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Recent Regulatory Developments

by

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This paper surveys some of the recent regulatory developments that have impacted many commodity market participants. Discussed below are Commodity Futures Trading Commission ("CFTC") and National Futures Association ("NFA") rule amendments and new rules related to distress events and compliance reporting, continuing relief concerning branch office inspections, registration for remote work and flexible work arrangements, supervisory requirements for third-party service providers, and a review of NFA's most recent survey of common deficiencies; CFTC and Securities and Exchange Commission ("SEC") enforcement cases concerning an oil fund's failure to disclose trading limits imposed during a market event; select CFTC enforcement cases involving the crypto industry; a CFTC case in the Eastern District of California concerning, among other issues, commodity pool operator ("CPO") and associated person ("AP") fraud and registration deficiencies; and a CFTC enforcement action against an energy trader concerning fraud, commodity trading advisor ("CTA") registration failures and misstatements to the Chicago Mercantile Exchange ("CME"). This paper will also highlight some key issues to watch as the recently proposed Lummis-Gillibrand Responsible Financial Innovation Act begins to move through Congress.

I. NFA Issues Reminder Regarding CPO Obligation to Report Certain Distress Events

NFA adopted a rule in 2021 to require CPOs to notify NFA upon the occurrence of certain events indicating that a pool may be in distress.[1] Citing recent market volatility across asset

[1] NFA Compliance Rule 2-50; *see* NFA Notice to Members I-21-15 (Apr. 13, 2021), https://www.nfa.futures.org/news/newsNotice.asp?ArticleID=5346; NFA Notice to Members I-21-20 (June 29, 2021), https://www.nfa.futures.org/news/newsNotice.asp?ArticleID=5377; Proposed NFA Compliance Rule 2-50 and related Interpretive Notice entitled NFA Compliance Rule 2-50: CPO Notice Filing Requirements (Mar. 5, 2021),

classes, the NFA issued a notice to NFA Members ("Members") in March 2022, reminding Members of their obligations to file any required notices in accordance with NFA Compliance Rule 2-50.[2] Pursuant to NFA Compliance Rule 2-50, a CPO experiencing any of several "reportable events" must notify NFA by 5:00 p.m. (U.S.) Central Time on the following business day.

The notice requirement is designed to assist NFA in identifying CPOs and commodity pools that may be faced with adverse financial situations, and thus potentially unable to meet their obligations.

Summary of NFA Compliance Rule 2-50

Under Compliance Rule 2-50, any of the following events would be reportable by the CPO of the relevant commodity pool:

- The pool is unable to meet a margin call;
- The pool is unable to satisfy redemption requests in accordance with the pool's governing documents;
- The CPO suspends investor withdrawals or redemptions; or
- A swap counterparty of the pool asserts that the pool is in default.

Compliance Rule 2-50 is accompanied by an interpretive notice that clarifies that the new rule applies with respect to commodity pools for which the CPO has a reporting requirement to NFA (*e.g.*, Rule 4.7 pools).[3]

Reportable Events

Inability to Meet a Margin Call

A CPO would be required to report to the NFA if its pool is unable to meet a margin call within the time period specified by the pool's futures commission merchant ("FCM") or broker.[4] Notably, if the CPO is not able to meet a margin call on the day of the call, but reasonably expects to meet the margin call by the deadline prescribed by the FCM or broker, Rule 2-50 would not be triggered.

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https://www.nfa.futures.org/news/PDF/CFTC/Proposed-CR-2-50-and-Interp-Notc-CPO-Notice-Filing-Requirements.pdf.

[2] *See* NFA Notice I-22-10 (March 11, 2022), https://www.nfa.futures.org/news/newsNotice.asp?ArticleID=5455.
[3] *See* NFA Interpretive Notice 9080 – NFA Compliance Rule 2-50: CPO Notice Filing Requirements (June 30, 2021), https://www.nfa.futures.org/rulebook/rules.aspx?Section=9&RuleID=9080.

[4] *See id.*

Inability to Satisfy an Investor's Request to Redeem

A CPO must report to the NFA if its pool is unable to satisfy an investor redemption request that would be permitted by the terms of the pool's governing documents.[5] In determining whether a pool will be unable to satisfy redemption requests, the CPO may take into consideration any applicable grace period or other provisions that may affect the timing of a redemption payment. For example, a pool may be able to offer in-kind payments in lieu of cash payments. If the CPO ultimately determines that a pool will not be able to meet a redemption request, however, the CPO must report to NFA, even if the applicable grace period has not yet passed.

Redemption Halts

If a pool unexpectedly suspends or otherwise halts redemptions (either temporarily or permanently), due to market events or other exigencies that impact the pool's ability to pay redemption proceeds, the CPO must notify NFA.[6] This aspect of Rule 2-50 does not extend to any delays in satisfying redemption requests that are based on a predetermined gate or lockup established by the pool's operative agreements.

