

CFTC Brings Significant Enforcement Action Against Online Cryptocurrency Exchange

The action reflects the CFTC's expanded jurisdiction and provides further clarity on what constitutes "actual delivery" in cryptocurrency trading.

On June 2, 2016, the US Commodity Futures Trading Commission (CFTC) issued an order (the Bitfinex Order) filing, and simultaneously settling, charges against Hong Kong-based BFXNA, Inc., d/b/a Bitfinex (Bitfinex), in connection with Bitfinex's operation of an online cryptocurrency trading platform (the Platform).¹ Specifically, the Bitfinex Order finds that Bitfinex facilitated the execution of illegal, off-exchange commodity transactions in violation of the Commodity Exchange Act (the CEA) by (i) permitting retail and non-retail users to engage in financed cryptocurrency transactions on the Platform that did not result in "actual delivery" of the underlying cryptocurrency within 28 days and (ii) failing to register the Platform with the CFTC as a designated contract market (DCM). The Bitfinex Order further finds that Bitfinex violated the CEA by accepting cryptocurrency orders and receiving customer funds in connection with such transactions on the Platform, without registering with the CFTC as a futures commission merchant (FCM).²

Notably, the Bitfinex Order follows the CFTC's enforcement action in September 2015 against Coinflip, Inc.,³ in which the CFTC first formally pronounced that Bitcoin and other cryptocurrencies are properly classified as "commodities" under the CEA and thus subject to CFTC jurisdiction. The Bitfinex Order highlights the CFTC's continued focus on and jurisdiction over the cryptocurrency market.

Regulatory Framework

Futures Contracts and Cash Transactions

The CFTC regulatory framework distinguishes futures contracts and other derivatives from cash or "spot" transactions in commodities. Unlike futures contracts (or options thereon), in which delivery is deferred and such delivery is possible but unlikely to occur, a cash or spot transaction will result in the immediate sale and delivery of the commodity, absent extraordinary or extenuating circumstances. Cash or spot transactions in commodities that are for immediate or near-immediate delivery are generally outside the scope of the CFTC's regulatory authority for most purposes.⁴

Retail Commodity Rules

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the Dodd-Frank Act)⁵ amended the CEA to provide the CFTC with expanded authority over certain retail commodity transactions (the Retail Commodity Rules). Any such retail commodity transaction falling within the scope of the Retail Commodity Rules — and thus within the scope of CFTC jurisdiction — is subject to certain provisions of the CEA, as if such agreement were a contract of sale of a commodity for future delivery (*i.e.*, a futures contract), including Section 4(a) of the CEA, which requires all futures contracts to be

traded on a registered DCM.⁶ The Retail Commodity Rules broadly apply to any agreement, contract or transaction (a Retail Commodity Transaction) that is:

- Entered into with, or offered to (even if not entered into with), a non-eligible contract participant (a non-ECP)⁷ or non-eligible commercial entity (a non-ECE)⁸ (*i.e.*, a retail customer)
- (i) Entered into or offered on a leveraged or margined basis or (ii) financed by the offeror, the counterparty or a person acting in concert with the offeror or counterparty⁹

The CEA further provides a limited exception to the Retail Commodity Rules for contracts that result in “actual delivery” of the commodity within 28 days.¹⁰

Separately, Section 4(d) of the CEA requires a person to register as an FCM if such person (i) is engaged in soliciting or accepting orders for Retail Commodity Transactions and (ii) accepts money in connection with such transactions.¹¹

Cryptocurrencies Are “Commodities”

In September 2015, the CFTC issued an order filing and settling charges with respect to the operation of Derivabit, a Bitcoin options trading platform (the Derivabit Order). Specifically, the Derivabit Order found that Derivabit’s operator (Coinflip, Inc.) and its chief executive officer violated the CEA by operating a facility for the trading or processing of commodity options without registering with the CFTC as a DCM or as a swap execution facility (SEF). The Derivabit Order marked the CFTC’s first enforcement action involving Bitcoin derivatives and the CFTC’s first formal pronouncement that Bitcoin and other cryptocurrencies are properly classified as “commodities” under the CEA, providing a preview of the scope of future CFTC regulation of the cryptocurrency market. By issuing the Derivabit Order, the CFTC clarified several issues regarding Bitcoin and other cryptocurrency derivative products, namely:

