and anti-manipulation authority, when participants trade commodities on margin or leverage, the CFTC fully regulates the margined or leveraged trading activity as futures contracts, unless an exception applies. If the margined or leveraged trading activity is fully regulated as futures trading, then the trading activity is subject to the requirement, among others, that the contracts be executed on a futures exchange referred to as a designated contract market.¹⁵ Furthermore, entities that facilitate trading in the fully regulated margined or leveraged contracts may need to register with the CFTC. For example, participants that execute orders and accept margin funds on behalf of market participants may need to register with the CFTC as a futures commission merchant (“FCM”).

There are two primary exceptions to the CFTC fully regulating commodity contracts traded on margin or leverage as futures contracts. First, trading on margin or leverage is not regulated as a futures contract if the parties to the trading activity are “eligible contract participants” or “eligible commercial entities,” which are definitions designed to identify sophisticated market participants, but exclude retail participants.¹⁶ Entities or persons that are not eligible contract participants or eligible commercial entities are often referred to as retail customers. Second, the CFTC does not regulate commodity trading on margin or leverage, even if the parties to the trading are retail customers, so long as the trading in the contracts “result[s] in actual delivery within 28 days or such longer period as the [CFTC] may determine.”¹⁷ On March 24, 2020, the CFTC issued interpretive guidance further explaining the meaning of actual delivery of virtual currencies for purposes of the actual delivery exception.¹⁸

¹³ *Id.* at 7.

¹⁴ Section 6(c)(1) of the Act, 7 U.S.C. § 9(1) (2018), and Regulation 180.1(a)(2), 17 C.F.R. § 180.1(a)(2) (2020).

¹⁵ See Section 2(c)(2)(D) of the Commodity Exchange Act (“CEA”).

¹⁶ See CEA Sections 1a(17) & (18).

¹⁷ See CEA Section 2(c)(2)(D)(ii)(III)(aa).

¹⁸ For a summary of the CFTC's March 24, 2020 interpretation, please refer to Willkie's previous client alert dated March 30, 2020 (available [here](#)).

CFTC Enforcement Actions Against Tether, Kraken and Bitfinex Reassert Agency's Broad Jurisdiction in Crypto

Kraken Settlement: \$1.25 Million Penalty with Undertakings

According to the Kraken Order, from June 2020 to July 21, 2021, Kraken operated a digital asset platform that allowed retail customers to purchase and sell digital assets, including bitcoin, *on margin*.¹⁹ Kraken “offered potential and existing U.S. customers the ability to enter into margined retail commodity transactions on its exchange” during the relevant period.²⁰ In determining whether a customer qualified for margin, Kraken required the customer to meet certain contractual prerequisites, but did not assess whether the customer was an ECP, ECE, or a retail customer. Customers had the option to settle transactions with their own funds or to trade on margin, “for which Kraken was the sole provider.”²¹

Margined transactions were conducted through Kraken’s central limit order book and execution facility, and “Kraken maintained physical or constructive custody of all digital assets or fiat currency purchased using margin for the duration of a customer’s open margined position.”²² Customers who traded on margin were only obligated to repay Kraken upon closing their open margined position. A position remained open until a customer “submitted a closing trade, [or] repaid the margin, or Kraken initiated a forced liquidation, based on the occurrence of certain triggering events.”²³ Customers were required to repay Kraken within 28 days, and if a customer failed to repay Kraken within that time frame, Kraken could unilaterally force the margined position to be liquidated. Additionally, Kraken could force liquidation if the value of the collateral dropped below certain thresholds.²⁴

The Kraken Order explained that certain transactions conducted on the Kraken platform did not comply with the “actual delivery” exception to the CFTC’s mandatory exchange trading requirement because Kraken maintained possession and control of the “entire quantity of the assets purchased using margin,” and therefore customers were not able to use the assets “freely in commerce away from the execution facility until the customer satisfied the repayment obligation.”²⁵ Consequently, Kraken could not rely on the actual delivery exception to shield it from the CFTC regulating the contracts as futures contracts under the CEA.

Because the products traded through Kraken were subject to regulation as futures contracts, the Kraken Order also found that Kraken violated the CEA for failing to register as an FCM. Specifically, Kraken accepted orders for and entered into retail commodity transactions with customers, and also accepted money or property (or extended credit in lieu thereof) to

¹⁹ Specifically, the name of the entity at issue in the Kraken Order is Payward Ventures, Inc. (d/b/a Kraken).

²⁰ Kraken Order at 2.

²¹ *Id.*

²² *Id.*

²³ *Id.* at 3.