Swap Default

In the event a pool's swap counterparty declares that a pool is in default and the CPO does not reasonably believe that the pool can cure such default within the period permitted by the relevant swap agreement, the CPO would be required to report to the NFA.[7] Rule 2-50 mandates reporting to NFA even if (i) the CPO disputes the counterparty's assertion of a default; or (ii) the CPO is engaged in discussions with the counterparty to liquidate positions.

Reporting Mechanics

Notice filings required by Rule 2-50 must be made by the CPO by means of NFA's EasyFile system, which can be accessed via the NFA website. The filing made pursuant to Rule 2-50 must include a summary of the event as well as all relevant subsection(s) of Rule 2-50 and the names of the impacted pool(s). As noted above, each CPO must ensure that it is capable of filing timely notification to the NFA upon the occurrence of the above-listed events.

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[5] *See id.*

[6] *See id.*

[7] *See id.*

II. NFA Adopts Exclusion from Branch Office Registration for Remote Work and Flexible Work Arrangements

In September 2021, the NFA issued a Notice to Members further clarifying the contours of recently adopted amendments to the definition of a branch office that exclude certain remote work and flexible work environments from being deemed branches.[8]

Interpretive Notice 9002 requires each NFA Member firm, other than a swap dealer, to list its branch offices on its Form 7-R.[9] Before the amendments, the term "branch office" was defined to mean any location, other than the main business address at which a Member firm, other than a swap dealer, employs a person engaged in activities requiring registration as an AP.[10]

In March 2020, due to the COVID-19 pandemic, NFA issued a Notice to Members providing relief from certain branch office requirements for Member firms that permitted their registered APs to work remotely from locations that had not been listed as branch offices.[11] The Notice required Members that permitted APs to work remotely to implement alternative supervisory methods to adequately supervise APs and meet recordkeeping requirements. That relief expired on September 23, 2021.[12]

Recognizing that Members may permanently adopt hybrid work environments and permit their APs to work remotely, NFA amended the definition of branch office in Interpretive Notice 9002. The amended definition of branch office excludes any remote working location or flexible shared workspace where one or more APs from the same household live or rent/lease, provided that:

- The AP(s) does not hold the location out publicly as the Member's office;

[8] NFA Notice to Members I-21-28 (Sept. 16, 2021) established an effective date of September 23, 2021 https://www.nfa.futures.org/news/news Notice.asp?ArticleID=5403. *See* NFA Interpretive Notice 9002 https://www.nfa.futures.org/rulebook/rules.aspx?Section=9&RuleID=9002.

[9] *See* NFA Interpretive Notice 9002 – Registration Requirements: Branch Offices (Sept. 23, 2021), https://www.nfa.futures.org/rulebook/rules.aspx?Section=9&RuleID=9002. Designation as a "branch office" imposes additional requirements on a Member firm with respect to the branch office. Different requirements apply depending on the type of commodity interest activity at a branch.

[10] *See* Proposed Amendments to NFA Interpretive Notice: Registration Requirements: Branch Offices (Aug. 23, 2021), https://www.nfa.futures.org/news/PDF/CFTC/082321-Proposed-Amendments-NFA-Interpretive-Notice-Registration-Requirements-Branch-Offices.pdf?j=186139&sfmc_sub=51546874&l=17073_HTML&u=3570546&mid=100026896&jb=0.

[11] NFA Notice to Members I-20-12 (Mar. 13, 2020), https://www.nfa.futures.org/news/newsNotice.asp?ArticleID=5214.

[12] *See* NFA Notice to Members I-21-28.

- The AP(s) does not meet with customers or physically handle customer funds at the location; and
- Any CFTC- or NFA-required records created at the remote location are accessible at the firm's main or applicable branch office(s) as required under CFTC and NFA requirements.[13]

Members may delist locations currently identified as branch offices when they fall outside the amended definition.[14]

The exclusion under the NFA's amended definition of branch office is similar, but not identical, to the analogous exclusions applicable to FINRA members.[15] FINRA Rule 3110 excludes from FINRA's branch office definition any location that is an AP's *primary residence*, provided:

- Only one AP, or multiple APs who reside at that location and are members of the same immediate family, conduct business at the location;
- The location is not held out to the public as an office and the AP does not meet with customers at the location;
- Neither customer funds nor securities are handled at that location;
- The AP is assigned to a designated branch office, and such designated branch office is reflected by such AP on all business cards, stationery, retail communications and other communications to the public;
- The AP's correspondence and communications with the public are subject to the firm's supervision in accordance with Rule 3110;
- Electronic communications (*e.g.*, e-mail) are made through the member's electronic system;
- All orders are entered through the designated branch office or an electronic system established by the member that is reviewable at the branch office;
- Written supervisory procedures pertaining to supervision of sales activities conducted at the residence are maintained by the member; and
- A list of the residence locations is maintained by the member.[16]

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[13] NFA Interpretive Notice 9002.