- Bitcoin and other cryptocurrencies are “commodities” as defined in Section 1a(9) of the CEA.
- Cryptocurrency derivatives — including futures, options or swaps — are subject to CFTC jurisdiction.
- Any platform for trading or executing cryptocurrency swaps (i) must be registered with the CFTC as a SEF or DCM under Section 5h(a)(1) of the CEA and (ii) is subject to CFTC regulations governing SEFs and DCMs.¹²

Bitfinex Order: CFTC Findings

According to the Bitfinex Order, Bitfinex operates an online platform for exchanging and trading cryptocurrency — primarily Bitcoin — on which users may (i) exchange US Dollars for cryptocurrency, and vice versa, as well as (ii) exchange one form of cryptocurrency for another.¹³ One of the features that Bitfinex offered on its platform was a “Margin Trading” feature, pursuant to which Platform users could borrow US Dollars and cryptocurrency from other users (referred to as Margin Funding Providers) in order to engage in cryptocurrency transactions on the Platform.¹⁴ This feature was available, not only to ECPs/ECEs, but also to retail customers using the Platform.¹⁵

“Actual Delivery” of Cryptocurrency

The CFTC alleged that, from about April 2013 until at least February 2016,¹⁶ Bitfinex employed three different methods of holding cryptocurrency that had been purchased by Platform users (*i.e.*, cryptocurrency buyers) pursuant to the Margin Trading feature (such cryptocurrency referred to herein as, Leveraged Cryptocurrency):

- Under the first method, Leveraged Cryptocurrency was held for the benefit of the respective cryptocurrency buyer in an omnibus digital wallet (*i.e.*, an e-wallet) held by and in the name of Bitfinex. Although the cryptocurrency buyers' individual interests in the Leveraged Cryptocurrency held in the omnibus e-wallet were accounted for by Bitfinex in real time, the omnibus e-wallet was nonetheless owned and controlled by Bitfinex. Bitfinex considered the Leveraged Cryptocurrency held in the omnibus e-wallet to belong to the respective cryptocurrency buyers, subject to a lien in the amount of any outstanding loan, plus fees owed to the relevant Margin Funding Provider(s).
- Under the other two methods, Leveraged Cryptocurrency was held in separate e-wallets established by a third party that were individually enumerated for each respective cryptocurrency buyer. The third party establishing the individually enumerated e-wallets holding the Leveraged Cryptocurrency had no contractual relationship with the cryptocurrency buyers.

The CFTC noted in the Bitfinex Order, however, that, for each of the three methods, Bitfinex retained control over the “private keys” associated with the various e-wallets holding the Leveraged Cryptocurrency.¹⁷ Moreover, cryptocurrency buyers utilizing the Margin Trading feature had no rights to access or use the Leveraged Cryptocurrency in any of the e-wallets, whether omnibus or individually enumerated, until Bitfinex released such Leveraged Cryptocurrency following satisfaction of the outstanding loan by the relevant cryptocurrency buyer.¹⁸

With respect to each of the aforementioned methods, the CFTC found in the Bitfinex Order that **none** of the Leveraged Cryptocurrency transactions executed on the Platform resulted in “actual delivery” within 28 days because Bitfinex **did not** transfer possession and control of the Leveraged Cryptocurrency to the relevant cryptocurrency buyers. Moreover, the Leveraged Cryptocurrency in the omnibus e-wallet was held subject to satisfaction of the liens by the respective cryptocurrency buyer. As a result, the CFTC found that the Leveraged Cryptocurrency transactions **were not** eligible for the CEA’s exception for Retail Commodity Transactions because “actual delivery” had not occurred.