²⁴ *Id.*

²⁵ *Id.*

CFTC Enforcement Actions Against Tether, Kraken and Bitfinex Reassert Agency's Broad Jurisdiction in Crypto

margin these transactions. As a result, Kraken met the definition of an FCM, and violated the CEA for failure to register as an FCM during the relevant period.

Kraken agreed to pay a civil monetary penalty of \$1.25 million.²⁶ The Kraken Order also imposed an undertaking for Kraken to “implement and maintain systems and procedures reasonably designed to prevent margined or leveraged trading on Respondent’s trading platform by U.S. residents who are not eligible ECPs.”²⁷ Specifically, the Kraken Order required Kraken to implement such systems by June 23, 2021, and all existing open margined positions held by U.S. residents who are not ECPs were required to be closed by July 21, 2021.²⁸ The CFTC noted that Kraken had cooperated with its investigation, including voluntarily responding to requests for information in a timely fashion, proactively reaching out to the CFTC for guidance on complying with the CEA and CFTC regulations, implementing remediation efforts, and taking steps to close the unlawful U.S.-based margin trading business.²⁹

Bitfinex Settlement: \$1.5 Million Penalty with Undertakings

According to the Bitfinex Order, from at least March 1, 2016 through at least December 31, 2018 Bitfinex operated a digital asset trading platform that allowed its customers to enter into and execute a variety of digital currency related commodity transactions on margin.³⁰ Bitfinex offered trades on either a leveraged or margined basis on both long and short positions to these customers.³¹ To facilitate the trades, Bitfinex utilized a peer-to-peer funding program where Bitfinex customers would offer fiat or digital currencies in their own accounts to allow other customers to meet margin requirements.

To trade with margin, Bitfinex required its customers to hold a percentage of the value of their open positions in a “Margin Wallet,” which held both fiat and digital currencies. A customer’s margined position remained open “until the customer submit[ted] a closing trade, or Bitfinex initiate[d] a forced” liquidation, which typically occurred when the equity held in the Margin Wallet dipped below the required maintenance margin.³² When initiating a forced liquidation, Bitfinex acted as the customer’s counterparty to that transaction.

²⁶ *Id.* at 6.

²⁷ *Id.* at 7.

²⁸ *Id.*

²⁹ *Id.* at 2–3.

³⁰ Bitfinex Order at 3.

³¹ The Bitfinex entities consist of BFXNA Inc. (“BFXNA”), BFXWW Inc. (“BFXWW”) and iFinex Inc. (“iFinex”).

³² *Id.* at 3.

CFTC Enforcement Actions Against Tether, Kraken and Bitfinex Reassert Agency's Broad Jurisdiction in Crypto

Although Bitfinex asserted that it had safeguards in place to prevent unauthorized customers from opening an account, the CFTC found that during the relevant period, numerous U.S. retail customers were able to access and use the platform:³³

- First, although Bitfinex claimed that it implemented an automated system requiring customers to verify their place of residence before withdrawing fiat currency or digital currencies through its platform, Bitfinex customers, including those in the United States could click through and simply ignore the platform's "Terms of Service" and continue to access the Bitfinex platform. Those customers, who had not verified their place of residence, were able to deposit cryptocurrencies and enter into retail commodity transactions on the Bitfinex platform.
- Second, Bitfinex was aware that many U.S.-based customers used VPNs to mask their internet protocol (IP) address, allowing them to conceal the fact that they were residing in the United States and thus make use of Bitfinex's services.
- Third, even though Bitfinex developed an "Individual On-boarding Procedure" that outlined its Know-Your-Customer program, that procedure allowed U.S. citizens that were "Bitfinex Personnel" (i.e., current employees or contractors) to trade on the Bitfinex Platform.

The Bitfinex Order explained that by facilitating commodity transactions involving U.S. retail customers, Bitfinex was required to comply with Section 4(a) of the CEA. Under Section 4(a), any relevant transaction must be "made on or subject to the rules of a board of trade that has been designated or registered by the CFTC as a contract market for the specific commodity." Because Bitfinex was not registered as an exchange under the applicable regulation, the commodity transactions it enabled through its platform constituted illegal, off-exchange transactions in violation of Section 4(a) of the CEA.³⁴

Additionally, under a 2016 settlement with the CFTC in *In re BFXNA Inc. d/b/a Bitfinex*, CFTC No. 16-19, 2016 WL 3137612 (June 2, 2016), Bitfinex was required to "cease and desist" from offering, entering into or otherwise intermediating the execution of financed retail commodity transactions to U.S. retail customers unless said transactions were made subject to a CFTC-registered contract market.³⁵ By continuing to offer the same leveraged, margined, or financed commodity transactions in violation of the Commission's regulations, the CFTC alleged that Bitfinex violated Part VII.A of the 2016 order.³⁶

³³ *Id.* at 5.