[14] *See* NFA Notice to Members I-21-28.

[15] FINRA Rule 3110(f)(2)(A)(ii).
[16] FINRA Rule 3110(f)(2)(A)(ii).

FINRA Rule 3110 provides additional exclusions of relevance to remote working and flexible work arrangements. Rule 3110 excludes any location, other than a primary residence, that is used for securities business for fewer than 30 business days in any one calendar year, provided the member complies with the conditions above other than the required list of residence locations.[17] Rule 3110 also excludes any location that is used primarily to engage in non-securities activities and from which the AP(s) effects no more than 25 securities transactions in any one calendar year.[18] In addition, Rule 3110 excludes a temporary location established in response to the implementation of a business continuity plan.[19] Recently, on July 15, 2022, FINRA submitted a rule change proposal to the SEC that would further relax the regulatory framework governing remote or alternative worksite inspections. The rule proposal would create a new designation of office, a "Residential Supervisor Location." Under the proposal, a Residential Supervisor Location would be subject to inspection at least every three years, as opposed to the annual inspection requirement that attaches to an office of supervisory jurisdiction.

III. NFA Extends Relief for On-site Inspections

Providing additional relief with respect to branch offices, in 2020 and 2021, NFA allowed Members to perform remote inspections of branch offices and guaranteed introducing brokers (IBs). The initial 2020 relief was extended through 2021,[20] and earlier this year was further extended through the end of 2022.[21] Members are still required to conduct an annual inspection of their branch offices and guaranteed IBs by December 31, 2022. Under the ongoing relief, however, these inspections may be conducted remotely.

IV. NFA Adopts Supervisory Requirements Regarding Third-Party Service Providers

NFA Interpretive Notice 9079 addresses the use by Member firms of third-party service providers. Effective on September 30, 2021, Interpretive Notice 9079 establishes general requirements relating to a Member's written supervisory framework and provides guidance on the

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[17] FINRA Rule 3110(f)(2)(A)(iii).

[18] FINRA Rule 3110(f)(2)(A)(v). Any retail communication identifying a location relying on this exclusion must set forth the address and telephone number of the location from which the AP(s) conducting business at the non-branch locations are directly supervised. *Id.*

[19] FINRA Rule 3110(f)(2)(A)(vii).

[20] *See* NFA Notice to Members I-20-35 (October 1, 2020), https://www.nfa.futures.org/news/newsNotice.asp?ArticleID=5287, and NFA Notice to Members I-21-25 (July 19, 2021), https://www.nfa.futures.org/news/newsNotice.asp?ArticleID=5386.

[21] See NFA Notice to Members I-22-05 (February 1, 2022), https://www.nfa.futures.org/news/newsNotice.asp?ArticleID=5446.

areas to be addressed in such framework.[22] In developing the Interpretive Notice, NFA considered guidance issued by other regulators and standard setting organizations.[23]

Interpretive Notice 9079 requires a Member that outsources regulatory functions to adopt and implement a supervisory framework that is designed to mitigate outsourcing-related risks. NFA Compliance Rules 2-9 and 2-36 place a continuing responsibility on a Member to diligently supervise its employees and agents in all aspects of their commodity interest activities.[24] To assist Members with establishing supervisory frameworks for outsourcing, the Interpretive Notice outlines minimum areas that should be addressed and provides guidance on the types of activities a Member should conduct in each of these areas. In particular, the Interpretive Notice provides guidance on the following areas:

- The initial risk assessment, including primary areas of risk to be examined (information security, regulatory, and logistics);
- Onboarding due diligence, including the scope of due diligence and the written agreement for services;
- Ongoing monitoring, including ongoing reviews, senior management involvement, and contractual renewals;
- Termination, including sufficient notice to ensure a smooth transition and post-termination treatment of confidential information; and
- Recordkeeping.

Members remain responsible for meeting their regulatory obligations in situations where they utilize a third-party service or software provider. Specifically, NFA has issued several other Interpretive Notices that address the use of a third-party service or software provider in a number of areas, including anti-money laundering, automated order routing, electronic trading systems and information systems security programs.[25] Among other things, these Interpretive Notices emphasize that Members should conduct both initial and ongoing due diligence when establishing and maintaining a relationship with a third-party service or software provider.

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[22] NFA Interpretive Notice 9079 – NFA Compliance Rules 2-9 and 2-36: Members' Use of Third-Party Service Providers (Sept. 30, 2021), https://www.nfa.futures.org/rulebook/rules.aspx?Section=9&RuleID=9079; *see* NFA Notice to Members I-21-13 (Mar. 24, 2021), https://www.nfa.futures.org/news/newsNotice.asp?ArticleID=5342.