The CFTC stated in the Bitfinex Order that it takes a functional approach to determining whether “actual delivery”¹⁹ has occurred, specifically noting the relevance of the following factors:

- How the agreement, contract or transaction is marketed, managed and performed
- Ownership, possession, title and physical location
- Relationships between the buyer, seller and possessor of the commodity
- Manner in which the sale is recorded and completed

Bitfinex Engaged in Illegal, Off-Exchange Transactions

Section 4(a) of the CEA makes it unlawful for any person to offer to enter into, enter into, execute, confirm the execution of, or conduct an office or business in the United States for the purpose of soliciting, accepting any order for, or otherwise dealing in any transaction in, or in connection with, a commodity futures contract, unless such transaction is 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 or derivatives transaction execution facility for the specific commodity. The CFTC concluded in the Bitfinex Order that Bitfinex violated Section 4(a) of the CEA because:

- Bitfinex offered to enter into, executed and/or confirmed the execution of these Leveraged Cryptocurrency transactions

- All of the Leveraged Cryptocurrency transactions at issue were conducted on the Platform, which **was not** registered as a DCM pursuant to the CEA

Bitfinex Failed to Register as a Futures Commission Merchant

Section 4d(a) of the CEA requires all persons acting as FCMs (*i.e.*, persons engaged in soliciting or accepting orders for Retail Commodity Transactions, or accepting money in connection with Retail Commodity Transactions) to register as such with the CFTC. The CFTC also concluded that Bitfinex violated Section 4(d) of the CEA by failing to register as an FCM because, in operating the Platform, Bitfinex both:

- Accepted orders from users for Retail Commodity Transactions (*i.e.*, the Leveraged Cryptocurrency transactions)
- Received funds from such users in connection with such Leveraged Cryptocurrency transactions²⁰

The Bitfinex Order imposed a US\$75,000 civil monetary penalty against Bitfinex and ordered Bitfinex to cease and desist from such violations of the CEA. The CFTC noted Bitfinex's "significant" cooperation with the CFTC's investigation, which included affirmatively contacting the Division of Enforcement to offer its cooperation and responding fully and quickly to requests for information. The CFTC also noted that Bitfinex made changes to its business practices — during and in response to the investigation — in order to attempt to comply with the CEA and CFTC regulations.

Key Takeaways

The Bitfinex Order demonstrates the CFTC's continued focus on regulating the cryptocurrency market, and is noteworthy in a number of respects. First and foremost, the Bitfinex Order highlights that existing laws and regulations for commodities markets apply with equal force to businesses and financial institutions utilizing cryptocurrency. Businesses that offer, or will offer, services to cryptocurrency buyers, sellers or other market participants should carefully review the CFTC's existing regulatory framework to consider whether and how their services may be subject to CFTC regulations. Firms that currently use e-wallets to process the transfer of cryptocurrency from one market participant to another should, in particular, review their current practices in light of the Bitfinex Order to assess who has access to and control of those e-wallets and their private keys, to ascertain whether — taking into account this new guidance regarding "actual delivery" — their spot trades would continue to benefit from the exemption under the Retail Commodity Rules for contracts that result in "actual delivery" within 28 days.

The Bitfinex Order is also the latest instance of the CFTC stating that it values cooperation with Division of Enforcement investigations, underscoring the importance of anticipating and understanding CFTC staff concerns. The Bitfinex Order and each new enforcement action involving cryptocurrency provide important insights into the CFTC's emerging approach to regulating these evolving markets.

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Endnotes

¹ *In re BFXNA INC. d/b/a Bitfinex*, Order Instituting Proceedings Pursuant to Sections 6(c) and 6(d) of the Commodity Exchange Act, as Amended, Making Findings and Imposing Remedial Sanctions, CFTC Docket No. 16-19 (June 2, 2016), *available at* <http://www.cftc.gov/udc/groups/public/@lrenforcementactions/documents/legalpleading/enfbfxnaorder060216.pdf> (Bitfinex Order).

² Bitfinex consented to the CFTC's entry of the Bitfinex Order, without admitting or denying any of the findings or conclusions therein.

³ *In re Coinflip, Inc., d/b/a Derivabit, et al.*, Order Instituting Proceedings Pursuant to Sections 6(c) and 6(d) of the Commodity Exchange Act, Making Findings and Imposing Remedial Sanctions, CFTC Docket No. 15-29 (Sept. 17, 2015), *available at* <http://www.cftc.gov/udc/groups/public/@lrenforcementactions/documents/legalpleading/enfcoinfliporder09172015.pdf> (Derivabit Order). For further discussion, please refer to our *Client Alert* regarding the Derivabit Order: Cryptocurrencies Are Commodities: CFTC's First Bitcoin Enforcement Action, *Client Alert* No. 1874 (Sept. 21, 2015), *available at* <https://www.lw.com/thoughtleadership/LW-CFTC-first-bitcoin-enforcement-action>.