³⁴ Bitfinex Order at 7.

³⁵ *Id.*

³⁶ *Id.*

CFTC Enforcement Actions Against Tether, Kraken and Bitfinex Reassert Agency's Broad Jurisdiction in Crypto

Finally, the CFTC found that by accepting funds and orders for, acting as a counterparty to, and accepting money or property for margined retail commodity transactions, Bitfinex operated as an FCM without obtaining the required registration.³⁷

Bitfinex agreed to pay a civil monetary penalty of \$1.5 million.³⁸ Similar to the Kraken Order, the Bitfinex Order imposed an undertaking for Bitfinex to take steps to prevent future unlawful trading by adopting systems that would prevent U.S. retail customers from engaging in improper transactions on its platform. These measures must be implemented by the end of 2021.³⁹

Implications

The CFTC's settlements with Tether, Kraken, and Bitfinex, along with the recent consent order entered into by the U.S. Southern District of New York for a permanent injunction and \$100 million fine against five companies running "BitMEX" in connection with charges brought by the CFTC, highlight the agency's unabated focus on digital asset platforms.⁴⁰ The Tether Order, in particular, represents one of the first formal actions undertaken by the U.S. regulators against sponsors of stablecoins. Although the issue of regulatory jurisdiction over stablecoins is one that heretofore has not been authoritatively addressed, it is likely to be more widely discussed as the United States Financial Oversight Council is soon scheduled to address the financial stability implications of stablecoins.

Although the CFTC is clearly staking out an increased enforcement presence in the digital asset trading space, at least one Commissioner has expressed reservations about the scope of the CFTC's enforcement role in the absence of clear industry guidance. In a recent statement, Commissioner Stump questioned whether future settlements in the same vein as Tether and Bitfinex will lead to consumer protections or whether the CFTC is just "push[ing] the limits of [its] enforcement authority in order to claim a piece of the jurisdictional pie."⁴¹ Commissioner Stump proposed that if the CFTC is going to continue holding entities such as these accountable for CEA violations, it must also provide reasonable guidance to allow entities to run their businesses in compliance with the CEA and the CFTC's regulations.

³⁷ Bitfinex Order at 6.

³⁸ Bitfinex Order at 8.

³⁹ *Id.* at 9–10.

⁴⁰ Willkie recently published a client alert on the BitMEX consent order. See CFTC Pushes Enforcement on Overseas Crypto Platform (Sept. 16, 2021), available [here](#).

⁴¹ Concurring Statement by Commissioner Dawn D. Stump Regarding Tether and Bitfinex Settlement (October 15, 2021), available [here](#).

CFTC Enforcement Actions Against Tether, Kraken and Bitfinex Reassert Agency's Broad Jurisdiction in Crypto

Willkie has a dedicated team of attorneys with extensive knowledge and experience in all aspects of the Commodity Exchange Act and the CFTC regulatory regime. We would be pleased to assist on your matters.

Athena Eastwood

202 303 1212

aeastwood@willkie.com

J. Christopher Giancarlo

212 728 3816

jcgiancarlo@willkie.com

Neal E. Kumar

202 303 1143

nkumar@willkie.com

Rita M. Molesworth

212 728 8727

rmolesworth@willkie.com

Paul J. Pantano Jr.

202 303 1211

ppantano@willkie.com

Deborah A. Tuchman

212 728 8491

dtuchman@willkie.com

Conrad G. Bahlke

212 728 8233

cbahlke@willkie.com

Margo Bailey

202 303 1178

mbailey@willkie.com

Lisa Eskenazi

212 728 3349

leskenazi@willkie.com

Serge B. Agbre

202 303 1173

sagbre@willkie.com

Steven C. Matos

212 728 8757

smatos@willkie.com

Michael Hartz

202 303 1161

mhartz@willkie.com

Copyright © 2021 Willkie Farr & Gallagher LLP.

This alert is provided by Willkie Farr & Gallagher LLP and its affiliates for educational and informational purposes only and is not intended and should not be construed as legal advice. This alert may be considered advertising under applicable state laws.

Willkie Farr & Gallagher LLP is an international law firm with offices in Brussels, Chicago, Frankfurt, Houston, London, Los Angeles, Milan, New York, Palo Alto, Paris, Rome, San Francisco and Washington. The firm is headquartered at 787 Seventh Avenue, New York, NY 10019-6099. Our telephone number is (212) 728-8000 and our fax number is (212) 728-8111. Our website is located at www.willkie.com.