[23] *See* Proposed Interpretive Notice entitled NFA Compliance Rules 2-9 and 2-36: Members' Use of Third-Party Service Providers (Feb. 26, 2021), https://www.nfa.futures.org/news/PDF/CFTC/022621-ProposedInterpNoticeCRs2-9and2-36- MembersUse3rdPartyServiceProviders.pdf.

[24] *See* NFA Compliance Rules 2-9 and 2-36.

[25] *See, e.g.*, NFA Interpretive Notice 9070 – NFA Compliance Rule 2-9, 2-36 and 2-49: Information Systems Security Programs (Sept. 30, 2019), https://www.nfa.futures.org/rulebook/rules.aspx?RuleID=9070&Section=9.

V. NFA Survey of Common Deficiencies

In January 2022, NFA released a survey of common deficiencies as an educational tool for its Members.[26] NFA highlighted the following requirements and common deficiencies for Members:

- *Self-Examination Questionnaire*—Members are required to review their business on an annual basis, and in accordance with the most recent Self-Examination Questionnaire available on NFA's website;[27]

- *Third-Party Service Providers*—As detailed in Section IV above, Members must adopt and implement written policies and a supervisory framework designed to provide oversight with respect to any third-party service provider to which a Member outsources a regulatory function. Members are also required to maintain records sufficient to demonstrate compliance with this supervisory requirement;

- *Cybersecurity*—Members are required to establish and maintain a written information security program, or ISSP, governing a firm's cybersecurity protocol. Additionally, Members must notify NFA upon the occurrence of certain cyber related incidents via NFA's Cyber Notice Filing System. Cybersecurity training is required for employees both upon hiring and on an annual basis;

- *Pool Financial Reporting; Notification Requirements*—NFA highlighted a number of notice reporting requirements for Members, including: (1) notice with respect to a distress event (as described in Section I above), (2) changes in fiscal year end (for a year end other than the calendar year end), (3) changes in the CPO's independent CPA that has been engaged to audit pool financial statements, (4) extension requests with respect to filing a pool's financial statement, (5) notices regarding a pool's cessation of trading, including an update to the Annual Questionnaire and a final audit filing; and

- *Calculation of Financial Ratios*—NFA provided a reminder that CPOs and CTAs must use the accrual method of accounting and GAAP (or another internationally recognized accounting standard) when computing financial ratios.

VI. CPO Settles Charges with CFTC and SEC for Failure to Fully Disclose Information Relating to Trading Limitations to Commodity Pool Participants

In November 2021, the CFTC announced settled charges against a registered CPO for failing to fully disclose certain position limits that its FCM imposed on one of the CPO's exchange-traded commodity pools (the "ETP").[28] On the same day, the SEC settled charges in a parallel

[26] *See* NFA Notice to Member I-22-03 (January 13, 2022), https://www.nfa.futures.org/news/newsNotice.asp?ArticleID=5444.

[27] *See* https://www.nfa.futures.org/members/self-exam-questionnaire.html.

[28] *In re United States Commodity Funds, LLC*, CFTC Docket No. 22-06 (Nov. 8, 2021), https://www.cftc.gov/media/6716/enfunitedstatescommodityorder110821/download; *see CFTC Orders United States*

matter.[29] Collectively, the CPO and ETP have agreed to pay $2.5 million in penalties to settle the parallel cases.

The ETP's investment objective was to track a benchmark of short-term oil futures contracts. As macroeconomic events roiled the oil markets in April 2020, the near-month oil futures contract that was next to expire—otherwise known as the "front month futures contract"—"went negative" (*i.e.*, breached zero and settled in negative territory) for the first time ever. Around the same time, the ETP received record investor inflows and exhausted its inventory of available shares, announcing a suspension of new creations of shares until a registration statement for the issuance of additional shares was declared effective by the SEC.

Contemporaneously, the ETP's sole FCM informed the CPO that it would not clear any new futures contracts for the ETP's account funded with the proceeds from the sale of new fund shares and did not want the risk profile of the FCM's clearing relationship with the ETP to increase through additional share creations. The CFTC's order found that from about April 22, 2020 to June 12, 2020, the CPO failed to fully disclose to commodity pool participants that the FCM had imposed position limits on the ETP that would render the ETP unable to purchase additional futures contracts in connection with the future offering of new ETP shares.

The CPO made several disclosures concerning the ETP's portfolio that were found to be inadequate. The ETP's Forms 8-K discussed "risk mitigation measures" taken by the FCM with respect to the ETP acquiring additional oil futures contracts but did not disclose the substance of the FCM's position limit or that it had effectively curtailed the ETP's ability to invest funds from future sales of fund shares into the purchase of additional futures contracts. According to the orders, this failure to disclose material information to investors amounted to a violation of the anti-fraud provisions in Section 4*o*(l)(B) of the Commodity Exchange Act (the "CEA"), CFTC Regulation 4.41(a)(2), and Section 17(a)(3) of the Securities Act of 1933.