⁴ See Further Definition of "Swap," "Security-Based Swap" and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping, 77 Fed. Reg. 48208, 48256 (Aug. 13, 2012) (to be codified at 17 C.F.R. pts. 1, 230, 240, 241), *available at* <https://www.gpo.gov/fdsys/pkg/FR-2012-08-13/pdf/2012-18003.pdf> (the Further Definitions Rules).

⁵ Public Law 111-203, 124 Stat. 1376 (2010).

⁶ 7 U.S.C. § 6(a).

⁷ Section 1(a)(18) of the CEA defines "eligible contract participant" to include, *inter alia*: (i) an organization with total assets in excess of US\$10 million; (ii) a corporation that (a) has a net worth in excess of US\$1 million and (b) is using the instrument in connection with its business or to hedge commercial risk; (iii) an individual who has amounts invested on a discretionary basis,

the aggregate of which is in excess of US\$10 million; or (iv) an individual who has amounts invested on a discretionary basis, the aggregate of which is in excess of US\$5 million, where such individual is using the instrument in order to manage the risk associated with an asset owned or liability incurred, or reasonably likely to be owned or incurred, by the individual. 7 U.S.C. § 1a(18).

⁸ The term “eligible commercial entity” is defined in Section 1a(17) of the CEA. 7 U.S.C. § 1a(17).

⁹ 7 U.S.C. § 2(c)(2)(D).

¹⁰ 7 U.S.C. § 2(c)(2)(D)(ii)(III)(aa); see Retail Commodity Transactions Under Commodity Exchange Act, 78 Fed. Reg. 52426 (Aug. 23, 2013) (to be codified at 17 C.F.R. pt. 1), available at <https://www.gpo.gov/fdsys/pkg/FR-2013-08-23/pdf/2013-20617.pdf> (Retail Commodity Transaction Rules).

¹¹ 7 U.S.C. § 4(d).

¹² Derivabit Order at 3; see also *In re TeraExchange LLC*, Order Instituting Proceedings Pursuant to Sections 6(c) and 6(d) of the Commodity Exchange Act, Making Findings and Imposing Remedial Sanctions, CFTC Docket No. 15-33 (Sept. 24, 2015), available at <http://www.cftc.gov/idc/groups/public/@lrenforcementactions/documents/legalpleading/enfteraexchangeorder92415.pdf>.

¹³ Bitfinex Order at 2.

¹⁴ Bitfinex Order at 2-3.

¹⁵ Bitfinex Order at 3-4.

¹⁶ Bitfinex Order at 1. Significantly, the conduct that gave rise to Bitfinex's alleged violations of the CEA began more than two years prior to the CFTC's formal pronouncement that Bitcoin and other cryptocurrencies are commodities.

¹⁷ In the context of cryptocurrencies, a “private key” is a secret number (usually a 256-bit number, akin to a password) associated with an e-wallet that allows Bitcoin in that particular e-wallet — and only that e-wallet — to be spent.

¹⁸ Bitfinex Order at 3-6 (citing Retail Commodity Transaction Rules, 78 Fed. Reg. at 52428).

¹⁹ The CFTC defined “actual delivery” in the Bitfinex Order to mean a real and immediate transfer of possession and control to the buyer (or its agent) of the commodity. Bitfinex Order at 5 (citing *CFTC v. Hunter Wise Commodities, LLC*, 749 F. 3d 967, 978-79 (11th Cir. 2014); Black's Law Dictionary 494 (9th ed. 2009)).

²⁰ Bitfinex Order at 7 (citing 7 U.S.C. § 1a(28)(i)(I)(aa)(DD); *CFTC v. Hunter Wise Commodities, et al.*, 1 F. Supp. 3d 1311 (S.D. Fla. 2014)).