VII. CFTC Enforcement Actions Against Crypto Businesses Tether, Kraken and Bitfinex

In September and October 2021, the CFTC published separate settlements against major institutions involved in digital asset markets, including Tether, Kraken and Bitfinex.[30]

Commodity Funds LLC to Pay $2.5 Million for Failure to Fully Disclose Information Relating to Trading Limitations to Commodity Pool Participants, CFTC Release No. 8457-21 (Nov. 8, 2021), https://www.cftc.gov/PressRoom/PressReleases/8457-21?utm_source=govdelivery.

[29] *In re United States Commodity Funds LLC and United States Oil Fund, LP*, Securities Act Release No. 11006 (Nov. 8, 2021), https://www.sec.gov/litigation/admin/2021/33-11006.pdf.

[30] *In re Tether Holdings Limited, et al.*, CFTC Docket No. 22-4 (Oct. 15, 2021) ("Tether Order"), https://www.cftc.gov/media/6646/enftetherholdingsorder101521/download; *In re Payward Ventures, Inc. (d/b/a Kraken)*, CFTC Docket No. 21-20 (Sept. 28, 2021) ("Kraken Order"), https://www.cftc.gov/media/6426/enfpaywardorder092821/download; *In re iFinex Inc., et al.*, CFTC Docket No. 22-05 (Oct. 15, 2021) ("Bitfinex Order"), https://www.cftc.gov/media/6651/enfbfxnaincorder101521/download; *see CFTC Orders Tether and Bitfinex to Pay Fines Totaling $42.5 Million*, CFTC Release No. 8450-21 (Oct. 15, 2021), https://www.cftc.gov/PressRoom/PressReleases/8450-21.

These settlements bring to light the complex nature of CFTC jurisdiction over the commodities markets. The Tether settlement highlights the CFTC's limited jurisdiction to pursue fraud and manipulation in the commodities markets. Importantly, the Tether settlement also represents the first CFTC settlement addressing a so-called stablecoin, and thus indicates that the CFTC considers one of the major stablecoins in the digital asset market to be a commodity, and thus under its jurisdiction, rather than a security regulated by the SEC. The Kraken and Bitfinex settlements showcase the CFTC's jurisdiction to regulate retail commodity transactions that trade on margin.

These settlements do not involve CPOs, CTAs or investment advisers. Nonetheless, all market participants should be aware of cases in the rapidly evolving digital asset arena. With the recent proposal of the Lummis-Gillibrand Responsible Financial Innovation Act, discussed in greater detail in Section IX below, it is clear that the CFTC's role in regulating digital assets is evolving, and that any legislation will ultimately have a number of implications for fund managers, including CPOs and CTAs. First, the categorization of a digital asset as a commodity, commodity interest or security is relevant for any asset manager or adviser as such party determines whether the trading of a particular instrument could render the party a CPO, CTA or investment adviser, for example. Second, NFA Bylaw 1101 may be implicated for a registered CPO or CTA. That bylaw prohibits Members from doing commodity interest business with another party that is required to be registered with the CFTC and a Member of NFA but is not. Finally, and perhaps most importantly, the law applicable to digital assets, including virtual currency, is continuing to evolve. Myriad domestic and international agencies will regulate aspects of this developing marketplace; some of that regulation may overlap.

Tether Settlement

In 2014, Tether introduced a stablecoin called the U.S. dollar tether token ("USDt"), which is pegged to the U.S. dollar.[31] The CFTC defined a "stablecoin" as a type of virtual currency whose value is derived from a fiat currency.[32] 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 this definition of a "commodity" under the CEA on the basis that courts have ruled that digital currencies fall within the definition of a commodity.[33]

Since 2014, Tether "represented that one USDt may always be redeemed for one U.S. dollar."[34] Prior to November 2017, USDt could only be acquired and redeemed through Tether's

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

[32] Tether Order at 3.

[33] *Id.* 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).

[34] Tether Order at 3.

platform. At some point in November 2017, Tether's systems were the target of a cyberattack which resulted in the unauthorized transfer of nearly 31 million units of USDt. For a period of time following the cyberattack, 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.[35]

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 Tether Limited."[36] 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."[37]

According to the Tether Order, however, 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 fully backed by actual fiat currency only 27.6% of the time.[38]

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.[39] 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 cyberattack 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

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[35] *Id.* at 4.

[36] *Id.*

[37] *Id.* at 5.

[38] *Id.*

[39] *Id.* at 6.

Tether Reserves had to be manually inputted into the Tether Database."[40] 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 affiliated entities."[41] 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.[42] 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 "physical" or spot commodity markets currently is limited to anti-fraud and anti-manipulation authority,[43] 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 designated contract market.[44] 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 an FCM.

Two primary exceptions exist 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" ("ECP") or "eligible commercial entities" ("ECE"), which terms identify sophisticated market participants and exclude retail participants.[45] Parties that are not ECPs or ECEs are generally considered to be retail. Second, the CFTC does not regulate commodity trading on margin or leverage, even if the parties

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[40] *Id.*

[41] *Id.* at 7.

[42] CEA Section 6(c)(1) and CFTC Regulation 180.1(a)(2).

[43] The Digital Assets Bill, as discussed in Section IX below, proposes to, among other things, expand the CFTC's jurisdiction to the spot market with respect to digital assets.

[44] *See* CEA Section 2(c)(2)(D).

[45] *See* CEA Sections 1a(17) & (18).

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."[46] 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.[47]

Kraken Settlement

According to the Kraken Order, from June 2020 to July 2021, Kraken operated a digital asset platform that permitted retail customers to purchase and sell digital assets, including bitcoin, *on margin*.[48] Kraken "offered potential and existing U.S. customers the ability to enter into margined retail commodity transactions on its exchange."[49] 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."[50]

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."[51] Customers who traded on margin were obligated to repay Kraken only 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."[52] 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.[53]

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

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[46] *See* CEA Section 2(c)(2)(D)(ii)(III)(aa).

[47] *See Retail Commodity Transactions Involving Certain Digital Assets*, 85 FR 37734 (June 24, 2020), https://www.federalregister.gov/documents/2020/06/24/2020-11827/retail-commodity-transactions-involving-certain-digital-assets.

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

[49] Kraken Order at 2.

[50] *Id.*

[51] *Id.*

[52] *Id.* at 3.

[53] *Id.*

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."[54] 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 margin these transactions. As a result, Kraken met the definition of an FCM, and violated the CEA for failure to register as such.

Kraken agreed to pay a civil monetary penalty of $1.25 million.[55] Kraken also undertook to "implement and maintain systems and procedures reasonably designed to prevent margined or leveraged trading on [Kraken's] trading platform by U.S. residents who are not eligible ECPs."[56] Specifically, the Kraken Order required Kraken to implement such systems by June 23, 2021, and to close all existing open margined positions held by non-ECP U.S. residents by July 21, 2021.[57] 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.[58]

Bitfinex Settlement

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 permitted customers to enter into and execute a variety of digital currency-related commodity transactions on margin.[59] Bitfinex offered trades on either a leveraged or margined basis on both long and short positions to these customers.[60] To facilitate the trades, Bitfinex utilized a peer-to-peer funding program by which Bitfinex customers would offer fiat or digital currencies in their own accounts to allow other customers to meet margin requirements.

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[54] *Id.*

[55] *Id.* at 6.

[56] *Id.* at 7.

[57] *Id.*

[58] *Id.* at 2–3.

[59] Bitfinex Order at 3.

[60] The Bitfinex entities consist of BFXNA Inc. ("BFXNA"), BFXWW Inc. ("BFXWW") and iFinex Inc. ("iFinex").

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.[61] When initiating a forced liquidation, Bitfinex acted as the customer's counterparty to that transaction.

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.[62] 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.[63]

Additionally, under the CFTC's 2016 settlement with Bitfinex,[64] 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.[65] By continuing to offer the same leveraged, margined, or financed commodity transactions in violation of the Commission's regulations, the CFTC alleged that BFXNA violated the 2016 order.[66]

Finally, the CFTC found that by accepting funds, orders or property for, and acting as a counterparty to, margined retail commodity transactions, Bitfinex operated as an FCM without obtaining the required registration.[67]

Bitfinex agreed to pay a civil monetary penalty of $1.5 million.[68] The Bitfinex Order imposed an undertaking for Bitfinex to take steps to prevent future unlawful trading by adopting

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[61] *Id.* at 3.

[62] *Id.* at 5.

[63] *Id.* at 7.

[64] *In re BFXNA Inc. d/b/a Bitfinex*, CFTC Docket No. 16-19 (June 2, 2016), https://www.cftc.gov/sites/default/files/idc/groups/public/@lrenforcementactions/documents/legalpleading/enfbfxnaorder060216.pdf.

[65] Bitfinex Order at 7.

[66] *Id.*

[67] *Id.* at 6.

[68] *Id.* at 8.

and implementing systems by the end of 2021 that would prevent U.S. retail customers from engaging in transactions on its platform.[69]

VIII. CFTC Actions Concerning Registration Failures, Fraud and False Statements

CFTC v. Financial Tree (EDCA)

In July 2022, the CFTC announced that the U.S. District Court for the Eastern District of California had entered an order granting CFTC's motion for a default judgment against multiple individuals and entities, including a law firm and its managing partner, based on a series of misconduct ranging from solicitation fraud, CPO and AP fraud, multiple CFTC registration violations and failure to comply with CPO regulations.[70]

The CFTC charged that from approximately June 2015 through June 2020, several of the defendants fraudulently solicited participation in two pools that were sold as vehicles for investing in binary options and forex trades (the "Pools"). During the relevant period, these defendants raised $14.32 million from 92 pool participants, effecting at least 134 wire transfers. These wire transfers were made to the Glenn Law Firm's bank accounts.

Upon accepting funds, the defendants instituted a Ponzi scheme, whereby certain participants received payments; these payments were made from the funds of new pool participants. The defendants also misappropriated funds for personal benefit and redirected approximately $6.3 million of the funds raised into their own business and personal accounts, which were then misappropriated for various personal uses ranging from home renovations to gambling. Defendants did not deposit pool funds into fiduciary-protected segregated accounts, and never employed binary options and forex strategies as advertised.

The findings indicated that, during the relevant period, Financial Tree, Financial Tree Solution Group, New Money Advisors, LLC and the Glenn Law Firm, acted as CPOs because they were engaging in a business that is of the nature of a commodity pool, and soliciting and accepting funds on behalf of the Pools. None of these defendants, however, registered as a CPO with the CFTC. Financial Tree also operated as a commodity pool insofar as it had a forex trading account in its name that traded Pool funds. Financial Tree was not registered with the CFTC in any capacity. In addition, the individual defendants who solicited investors for the Pools were acting as APs. None of these defendants were registered as APs of the CPOs.

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[69] *Id.* at 9–10.

[70] *Commodity Futures Trading Commission v. Financial Tree d/b/a Financial Tree Trust, et. al., No. 2-20-cv-01184 TLN AC (Eastern District CA 2022); see* https://www.cftc.gov/PressRoom/PressReleases/8556-22. In addition to several individuals, defendants included entities Financial Tree, Financial Tree Solution Group, New Money Advisors, LLC, The Law Firm of John Glenn, P.C. (the "Glenn Law Firm"). A number of Relief Defendants were named as well. The CFTC's complaint charged the Defendants with violating Sections 4b(a)(2)(A)-(C), 4c(b), 4k(2), 4m(1), 4o(1)(A)-(B), and 2(c)(2)(C)(iii)(I)(cc) of the CEA, 7 U.S.C. §§ 6b(a)(2)(A)-(C), 6c(b), 6k(2), 6m(1), 6o(1)(A)- (B), and 2(c)(2)(C)(iii)(I)(cc) (2018), and CFTC Regulations 4.20(a)(1), (b)-(c), 4.21, 4.22, 5.2(b)(1)-(3), 5.3(a)(2), and 32.4, 17 C.F.R. §§ 4.20(a)(1), (b)-(c), 4.21, 4.22, 5.2(b)(1)-(3), 5.3(a)(2), and 32.4 (2021).

Beyond the fraud and failure to register violations, the CFTC alleged that the CPOs violated a number of other CFTC requirements: failing to operate the Pools as separate legal entities from the CPOs; commingling non-pool property with Pool funds; and transferring Pool funds to various business and personal accounts of defendants. Defendants also violated CFTC Regulations 4.21 and 4.22 by failing to deliver pool disclosure documents and account statements. The Defendants various material misrepresentations to pool participants throughout the scheme and misappropriation of funds resulted in commodity option fraud and forex fraud under the CEA. As a result, the Court imposed over $29 million in restitution and penalties on the various Defendants.

Powerline Petroleum, LLC

On July 19, 2022, the CFTC announced its order requiring Powerline Petroleum, LLC ("Powerline"), an Illinois limited liability company, to pay $875,000 related to misconduct constituting fraud, making false statements to the CME and failure to register as a CTA. In addition to Powerline, Darren Dohme, co-founder and Managing Partner of Powerline, and Adam Wright, a co-owner, were also named Respondents in the CFTC action. Each of Dohme and Wright are principals and registered APs of Powerline.

Powerline marketed itself as a "consulting and execution resource." From approximately 2015 through 2019, Powerline offered clients advice concerning hedging strategies, and made available execution services to effect those strategies using block trades in options on energy futures. Powerline offered customized hedging strategies tailored to satisfy individual client needs. Powerline would typically reach out to its various clients and recommend specific trades based on their perceived needs. Whereas Powerline purported to simply be acting as a go between to facilitate the various trades it recommended to clients, in fact, Powerline was a counterparty to those trades. Powerline would offer the trades to its clients at a certain price having already executed the trade at more favorable terms, thus profiting from the difference between the price offered to clients, and the price Powerline was able to achieve for itself. In failing to disclose, and otherwise affirmatively misrepresenting its status as a counterparty to these transactions, Powerline was defrauding its clients, ultimately charging them an undisclosed markup on the trades.

In September 2019, the CME requested information from Powerline with respect to block trades it was making on behalf of its clients. Following CME's request, Wright and Dohme sent a backdated letter to clients purporting to disclose that they were in fact acting as counterparties to the trades they were recommending. The backdated letter claimed that Powerline was "acting as a Clearport Principal" and taking trades into its own account, before passing them to client accounts. The letter did not, however, specifically disclose that Powerline was acting as a counterparty to the clients, in conflict with their interests. After receiving a second request for information from the CME in January 2020, Powerline sent CME the backdated letter, creating the false impression that timely disclosures were provided to Powerline clients.

In addition to being an undisclosed counterparty, Powerline was acting as a CTA by recommending specific, tailored trades to clients. Powerline was not registered as a CTA, nor did it qualify for an exemption from CTA registration. The CTA registration violation highlights how

an atypical advisor -- that does not directly trade on behalf of client accounts -- may nevertheless be required to register as a CTA when its advice is specifically tailored to a client's situation.

Based on these violations, the CFTC found that the Respondents Powerline, Dohme and Wright violated Sections 4o(1)(A)-(B) and 9(a)(4) of the CEA, and that Powerline and Dohme violated Section 4m(1) of the CEA, and CFTC Regulations 4.31 and 4.34.

IX. Lummis – Gillibrand Digital Assets "Crypto" Bill

On June 7, 2022, Senators Cynthia Lummis and Kirsten Gillibrand introduced the "Responsible Financial Innovation Act" (the "Digital Assets Bill") aimed at providing a comprehensive regulatory framework to govern digital assets. While the ultimate passage of the Digital Assets Bill is not likely in the near term, the basic framework of the bill is worth considering herein, especially with regard to its potential impact on current, and potentially new classes of CFTC registrants. As proposed, the Digital Assets Bill provides a comprehensive regulatory framework with the CFTC at its center.

The Digital Assets Bill addresses a number of regulatory areas and issues ranging from the tax treatment of digital assets and Digital Autonomous Organizations (DAOs), to consumer protection. Perhaps most significantly, the CFTC would act as the primary regulator of digital assets in the United States. Under the current patchwork framework, each of the SEC and CFTC have claimed jurisdiction over digital assets in certain varying contexts. Currently, as a general matter, the SEC has jurisdiction over digital assets deemed securities, whereas the CFTC maintains anti-fraud and anti-manipulation jurisdiction over digital assets considered commodities. These jurisdictional lines are not always clear. They can create uncertainty for asset managers attempting to navigate the digital assets space. The Digital Assets Bill grants the CFTC exclusive jurisdiction over digital assets by including such assets in the definition of "commodity," with certain exceptions (such as for non-fungible assets or "NFTs," or assets that confer certain rights with respect to a business, such as an equity or debt interest, liquidation rights, interest or dividend rights, certain profit or revenue shares or other financial interests in an entity). Jurisdiction over certain "ancillary assets" is also split between the CFTC and SEC.[71] The Digital Assets Bill also authorizes the creation or a Self-Regulatory Organization ("SRO") to oversee digital assets, presumably similar to the way NFA is tasked with overseeing the futures and swaps markets.

The Digital Assets Bill outlines a comprehensive regulatory framework that, while not removing all doubt and ambiguity with respect to the jurisdiction of digital assets, would seemingly make the CFTC the primary regulator of such instruments, while also maintaining the SEC's jurisdiction over securities in the digital assets space. By including digital assets in the definition of "commodity" under the CEA, managers and advisors that trade in such assets may ultimately

[71] An "Ancillary Asset" is defined in the bill to mean "an intangible, fungible asset that is offered, sold, or otherwise provided to a person in connection with the purchase and sale of a security through an arrangement or scheme that constitutes an investment contract . . . ." The bill further provides for certain exclusions to the definition of "ancillary assets" for assets that confer certain rights with respect to a business, such as an equity or debt interest, liquidation rights, interest or dividend rights or other financial interest in an entity, certain profit or revenue shares or other financial interests in an entity.

be swept into the definition of CPO or CTA, potentially triggering a registration requirement with the CFTC. It is also possible that new categories of registrants may be created to cover managers and advisors that trade digital assets on behalf of clients. Perhaps most notable, the Digital Assets Bill would expand the CFTC's jurisdictional mandate by giving it the authority to regulate digital asset transactions in the spot market. Currently, the CFTC is charged primarily with regulating transactions in futures, swaps and other derivatives. Regulating a spot market would be a significant new endeavor for the CFTC.

August 9, 2022